

# **Joint AFME – ISDA (“the industry”) Response to the European Commission’s Consultation on CRR3 Implementation**

**December 2019**

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## Introduction

The Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA), collectively 'the industry', welcome the opportunity to comment on the European Commission's consultation on CRR3.

### 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: [www.afme.eu](http://www.afme.eu).

### About ISDA

Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. ISDA has over 900 member institutions from 71 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. ISDA is listed on the EU Register of Interest Representatives, registration number 46643241096-93. Information about AFME and its activities is available on the Association's website: [www.isda.org](http://www.isda.org).

## Executive Summary

The industry supports the initiative of the Commission to consult on the implementation of Basel III in Europe. It is crucial that the implementation of the Basel III standard in Europe is done in a risk-sensitive way which results in a robust and effective banking sector, whether through capital or lending markets, and which supports growth and the real economy – including the funding of SMEs, corporates, infrastructure and households. This should be done taking into account the European Council and Basel Committee’s overarching commitment to not significantly increase capital requirements. It should also involve a full review of the Pillar 2 framework. Furthermore, given the granular nature of the Basel III reforms, the European Commission and the EBA must assess and understand the potential effects on specific products, business models and the financing of the real economy across Member States.

More broadly than this, it is essential that Basel III is applied in a way that achieves consistent and equivalent outcomes across all jurisdictions, enabling banks to operate on a global level-playing field whilst also reflecting the specific financial and economic circumstances of Europe (e.g. the higher reliance of corporates and residential mortgages on bank funding, and the desire to deepen capital markets) and taking into account material developments in other major jurisdictions. Equivalent outcomes should be measured after taking account of genuine structural differences in markets and business models but so that all players operating in the EU can play an equal and effective role in deepening and integrating EU capital and banking markets. Furthermore, it is important for globally active banks that international standards are implemented following a consistent timeline across jurisdictions, including transitional arrangements and with a reasonable implementation period for banks once the legislative process is finalised. If the timeline for the process of Basel III legislation and implementation (or parts of it) extends beyond 2022, we urge the Commission to lead efforts to revise the timeline at a global level in an open and transparent way to ensure international alignment. This is important in the context of equivalence decisions and supervisory deference where misaligned implementation could have major consequences for banks operating cross-border.

Given the central role of banking in the EU economy and the role it plays in supporting EU’s capital markets activity, we have highlighted in our response a number of aspects (summarized below) of the Basel III agreement which will require deeper consideration in the development of CRR3 proposals. This should go hand in hand with the development of the Capital Markets Union (CMU) and Banking Union in the forthcoming Commission mandate. Indeed, in reviewing the industry’s response, we would highlight the significant cumulative impact the Basel III revisions will have on capital markets activities which cuts across all risk types, and which will consequently impact end users that use derivatives to hedge their risks or the liquidity of markets which users rely on to optimise strategic investment opportunities. Once the final agreement on Basel III has been legislated for, we urge the EU to undertake a review of the consistency of implementation and cumulative

impact of the measures, where necessary re-considering measures that have a disproportionately adverse impact on financing the economy and capital markets. Where appropriate, we propose that the Basel Committee looks at potential changes to the measures to improve their efficiency and calibration.

**Credit Risk:** This area of risk is subject to the broadest set of Basel revisions, and where industry has several priorities which the Commission should duly consider in its implementation.

First and foremost, in the absence of a fully-fledged CMU and continued reliance of corporates on bank financing, particularly for day-to-day treasury functions, infrastructure and financing of exports, it is important the credit risk framework does not unduly impact banks' ability to finance the real economy. The Commission should consider the impact of the Output Floor on financing of unrated corporates, and to address this we have set out a range of possible approaches. In addition, the SME supporting factor should be maintained as per CRR2. To support exports, the existing CRR framework for off balance sheet items (CCFs and definitions) related to trade should also be maintained until reviewed at Basel, and at the very least the Basel III national discretion (see footnote 53 of the Basel agreement) should be applied as widely as possible. Under the Foundation approach, the EU should adopt the national discretion to waive the fixed maturity of 2.5 years and apply the effective maturity as under the advanced approach.

The negative impact of the credit risk changes on capital markets activities should be mitigated by taking as much of a risk sensitive approach as possible. This should include due consideration of the definition of venture capital investments, as well as the treatment of intragroup equity exposures and diversified equity portfolios, including diversified portfolios of private equity and venture capital investments. Short term exposures to corporates such as SFTs should be aligned with that for banks with a < 3-month maturity. The Commission should maintain the current CRR treatment for interbank exposures with a residual (not original) maturity of 3 months and extend this for trade finance interbank exposures to 6 months.

With respect to real estate lending, we note the Basel Guidelines cap the value of the property against which the lending is secured at the value at the time the loan was originated, to address the risks of possible cyclical effects in valuations. The current CRR treatment which allows upward valuation adjustments to reflect increasing markets values should be maintained. We also support the implementation of the loan splitting approach for real estate exposures where the repayment does not materially depend on cash flows generated by the property. If the competent authority exercises the discretion regarding the loan splitting approach, banks should be allowed to decide whether to adopt the whole loan or the loan splitting approach on a consistent basis.

For Specialised Lending which is widely used to finance many parts of the economic value chain, we recommend more granularity in the SA for lower risk loans to take account of the quality of the project, transactions, contractual structure, LTVs and structuring features. Likewise, we propose a review of the slotting approach for the lowest risk investment grade transactions. In light of the work already undertaken as part of the EBA's IRB repair work, for the IRB approach we recommend a flat 10% input floor removing the 40% collateral haircut.

**SFTs:** While the minimum haircut framework seeks to limit leverage and, more specifically, “to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage”<sup>1</sup>, it does not sufficiently distinguish between those SFTs that are financings (and, thus, increase leverage) and those that are for another purpose. Many SFTs are undertaken, not to provide financing, but rather to source a specific security, with the haircut being provided to the lender rather than borrower of the security. Unless revised, the SFT haircuts framework could increase SFT RWAs by 61% under the advanced approach and by 63% under the standardised approach, with over half of that impact coming from securities borrowing<sup>2</sup>. If banks and other liquidity providers cannot access “locked away” securities held by end investors for market making through securities borrowing transactions, it would have detrimental impacts on the functioning of EU capital markets and secondary markets in particular.

**Operational Risk:** While recent past losses can be an indicator of potential future losses, and historical losses are widely used in internal operational risk models, we do not support quantifying the loss component on the basis of 10-year long loss history, which then becomes the primary determinant of operational risk capital through the application of the Internal Loss Multiplier (ILM). Consequently, the key priority of industry is that the ILM should be set to one in the EU. Should this not be taken on board industry would support a five-year phase-in period, during which banks transfer from the current to the new SA-OR gradually.

**Market Risk:** The Industry remains concerned by certain elements in the Basel III reforms and the significant impact the package will have on capital requirements for specific product and risk categories. The implementation of the Fundamental Review of the Trading Book (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 CMU project. These concerns are supported by the EBA's Call for Advice analysis, with the impact of the 2019 FRTB

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<sup>1</sup> FSB: *Transforming Shadow Banking into Resilient Market-based Finance, Strengthening Oversight and Regulation of Shadow Banking, Regulatory framework for haircuts on non-centrally cleared securities financing*, 12 November 2015. <http://www.fsb.org/2015/11/regulatory-framework-for-haircuts-on-non-centrally-cleared-securities-financing-transactions-2/>

<sup>2</sup> <https://www.gfma.org/correspondence/the-gfma-and-icma-repo-market-study-post-crisis-reforms-and-the-evolution-of-the-repo-and-broader-sft-markets/>



standard 105% higher relative to current RWA levels for the same risks. While the broad contours of the FRTB framework are stable and the industry agrees with, there are specific elements that require further thought both within the internal models based and the standardised approaches. We highlight our key concerns in our response to the market risk questions.

**CVA Risk:** With respect to the CVA framework, there is an ongoing consultation published by the BCBS in November 2019 which will result in potential revisions to the Basel standard. Key industry recommendations will include seeking better hedge recognition to capture the benefits of hedging the systemic risk of a typically diversified CVA portfolio; a recalibration of specific elements of the CVA framework to remove some excess conservatism still prevalent in the SA-CVA framework; and adjustments to framework parameters and scope to induce greater convergence between the regulatory view of CVA and Industry best practices on accounting CVA. We hope these recommendations are reflected in the final standard and in doing so addresses some of the lack of risk sensitivity of the current CVA framework. The objective should be to bring the calibration down to a reasonable level both internationally and in the EU through transposition into the CRR3 package. A review of the existing CVA exemptions should only be performed once the Basel standard has been recalibrated and a thorough impact analysis has demonstrated the impact on end-users is significantly reduced.

**SA-CCR:** Considering the cumulative impact of new requirement impacting trading and market making activities in the Basel III package like market risk and CVA, the Industry also believes that a review of the Standardised-Approach for Counterparty Credit Risk (SA-CCR) is necessary. The aggregate impact resulting from the implementation of SA-CCR, including in the output floor, is still untested in the BCBS impact assessment published last March or the EBA Call for Advice. However, industry impact studies highlight that the impact is significant relative to both IMM and CEM; and for IMM initial indications are that SA\_CCR is 2-3xIMM, a relationship that now feels incongruent with the other risk stripes. We note that in Europe, SA-CCR will be subject to a review in 2023 by the EBA, but we ask that this be conducted before the EU implementation timeframe for CRR2 of end-June 2021. This is important in light of its broad impact and considering the cumulative effect of the Basel III reforms on trading and wholesale market activities. If policymakers do not conduct a review of SA-CCR prior to its implementation, we urge European authorities to consider alternative measures, such as re-calibrating the alpha factor as has been done in the final rule to apply SA-CCR in the US, which will offset the undue impact of SA-CCR until the review is complete.

**Output Floor:** As documented in the EBA's reports in response to the Commission's Call for Advice, the Output Floor (OF) will be the most impactful measure for Europe included in the Basel III reforms – it is therefore essential that it is appropriately implemented in terms of the level of application of the floor to banks, the methodology for calculating it, and in ensuring that the Standardised Approaches build in enough risk sensitivity so that lending to the real economy is not adversely



impacted. As such we support implementation of the OF at the highest level of consolidation on the aggregate RWA level (as calibrated by Basel) in order to maintain business model neutrality and support consistent international implementation. We note this is also the position of the SSM. Furthermore, the calculation of the floor should be a 'backstop' and therefore follow a 'parallel approach' to setting capital requirements based on whatever is the higher of: (i) the floor calculated as 72.5% of RWAs under the standardised approach (Basel III capital stack only); or (ii) the risk based requirement applying RWA calculated using approved internal models and standardised approaches as applicable (including Pillar 2 and the SRB). We would also ask the Commission to analyse and assess why the output floor is so binding for EU banks relative to other parts of the framework. Finally, following implementation of the floor there should be a full review of the Pillar 2 and EU Buffer frameworks to ensure that there is no double counting of risks which will be included in Pillar 1 following the implementation of Basel III in the EU.

**Centralised Disclosure:** The industry notes the possible benefits that centralised disclosure could deliver in theory although we note some of the significant practical challenges that this might entail. However, we would not be comfortable in principle with the potential for the EBA to take part of the role of banks in their relations with investors and the market and we would question whether the proposal would lead to any decrease in administrative burden.

**Sustainable Finance:** Industry is working closely with the EBA to address climate risk as part of its CRR2 mandates, as well as contribute to the development of the sustainable taxonomy which has recently been agreed. While we support the action to address climate risk on bank balance sheets, it's important to note that the taxonomy, as currently designed, is not fit to be used for banks' whole portfolio. Any further introduction of measures should be done in a data-driven and risk sensitive way, and as such it would be premature to introduce further measures in CRR3.

**Fit and Proper:** We support consistent standards across EU Member States as a means to provide a harmonised approach to supervision and clarity for market participants and assist in ensuring the sound and prudent management of institutions. As a first step, it is vital that a review of corporate law in Member States is undertaken, in order to provide a more consistent base for discussions of how individual accountability can be further embedded in the management of financial institutions.

**Financial innovation and regulation:** In addition to the topics set out in the Commission's consultation we would also like to set out some views on financial innovation and regulation which we consider relevant to the implementation of CRR as an Annex to this document.

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## 1. Credit risk

### 1.1 Standardised Approach (SA-CR)

#### **External credit risk assessment approach (ECRA) vs standardised credit risk assessment approach (SCRA)**

***1) Views are sought on the relative costs and benefits of the ECRA provided by the final Basel III standards and the SCRA? In particular, how do the two approaches compare in terms of risk-sensitivity, impact on risk-weighted assets (RWAs) and operational burden? Please specify the relative costs and benefits of the two approaches for exposures to i) institutions, ii) covered bonds and iii) corporates. Please provide relevant evidence to substantiate your views.***

Given the limited progress on developing a Capital Markets Union (CMU) to date, and the reliance of the EU's corporate market on bank financing, we would urge regulators to be mindful of this in the implementation of the Standardised Approach (SA) alongside the Output Floor. Compared to the current framework, the implementation of Basel III will have a significant impact for banks that currently use IRB to calculate capital requirements for unrated corporates which are deemed investment grade. While the 100% risk-weight (RW) for unrated corporates under the SA remains 100%, per the ECRA, the introduction of the Output Floor raises the effective RW for banks using IRB. As the majority of EU corporate exposures are unrated this could, all other things being equal, result in financing becoming more expensive for unrated investment grade corporates. Industry's view is that the same capital requirements should be applied to borrowers of equivalent risk regardless of the rating approach used. Failing this, companies of equivalent risk potentially face different financing costs.

Furthermore, the recent analysis undertaken by the EBA as part of the Call for Advice exercise comparing the ECRA with the SCRA was based on proxy data to estimate the impact for IRB banks. This showed that at least 10% of investment grade unrated corporates (based on this proxy data) would be subject to a higher RW of 100% under the ECRA, compared to 65% under the SCRA. However, this analysis fails to take account of the consequent contribution of this impact to the output floor for banks using IRB to calculate capital requirements for unrated corporates. Hence, as the Commission undertakes its impact analysis for CRR3, we urge it to consider this interaction in order to ensure the same capital requirements are applied to borrowers of equivalent risk irrespective of the rating methodology used to assess such risk. This is all the more important when considering that, since the CMU project was set up in 2015, Europe's reliance on bank lending has increased – European companies continue to over rely on bank lending, with 88% of their new

funding in 2018 coming from banks and only 12% from capital markets – a decline from 14% on average in 2013-2017.<sup>3</sup>

***2) Would you deem refinements or clarifications necessary concerning the approach that you generally prefer, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.***

The industry has a range of views on the way the Basel III approach to corporates in the SA could be clarified or refined to ensure the same capital requirements are applied to borrowers of equivalent risk irrespective of the rating methodology used to assess such risk. The proposed solutions are as follows:

**Option 1:** Consider allowing banks to use scales or a ‘ECRA mapping approach’ for the purpose of the Output Floor calculation only. Essentially, for the purpose of IRB banks calculating RWAs on the SA for the sole purpose of the applying the Output Floor, banks would use their internally calculated probability of default (PD) for unrated corporates in order to map the counterparty to the external regulatory determined scale and hence acquire a corresponding Standard RW alternatively of 20%, 50% 75%, 100% or 150%. In this respect it should be noted that since December 2017 banks’ methods for calculating the PD have been subject to the TRIM exercise, updated to reflect the IRB repair work, and are now subject to a strict approval process as part of the TRIM guide and EBA guidelines.

**Option 2:** Introduce an SCRA Opt-in. In assessing the impact of the SA to Credit Risk for corporate exposures, the impact of the Output Floor on IRB banks headquartered in the EU can vary based on their relative exposures to rated and unrated exposures. When the calibration was finalised for banks using the ECRA, the impact assessments were based on averaged portfolios with a mix of rated and unrated corporate exposures. Under the ECRA, highly externally rated exposures would be treated beneficially, whereas lower rated and unrated exposures attract higher capital requirements compared to the SCRA, which is much less granular between the treatment of investment grade and high yield exposures. As such, for EU banks that have corporate exposure that is disproportionately weighted towards unrated corporates, the Output Floor may end up being more impactful than for other banks operating under ECRA or SCRA. To remedy this, we propose that EU banks be allowed to ‘Opt-In’ to the SCRA approach for their corporate exposures portfolio when calculating the Output Floor to prevent disproportionate impact to banks with a higher unrated composition of their corporate exposure portfolio. To exercise an ‘Opt-In’, the EU bank would need to remain in the regime for a minimum number of years. Allowing this option accommodates banks with particular

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<https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20CMU%20Key%20Performance%20Indicators%20Report.pdf>

corporate exposure profiles, while maintaining alignment with Basel requirements (SCRA) and minimising any level playing field considerations for international banks operating in the EU.

**Option 3:** Review the definition of ‘investment grade’ (IG) and how banks determine it. On this basis allow banks to apply the SCRA risk weight for IG corporates at 65%, and non-investment grade (NIG) corporates at 100%. The application of this approach should be integrated into banks’ existing supervisory review process and should be applied on a fully consistent basis. Making a determination (with reasonable confidence) of whether a company is IG or non-IG should be something all banks are capable of doing, SA or IRB. As part of the bank’s credit assessment process they will need to make an assessment of the creditors capacity to meet their obligations – very strong through to very weak – this should support the bucketing process in a similar vein to how Basel III sets out the determination that the customer has to have adequate means to meet their obligations in order to be considered IG. This credit process underpins the numeric rating bank then assign in the case of IRB banks.

Under this option the EU should also re-consider applying the requirement for IG corporates to have listed securities on a recognised exchange in order to apply a the 65% RW. Even if a corporate has a listing, it is not an indication of its credit quality – it could be IG or non-IG. Banks would therefore never rely on this one indicator alone to make a credit assessment. Furthermore, this requirement would present an unwarranted barrier given that many EU corporates tend to finance themselves through debt rather than equity, which is also attributable in part to underdeveloped capital markets in the EU. It should also be noted that such an approach would be consistent with the treatment of unrated banks as per paragraph 18 of the Standardised Approach where “Banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes must only apply SCRA for their unrated bank exposures, in accordance with paragraph 21”.

In addition to the options set out above, the Commission should seek to avoid additional costs to end-users that might arise from the Basel III approach. This is particularly relevant for corporates, especially when they are a subsidiary of a parent which has an external rating. The current CRR allows the external rating of a parent to be used as well for their subsidiaries if there is an explicit guarantee. In practice however, most subsidiaries are “integrated” with their parent. This means that they represent a core activity of the parent group’s business model and / or are highly integrated in the ‘value chain’ of the group and are owned by the parent. Likewise, it should be for corporates to decide if they need a rating for their own purposes such as a bond issuance. The cost of financing should not be linked to whether the corporate has acquired a rating as this in itself will entail costs and for some it would not be an option as it would be prohibitively expensive.

Finally, we also understand that the EBA, Commission and Member states have already considered some options for addressing the impact of the Output Floor on unrated corporates. Namely the

'hybrid approach' and the 'Banque de France ratings proposal' - both of these options warrant further analysis by the Commission prior to the publication of CRR3.

Regarding the 'hybrid approach', this would allow banks to apply the ECRA to rated exposures and SCRA to unrated investment grade corporate exposures. Some of our members would clearly support this being developed further, however, other members would be concerned about the impact on maintaining a level playing field between EU headquartered and international banks active in the EU. It should be investigated with a view to assessing whether it would address the impact of the floor, whilst also achieving the objective of ensuring the same capital requirements are applied to borrowers of equivalent risk irrespective of the rating methodology used.

With respect to the Banque de France proposal to develop a Central Bank rating process for corporates, based on their experience of developing ratings using FIBEN<sup>4</sup>, it is clear this has an ambitious and positive objective which would support the development of the CMU and better financial information on SMEs. Nonetheless, there are some open questions on how effective it would be in practice which the Commission should consider:

- How long it would take in practice to develop such a process of rating corporates across Europe (not just in one MS);
- How many corporates would eventually benefit from such a rating;
- The impact for banks with corporate portfolios which are mainly outside of the EU;
- The added value and benefit of such a process in comparison to the ratings provided by ECAIs or extending the scope of rating agencies that could be used to rate corporates; and
- Whether the processes banks already use for onboarding and assessing the creditworthiness of a client.

## Enhanced due diligence requirements

***3) Views are sought on the costs and benefits of implementing the various clarifications and specifications provided by the Basel III standards (paragraph 4) in relation to the due diligence to be performed by institutions. Please provide specific answers on each of the clarifications/specifications and support your view with relevant evidence.***

We deem that supervisory expectations would be the most appropriate method for setting due diligence requirements, rather than any changes to the Pillar 1 framework and consequential Pillar 1 charge that may arise. Entities currently have due diligence processes implemented within their risk management frameworks, and this will be augmented by the EBA guidelines on loan origination

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<sup>4</sup> BdF bases its ratings on the FIBEN Companies Database – created in 1978 – which was initially created in order to facilitate the implementation of the monetary policy. Updated on a daily basis, it is based on information obtained from various stakeholders, including banks, businesses, registries of commercial courts, the National Institute of Statistics and Economic Studies, newspapers with legal announcements (legal bulletins) and many others.



and monitoring due to be finalised next year. Entities should assess the results of the due diligence processes currently ongoing and decide whether the risk weights are to be adjusted upwards or downward on this basis.

Moreover, due diligence requirements can have significant costs for international banking groups with presence in third countries. For exposures arising from third-country subsidiaries, the requirements should be kept at the local level and they should not be subject to further requirements at the consolidated level. It would increase the administrative and cost burden and would be counterproductive for the assessment of the exposure, given that the knowledge of the counterparties is located at the local level.

***4) If you are of the view that the CRR/D should be amended to clarify/specify the rules on due diligence requirements, what would constitute an appropriate approach in your view? Please specify and provide relevant evidence.***

As per above we do not consider it necessary to include due diligence requirements in Pillar 1/CRR3.

***5) In your view, should the due-diligence requirements differentiate between exposures for which a rating exists, and unrated exposures treated under the SCRA (see above 1.1.1.1.), and if so, why? Please elaborate and provide relevant evidence.***

If due diligence requirements are set as a supervisory expectation as we propose, the supervisor is best placed to address this requirement.

#### **Definition of grades under the SCRA**

***6) Views are sought on the costs and benefits of implementing the definition of grades under the SCRA provided by the Basel III standards (paragraphs 22-29). Please provide relevant evidence to substantiate your views.***

Definition of grades should be consistent with Basel. This is a preferred option as it provides a better outcome. The SCRA should be implemented in accordance with Basel III as the calibration of the RW must be done on a consistent basis across jurisdictions.

***7) In your view, are the quantitative and qualitative criteria for the classification of counterparties into grades sufficiently clear or do you consider more specifications necessary to ensure a harmonised application of these criteria throughout the Union? Please elaborate and provide relevant evidence.***

N/A

***8) What are your views in relation to a potential clarification that also minimum capital and buffer requirements beyond the Basel minima (e.g. higher Pillar 1 requirements pursuant to***

***Article 458 CRR or systemic buffers pursuant to Article 133) should be taken into account for the classification into grades, where applicable in the jurisdiction of the counterparty institution?***

Paragraph 26 of the Basel III agreement (Grade B) mentions explicitly excluding buffers.

***9) Would you deem any other or further clarifications necessary to perform the classification into the three grades? Please elaborate and provide relevant evidence.***

N/A

### **Identification of short-term exposures to institutions**

***10) In your view, what are the relative costs and benefits of using the original maturity as opposed to the residual maturity for identifying short-term interbank exposures? Please provide relevant arguments and evidence to substantiate your views.***

Generally, we are opposed to the EBA's recommendation to replace residual maturity with original maturity for short-term exposures to institutions to foster international consistency in implementation of the Basel rules. The restriction to original maturity may significantly decrease the population of exposures that could benefit from the preferential treatment set out in Articles 119 (2) and 120 (2), which could negatively affect the interbank market. This is recognised in the EBA's CfA findings, where while 24% of the EBA's sample consider that the short-term portfolio would decrease by more than 15%. The industry would note that there are already several safeguards in place to avoid unjustified application of Article 129 (2) in case that short term ratings for any exposures to an institution are available. These safeguards comprise the interaction of the preferential treatment with short-term credit assessments as specified in Article 129 (3) (c) and the provisions of Article 140 (2).

We would like to note that the EBA states in its report (recommendation CR-SA9). *"This treatment [preferential treatment of short-term original maturity] was also included in the Basel II text, with the intention not to hinder the exchange of short-term liquidity between institutions by imposing restrictive RWs to such interbank exposures, but it was not implemented under the current CRR".* Therefore, it is important to maintain a preferential treatment regarding the maturity of such short-term exposures, both in the SA and IRB approaches in order to reach this objective.

Another concern regarding the definition of short-term exposures – rather than simply considering the calculation of the deal duration and the calculation point, the management's intention (which is also an important factor in the "short term" feature of the exposure) should also be taken into account.

It could also be beneficial to identify an exhaustive list of which transactions would fall into this definition e.g. nostri / vostri accounts etc.

***11) What are your views on the extension of the scope of the preferential treatment for short-term interbank exposures under Basel III from three to six months for exposures to institutions that arise from the movement of goods across national borders? To what extent would the change in definition change the amount of exposures benefitting from the preferential treatment? Please provide relevant evidence to substantiate your views.***

We consider the extension of the differentiated treatment for 3 months to 6 months where there is an underlying flow of goods or services a reasonable approach. In this respect the nature of the product is more relevant than the difference between 3 to 6 months (that is still considered short term). In our view, where there are some Letters of Credit or similar transaction with tenors close to 120 days or similar that deserves the same treatment.

We note under CRR Article 120(2) there is a differentiation for the Short Term (below 3 months) exposures to Financial Institutions. This is a reasonable measure to reflect that by nature shorter exposure should bear a lower risk. This treatment should also be applicable to corporate exposures as a way of recognizing this and avoid the adverse inclination to lend in longer tenors due to lack of incentive to lend short-term under the SA.

This is especially relevant for short-term trade finance self-liquidating exposures. As shown by ICC Trade Default Register<sup>5</sup>, these assets are very short term and they also have lower default rates for both Corporate and Financial Institutions debtors. For example, Import LCs have an average default rate of only 0,07% (2008 to 2017) or 0,19% for Trade Loans. In our view, this justifies for the treatment of short-term corporate exposure to also have a differential treatment, at least for Trade Finance related transactions.

See also our answer to Q15.

### **Treatment of unrated corporates**

***12) What is the share of your institution's/(member) institutions' exposures to rated and unrated corporate SMEs and to non-SMEs? What is the share of exposures to unrated corporates whose parent companies are externally rated? Please provide relevant evidence (e.g. underlying calculations, studies etc.).***

Industry is not in a position to provide data here, though we note that in the EBA report it highlights in figure 9 that the breakdown is around 80% unrated vs 20% rated.

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<sup>5</sup> <https://iccwbo.org/publication/icc-gcd-performance-guarantee-paper/>

Figure 9: Breakdown of exposures to corporates (excluding SMEs) by rating status (percentage of exposures to corporates excluding SMEs)

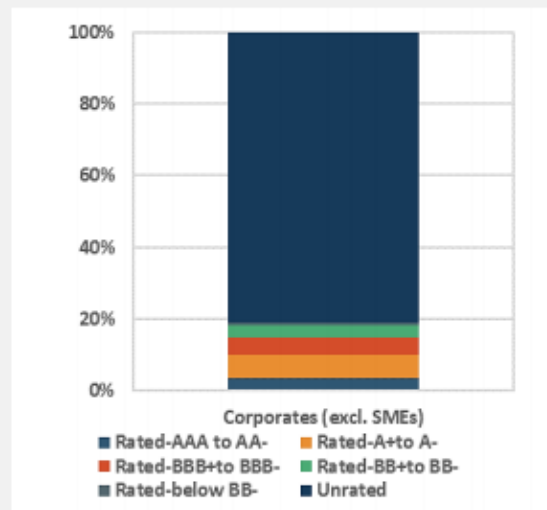
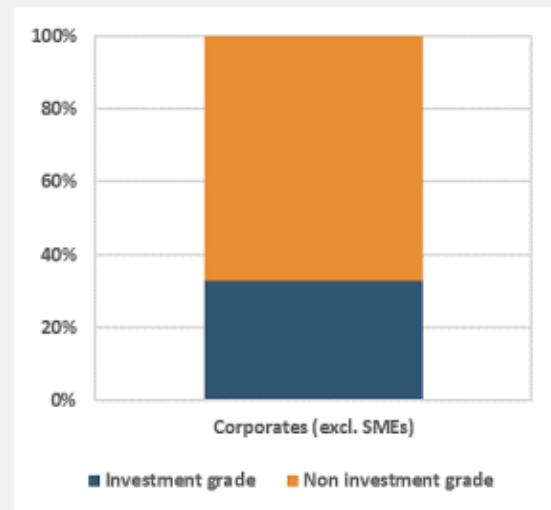


Figure 10: Breakdown of exposures to corporates (excluding SMEs) by grade (percentage of exposures to corporates excluding SMEs)



Sources: EBA 2018-Q2 QIS data and EBA calculations.

Notes: Based on a sample of 58 banks.

**13) Views are sought on the definition of ‘investment grade’ provided by the Basel III standards (paragraph 42). In particular, would you deem further refinements or clarifications necessary in order to ensure a consistent application across the Union? Please elaborate.**

See response to Q2 (‘Option 3’).

**14) What other measures, if any, could be taken to increase the risk-sensitivity of the standardised RW treatment of corporate exposures which currently have no external rating? Please elaborate and provide relevant evidence.**

Our priority is to ensure the same capital requirements are applied to borrowers of equivalent risk irrespective of the methodology used to assess such risk. The EBA report demonstrates this will not be the case – at least 10% more of investment grade unrated corporates (based on proxy data submitted by banks) would be subject to a higher RW of 100% under the ECRA, compared to 65% under the SCRA.

To minimise the number of unrated exposures impacted, we would encourage EU regulators to enlarge the range of authorized rating agencies including also those specialized in validating external

ratings of SMEs. The EC should also consider reducing the limitations imposed by the non-disclosure requirements that don't allow banks ask to any third party more information on a single customer as it would imply the the existence of a customer relationship between bank and customer. For other suggestions please refer back to our answer to Q2.

***15) In your view, which other aspects, if any, should be considered in the context of revising the standardised treatment of corporate exposures? Please elaborate.***

We support maintaining the SME supporting factor as it was agreed in CRR2.

More generally, in respect of minimising the impact of the SA on corporate financing through a more appropriate risk sensitive framework, we would urge legislators to reflect on the risk associated with short term exposures. Namely, RWs in the SA don't take into account short maturity as they do under the IRB maturity adjustment factor, which reflects short-term maturity as a risk mitigant. Only in case of Exposures to Banks with original maturity < 3 months is a favourable RW is permitted. No such favourable RW is take into account in the Corporate exposure class in Basel III. This will also significantly impact on capital markets transactions such as SFTs, which are normally short-term exposures of < 1year and therefore the RW is counterintuitive given the shorter - and thus safer - duration, and the overall SFT business. Legislators should therefore consider aligning the RWs for short-term exposures to corporates with that for short-term exposures to institutions.

**Treatment of specialised lending (SL)**

***16) Views are sought on the costs and benefits of implementing the specific treatment of SL exposures provided by the Basel III standards (paragraphs 44-48). In particular, how does this treatment compare with the current treatment in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

It is welcome that Basel III recognised over the course of its consultation and finalisation in December 2017 that banks should be able to continue to use the advanced approach and models for specialised lending (SL). Nonetheless, the final text raises a number of concerns which could curtail banks' ability to provide this form of financing in future in Europe. In this respect, it should also be recognised that SL is generally a European focused asset class, and this will significantly impact European banks' ability to offer this financing, in particular with regard to the lowest default (and least risky) portfolios. If not addressed, this could penalise the financing of essential European infrastructure as these types of assets require bespoke financing and structuring, underpinned by experienced teams. Renewable energy like offshore and onshore wind farms or solar plants are mainly financed in project finance and could also be impacted by banks' reduced lending capacity. Furthermore, irrespective of banks being able to continue to model, all banks will be required to calculate RWAs

under the SA for the purpose of the Output Floor. Consequently, if there is not enough risk sensitivity reflected in the SA for SL, then the SL calculation is expected to contribute to the Output Floor, which is a binding constraint for a number of banks.

In respect of the SA we would note that there are almost no externally rated SL transactions. Consequently, the revised SA is not risk sensitive for SL as there is only one RW level for object finance and commodities finance. While there are 3 levels of RWs for project finance, in practice only two apply as the high-quality criteria for the lowest RW are too restrictive. In comparison unsecured corporate loans have different RW to reflect the associated risk. SL exposures with a 100% RW or higher, are therefore treated like unsecured corporate loans and, in the pre-operational phase it is even more punitive as a 130% RW must be applied.

As a result, regulation will most likely drive banks' business models towards financing the riskiest transactions which have sufficient margins to support the overstated RWs and /or margin increases. Ultimately this will increase the cost of infrastructure for end users (e.g. higher electricity bills driven by the cost of more expensive power stations) and is undesirable from a risk management perspective.

Furthermore, we would urge the Commission to consider the interaction with the CMU. Larger and deeper capital markets will on the one hand support the issues banks will face due to the revised Basel III proposals. However, the main concern in Europe is that European Funds invest a large part of their funds in US (or Asian) markets instead of in their home markets. This is mainly driven by higher return expectations, certainty, transparency and more liquidity offered by the US markets. It could take years for capital markets to gain the same depth as in US, or even Asia, in Object and Project Finance. Furthermore, commodities financing is not a fit for capital markets due to the short-term nature and high monitoring requirements to keep risk under control. Specialised Lending assets are insufficiently homogeneous in terms of risk expectations or volumes and the returns are often not sufficiently attractive for investors. On the other hand where some smaller third parties provide funding infrastructure or transportation assets in Europe (e.g. object or project finance), margins generally are higher and security packages, including client care, are not comparable to the loans provided by specialised lending banks, in terms of lenders protection and control of risk. Finally, it should be noted that since the CMU project began Europe's reliance on bank lending has actually increased - counter to the CMU's stated objective - European companies continue to over rely on bank lending, with 88% of their new funding in 2018 coming from banks and only 12% from capital markets - a decline from 14% on average in 2013-2017. Hence, even with measures to stimulate, enlarge and improve European capital markets, they will not gain the size and depth within a couple of years to play an alternative role for banks in Specialised Lending (this excludes CRE that benefits from a sizeable capital market in Europe).



***17) Would you deem further refinements or clarifications concerning the structure or calibration of the treatment for SL necessary, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.***

Under the Standardised Approach lower risk loans should attract lower risk weights and EU legislators should consider introducing a more granular level of RWs.

Within the SL asset class, different levels of credit risk attached to specialised lending exposures are assigned the same RWs. e.g. Project finance: High quality = 80%; Operational projects: 100%; Pre-operational phase: 130%. However, the RWs do not fully take into account security packages and covenants which allow for control over future cash flows.

To better reflect this, industry recommends more granular RWs to consider the quality of the project, transactions, contractual structure, LTVs (where appropriate for the SL sub-sector) and structuring features (e.g. reflecting self-liquidating trade related exposures). In addition, the perimeters of the SA and IRB are different – under the SA specialised lending does not include exposures to real estate. This should be aligned with the IRB which does include IPRE and HVCRE. The criteria for assigning project finance exposures as high-quality are too restrictive and fail to identify most low-risk transactions.

We therefore support the opinion of the EBA's CfA in CR-IR 13 which considers that SL should not be treated as unsecured exposures. Recognition of the value of the SL security packages, should also apply in the SA and be reflected in the RW which would reduce this below 100% which would correspond to the lower RWs for unsecured corporate loans.

Hence, we propose 3 levels of RW as follows, depending on the transaction quality criteria set out the table below:



	50%	75%		110%
Project Finance	High quality operational phase	High quality pre-operational phase	or Operational phase	Pre-operational phase
Object Finance	High quality + LTV < 85%	High quality + LTV > 85%	or LTV < 85%	LTV > 85%
IPCRE	High quality + LTV < 75%	High quality + LTV > 75%	or LTV < 75%	LTV > 75%
Commodity Finance	High quality + Monitoring function	High quality	or Monitoring function	Other

### **Proposed SL Quality Criteria:**

We propose to assign RW levels based on whether one or both of the two conditions are fulfilled as set out below:

#### **Object finance:**

- (1) Loan-to-Value < 85% assessed yearly
- (2) High-quality based on the following criteria
  - **Asset quality** (value provided by an external appraiser, recognized builder, liquidity (to be assessed in light of employment of the asset))
  - **Contractual features** (employment of the asset, (lease, time charter, duration covering debt repayment in full pay out or leaving a balloon, itself possibly covered by a recourse or the asset value), Age of the asset upon full pay out of the debt. Quality of the counterparts (quality of the lessee, time charterer, quality of equity providers),
  - **Financial structure :**
    - 1<sup>st</sup> rank security over the asset
    - amount of debt granted for the asset financed , resulting in a certain LTV, debt repayment profile

#### **Project Finance :**

- (1) Project in operational phase
- (2) High-quality based on HQ criteria of Basel III text, with some amendments

- **Asset quality:**
  - **Construction period:** satisfactory due diligence, with notably experienced and credit worthy constructors providing adequate protections in case of delay or underperformance.
  - **Operating period:** robustness against adverse change in economic conditions (rationality of the project, competitive position, revenues features (see below))
- **Contractual feature:** revenues off-take contract, regulated revenues, or, partly contracted revenues and resilience to downside sensitivities. Quality of counterparts (off takers, equity providers (sponsors))
- **Financial structure:** Security package providing control of assets and cash flows

#### **Commercial Real Estate:**

- (1) Loan-to-Value < 75% assessed yearly
- (2) High-quality based on the following criteria

- **Prime-quality** location and property features, or good-quality assets within a diversified portfolio
- **Seniority** of claim
- **Strong interest-coverage ratio**

#### **Commodities Finance:**

##### **1. High-Quality based on the following criteria**

- **Liquidity** of the underlying commodity (existence of an exchange or liquid and tradable markets)
- **Hedge** of the commodity price via derivatives or fixed price sales contract
- **Adequate mitigation of country risk**
- **Investment-grade** direct counterparty risk and/or support by investment-grade guarantor,
- **Control:** goods held to the order of the bank, receivables paid in bank-controlled account, release of funds in committed facilities controlled by the bank

##### **2. Monitoring function** unit in place in the bank to check at least monthly

- Cash collections and economic position of the customer
- Performance of underlying transactions
- Monitoring of inventory positions, price risk and hedging

- Monitoring and tracking of transaction documents

***18) In your view, what other measures should be taken to better reflect the particular characteristics of SL exposures (as compared to general corporate exposures) thereby increasing the risk-sensitivity of the SA-CR and improving consistency with the IRBA? Please elaborate and provide relevant evidence.***

The S&P Annual Global Project Finance Default and Recovery Study provides a comparison of Project Finance (PF) default and recoveries with those of corporates ones.<sup>6</sup>

Default: the study indicates an average default rate of 1.5% (since 1998) for PF, vs 1.8% for corporates over the same period.

Recovery: S&P benchmarks Project Finance recoveries with those of senior unsecured bonds. The study indicates that “project finance debt recovery is at a higher rate than other bank loans and bonds”. PF average discounted recovery is above 75% vs roughly 50% for senior unsecured bonds, i.e. 1.5 times better for PF than for unsecured bonds, despite roughly similar default rates. (please note that in this paragraph Term loans indicated may cover both secured and unsecured ones, but probably don’t reflect only unsecured corporate exposures).

Therefore, the SA RW should on average be 1.5 times lower. Considering the 100% RW for unrated corporates or BB+ /BB ones in the corporate table 10, paragraph 40 (d424 Basel III text), the RW for PF should be 66% in average. This supports our proposal of more risk sensitive RW for PF, with 50%/75% and 110%. The 50% RW would be for transactions which are better than the average, 75% for standard ones and 110% for the riskiest ones.

Generally, we consider project finance to be less risky than corporate unsecured loans as the purpose of specialised lending structures is to enable lenders to control risks over time:

- Project Finance relates to infrastructure assets, which have long lives and deliver essential services or products, such as electricity, health care, etc, thus providing cash flows with a good visibility over the long run.
- The structure comprises preventive covenants and cash trap, DSRA, mechanisms which enable lenders to be quickly and in advance aware of a potential degradation of the project and to bear/manage periods of lower cash flows.
- The security package with notably the share pledge and step in rights (and in addition in some cases of delegation of contracts), and the available residual asset life after maturity enables a

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<sup>6</sup> N.b. study not in the public domain but can be provided on a bilateral basis

favourable recovery process in case of default. Notably, the security package is a strong means of pressure on sponsors (equity providers) in case of loan restructuring discussions and implies that these sponsors would rather bring some support rather than losing all their equity.

- The ring-fencing ensures that the SPV is generally isolated from the sponsors bankruptcy.
- Because of the limitation of activity of the SPV to the asset financed, the structure enables to restrict the use of the asset cash flows, to other activities/assets operation or to other investments that could generate negative cash flows and thus reduce the debt service coverage, leading to potential defaults and losses.
- Limitation of indebtedness ensures that no additional debt would materially reduce the share of cash flows dedicated to the debt repayment (capped amount or monitored through covenants).

Similarly, an Object Finance loan, like an aircraft finance loan should warrant a lower RW than an unsecured corporate loan to an airline. Otherwise, it would be equivalent to consider that the aircraft in security has a value of 0. Given the very high recoveries observed on aircraft finance (92% discounted recovery rate based on AWG study, 8% LGD in average), i.e. 1.8 times better than unsecured bonds), this asset class also warrants a lower, more granular RW, like those we propose in Q17 (50%, 75% /110%).

This also applies to other SL asset classes like shipping or commodities finance, as lenders control the asset and the cash flows generated. With the asset in security, no other secured debt can be raised by the borrower regarding the asset financed, whereas for an unsecured corporate loan, the borrower could issue more debt for the same assets financed.

***19) In your view, which other aspects, if any, should be considered in the context of revising the treatment of SL exposures?***

Industry fully supports the underlying intention of the Infrastructure Support Factor to support financing critical infrastructure and the energy transition. We recommend maintaining this treatment in CRR3, given the impact of the Basel III changes. Indeed, while the supporting factor provides welcome capital relief, it will not compensate for the wider impact of the Basel revisions for this asset class unless implemented alongside the other reforms the industry proposes for SA and IRB approaches to SL.

Also please see responses to CRM questions that are linked to this asset class.

**Standard treatment of equity exposures**

***20) In your view, are there any issues with the definition of equity exposures provided by the Basel III standards (paragraph 49) and the list of other instruments to be treated alike? In particular, would you deem further refinements or clarifications necessary regarding the scope of the equity exposure class in order to ensure a consistent application across the Union? Please elaborate.***

In the Basel III revisions all equity exposures will be treated under the standardised approach. In CRR the current risk-weighting applied to an investment in a well-diversified portfolio of equity investments on a standardised basis is currently 150%. Under the new Basel approach this will increase to a minimum of 250% (+67%) for equity exposures generally, and to 400% for venture capital exposures (+167%) as “speculative unlisted”. However, under the current CRR IRB simple method, diversified private equity exposures may be risk weighted at 190%. We note that the concept of “diversification” as set out in the current EU framework does not appear to have been considered in relation to the new rules and think the Commission should do so in the process of CRR3 implementation. In particular, we think that the EBA should consider how diversification in CRR Article 155 can be incorporated into the final rules and diversified portfolios should be eligible for the lower RW in CRR3.

Furthermore, the definition of venture capital is poorly defined both by Basel and current EU legislation and could lead to the highest increases in risk-weights being applied very broadly across this asset class. Such increases in risk-weights could have a significant knock on effect for the development of the Capital Markets Union. Notably, the definition of “venture capital” should focus on a small number of quantifiable variables for example the purpose of the investment, business age, turnover and profitability, or potentially be aligned with the recent EBA guideline issued on January 2019 that clarify: *“this includes exposures to firms that provide funding to newly established enterprises (e.g. funding for the development of a new product and for the related research for the enterprise to bring this product to the market, and funding for the build-up of the production capacity of the enterprise or for the expansion of the business of the enterprise).”*

Diverse portfolios of venture capital investments might be considered for lower risk weight than that proposed for “speculative unlisted”, for example as if they were equity investments with a 250% risk-weighting. Ideally separate definitions for both Venture Capital (“VC”) & Private Equity (“PE”) should be provided acknowledging that these are distinct investment types with different characteristics and risk profiles. Diverse portfolios of both PE and VC should be considered for a lower risk weight than currently proposed in the Basel III standards as noted above due to “diversification”.

We strongly support the EBA’s CfA recommendation CR-IR7 for a five-year phase in to move equity exposures from the IRB approach to the SA.

***21) Views are sought on the costs and benefits of the revised standard treatment for equity exposures under Basel III (paragraph 49-50). In particular, would you consider any further differentiation among equity exposures (apart from “speculative unlisted equity exposures” and “national legislated programmes” – see 1.1.4.2. and 1.1.4.3.) warranted, and if so, how should this differentiation be made and what would be its prudential rationale? Please elaborate and provide relevant evidence.***

Regarding intragroup equity exposures, the new risk weights implemented for equity exposures severely penalizes banking groups with significant bank subsidiaries. CRR should be neutral with regards to banking structure. In addition to this, penalizing intragroup equity treatment may act as a disincentive to the acquisition of banks located within or outside the EU. Given the nature of these holdings, a lower risk should be assigned to them – or ideally maintain the current CRR standardized treatment. In this respect, we welcome the request made by the Commission to the EBA to carry out a further impact assessment of Basel III on intra-group equity exposures.

***22) What other measures or safeguards could be put in place with regards to equity exposures to increase the risk-sensitivity and robustness of the credit risk framework and prevent regulatory arbitrage between the banking book and the trading book? Please elaborate and provide relevant evidence.***

N/A

#### **Treatment of ‘speculative unlisted equity exposures’**

***23) Do you agree that speculative unlisted equity exposures such as investments in private equity or venture capital firms should be subject to a relatively higher RW than other equity exposures? If you disagree, please explain and provide relevant evidence to substantiate your view.***

While these investments may carry higher risk, it is important that they are clearly defined so as not to have any unintended consequences, where investments are part of a diversified portfolio a lower risk weight should be considered – see Q20 for suggested definition.

***24) Views are sought on the definition of ‘speculative unlisted equity exposures’ provided by the Basel III standards (paragraph 51 and footnote 31). In particular, would you deem further refinements or clarifications necessary and if yes, what should those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.***

Yes, please see answer to Q20.

***25) What other measures could be put in place to address the elevated risk from unlisted equity exposures? Please elaborate and provide relevant evidence.***

N/A

**Treatment of equity holdings made pursuant to national legislated programmes**

***26) In your view, should the discretion for “national legislated programmes” provided by the Basel III standards should be implemented in the Union? If you disagree, please explain and provide relevant evidence to substantiate your view.***

N/A

***27) Would you deem additional safeguards necessary to ensure that only exposures under legislative programmes that effectively reduce the risk can benefit from the preferential RW? For instance, should the preferential RW for exposures subject to national legislated programmes be made dependent on evidence of lower riskiness of respective exposures, and if yes, what kind of evidence would be adequate?***

N/A

***28) In your view, how should “national legislated programmes” be defined within the context of the Union? In particular, would you deem further refinements or clarifications necessary concerning the existing definition, and if yes, what would those be and what would be their prudential rationale? Please elaborate.***

N/A

**Notion of ‘transactors’ and ‘other retail’**

***29) Views are sought on the costs and benefits of introducing the sub-asset class of transactors for regulatory retail exposures and specifying the treatment for other retail exposures. In particular, how does the approach provided by the Basel III standards compare with the current approach in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

We support the introduction of the new sub-asset class of transactors which increases risk sensitivity in the SA. Nevertheless, a simpler definition would be welcomed, for example defining the products which could fall under this category.



***30) In your view, does the reduction in RWs for exposures to transactors under Basel III prudently reflect the risks associated with such exposures? Please elaborate and provide relevant evidence.***

Yes, we support the additional risk-sensitivity this introduces, as has also been identified by the EBA in the CfA recommendation CR6. Nonetheless, the way in which the EBA proposes the lower RW is introduced might be too complex. A simpler way may be for the RW to be applied on a product basis instead i.e. apply to all credit card / charge card / overdraft exposures where the limit is fully undrawn on the payment date set under the transactor exposure e.g. a credit card with a specific customer.

***31) Would you deem further clarifications necessary concerning the notion of transactors and other retail, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.***

Indeed, we recommend the definition of ‘transactor’ be adapted and simplified to suit European financing activities. This could include enlarging the scope to capture types of financing in some jurisdictions which have the same features as credit cards. For example, a revolving line of credit that is not attached to a credit card should be recognized as a ‘transactor’ transaction (if it has the same characteristics).

***32) In your view, which other aspects, if any, should be considered in the context of revising the treatment of retail exposures? Please elaborate and provide relevant evidence.***

The implementation of the revised standardised approach will require significant changes to the data infrastructure to incorporate this new sub-asset class, for instance, at the product level, the identification of exposures eligible for the new ‘transactor’ treatment will require historical payment behaviours to be analysed.

#### **‘Granularity criterion’ and additional measures to ensure diversification**

***33) In your view, is the current CRR sufficiently clear to ensure a harmonised application of the “granularity criterion” or do you consider further guidance necessary? If yes, what are your views as to what this further guidance should entail?***

Industry supports the maintenance of Article 123(b) rather than the introduction of a granularity criterion of 0.2%, we therefore question the need for additional guidance on this topic. In this respect we also support the EBA CfA recommendation CR-SA22.

## Real estate (RE) exposures

***34) Views are sought on the relative costs and benefits of the LS approach and the WL approach provided by the final Basel III standard. In particular, how do the two approaches compare in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

The industry supports the EBA CfA recommendations CR-SA23 on loan splitting and inclusion of both approaches which are applied at the discretion of the firm. i.e. if national supervisor exercises the discretion regarding the loan splitting approach for real estate exposures where repayment does not depend on the cash flows generated by the property, banks should be allowed to decide whether to adopt the whole loan or the loan splitting approach to its portfolios on a consistent basis.

***35) Would you deem further refinements or clarifications necessary concerning the approach that you generally prefer, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.***

Further clarification would be welcomed on the treatment of exposures where the servicing of the loan materially depends on the cash flows generated by a portfolio of properties owned by the borrower.

***36) What would justify implementing both approaches in parallel from a risk perspective? If both approaches were to be implemented and made available on discretionary basis, how would comparability across institutions be ensured and how would regulatory arbitrage as well as undue complexity be prevented in this case?***

N/A

***37) Do you consider the assessment of the condition of “strong positive correlation” on a portfolio basis more appropriate than the assessment based on the individual RE exposure, and if yes, why? Please explain.***

We support EBA CfA recommendation CR-SA 31.

***38) If the assessment based on a portfolio basis were introduced, what are your views on whether it should be the only approach available in the Union or it should be an alternative approach to be applied at supervisory discretion on a case-by-case basis? Please explain.***

N/A

### **Eligibility of property under construction**

***39) What are your views on the costs and benefits of implementing the preferential treatment for certain properties under construction as provided by the Basel III standards? Please provide relevant evidence supporting your view.***

We support the national discretion provided for in Basel III and consequently the broadest interpretation of this in EBA CfA recommendation CR-SA25, however, we consider this should also apply to commercial undertakings, not just loans to individuals. Additionally, we think it useful if the term “under construction” is defined.

***40) Do you consider the threshold of one-to-four family residential housing units appropriate, and if not, which other threshold would you consider to be more appropriate? Please provide evidence supporting your view.***

We would question whether the threshold is required given this only applies to loans to individuals which would seem to exclude commercial undertakings.

### **Prudently conservative valuation criteria**

***41) Views are sought on the costs and benefits of the valuation criteria provided by the Basel III standards. In particular, how does this approach compare with the current approaches available under the CRR (MV and MLV) in terms of simplicity, comparability, risk sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

The industry supports the current CRR Article 208 provisions on loan valuation as being sufficiently prudent and would not recommend further changes to this approach. The values used should reflect the best view of the current risk and so should be able to move up as well as down. LTVs are, in fact, based on collateral evaluation that are periodically renewed.

***42) Would you deem additional specifications necessary to clarify how the MV or the MLV currently used by institutions would need to be adjusted to meet the valuation criteria provided by the Basel III standards? Would you deem further clarifications necessary to ensure a consistent application of the valuation criteria across the Union? Please elaborate.***

N/A

***43) What other measures could be taken to ensure that the value of RE collateral is sustainable over the life of the loan? Please elaborate and provide relevant evidence.***

N/A

***44) In your view, which other aspects, if any, should be considered in the context of revising the valuation criteria for RE property? Please explain.***

N/A

**(Re-)valuation: value at origination vs current value**

***45) Views are sought on the costs and benefits of capping the property value at loan origination. In particular, how does the approach provided by the final Basel III standards compare with the current approach of the CRR in terms of possible cyclical effects on RWs, risk sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

The proposed use of the origination valuation for calculation of loan-to-values ('LTVs') for property exposures could be misrepresentative as it reflects the property market at a single point in time. In this respect it is not as predictive of true mark-to-market values, particularly in falling markets when banks are more likely to be under stress. The use of origination valuation means loans which are re-mortgaged during their lifetime (with the same or different lenders) will have different LTV values as a result of rising house prices or falling house prices. The LTV, risk weight and therefore capital requirement for the same loan could be different depending on whether it is re-mortgaged during its lifetime or not – this, despite all other risk characteristics of the loan remaining unchanged. It should also be noted that in some Member States LTV is not considered in the borrowers' repayment capacity, rather it is the loan to income ratio. To address this issue, legislators should consider using a mark-to-market valuation unless a genuinely anti-cyclical valuation method can be devised.

***46) What other measures or safeguards could be provided to address possible cyclical effects of the re-valuation of real estate property? Please elaborate and provide relevant evidence.***

N/A

***47) In your view, which other aspects, if any, should be considered in the context of revising the requirement for re-valuation of RE collateral? Please elaborate and provide relevant evidence to substantiate your views.***

N/A

## **Land acquisition, development and construction (ADC) exposures – general treatment**

***48) What are your views on the costs and benefits of replacing the existing treatment of 'speculative immovable property financing' with the treatment of ADC exposures as provided by the Basel III standards?***

While we support the proposal to replace the current treatment of "speculative real estate financing" with the treatment of ADC, we think there should be a narrow definition aimed at assigning 150% RW only to very risky financing activities. Consequently, we suggest maintaining the definition proposed by Basel 3 in paragraph 74 and 75 but extend in paragraph 75 the possibility of a 100% assignment to RW for commercial real estate (i.e. outside of residential) when implementing into CRR.

In the case of a loan to a large developer or real estate property company, or to subsidiaries of such counterparts, this loan for general purpose should be treated as a corporate loan and not be subject to ADC requirements as the risk is on a large counterpart with diversified assets and activities.

We also deem it important to exclude the leasing exposures from this treatment, when the client has a binding property sale agreement already finalized with the future RE owner. Leasing real estate exposures, regardless of whether they are commercial or residential properties, should be excluded from the application of higher risk weights whenever the underlying financing operation is aimed at selling or renting the immovable property in construction, as long as the borrower (lessee) provides the lender (lessor) with an already existing irrevocable obligation of a third party to buy or rent the property.

***49) Would you deem further refinements or clarifications necessary concerning the scope or definition of ADC exposures, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.***

N/A

## **ADC exposures – conditions for the application of 100% RW**

***50) In relation to the condition for applying the preferential risk weight of 100% to certain ADC exposures, do you consider further specification necessary to ensure a harmonised application of this condition across the Union, for example by defining or quantifying any of the terms mentioned above? Please elaborate and provide relevant evidence to substantiate your views.***

ADC loans are not necessarily speculative ones as lenders require pre-sales or pre-leases. In some jurisdictions these pre-sales are binding contracts that cannot be cancelled by the purchaser. Furthermore, an amount of equity is brought which ensures that the break-even price is much lower than the grid price, i.e. there would be no loss for the lenders even with a substantial reduction of price. This non-speculative ADC activity would be unduly penalized by the standardized approach on which the output floor will be based. Consequently, the prudential treatment to pre-lease and pre-sales conditions for residential real estate (100% RW instead of 150% RW) should be enlarged to commercial real estate. We therefore welcome EBA CfA recommendation SA-33 which recognises the role of pre-sales or pre-leases and recommend further work be undertaken on this, also taking into account the amounts of equity brought.

### **RW multiplier to certain exposures with currency mismatch**

***51) What are your views on the costs and benefits of introducing the RW multiplier described above? Please provide relevant evidence to substantiate your views.***

The RW add-on for currency mismatch for mortgage and retail exposures will require data not yet captured, which will need a permanent monitoring of the currency's income, even where the wide majority of exposures will not be affected by this add-on. New processes will need to be established to feed the correct data into the regulatory reporting and management information systems. This will take time and grandfathering may be appropriate.

***52) In your view, what other measures could be taken to address the risks associated with currency mismatches? Would the restriction of this measure to retail and residential RE exposures to individuals be appropriate to tackle such risks in the EU? Please elaborate and provide relevant evidence.***

N/A

***53) In your view, which other aspects, if any, should be considered in the context of revising the treatment of exposures with currency mismatch under the SA-CR? Please provide relevant evidence to substantiate your views.***

N/A

### **Off-balance sheet (OBS) items - Definition of commitment**

***54) What is your view on the Basel III definition of commitments? Please provide relevant evidence to substantiate your views.***

In the Basel III definition of commitment we support the national discretion in footnote 53 of the agreement, however this exemption should be available to all counterparties and not solely limited to corporates and SMEs as the conditions indicate in the footnote, notably the fact the bank does not receive any fees is a factor independent of the counterparty category.

***55) What is your view on the national discretion to exempt certain arrangements for corporates and SMEs from the definition of commitments? In your view, which arrangements should be exempted from the definition of commitment, if any? Please provide relevant evidence to substantiate your views.***

The national discretion in footnote 53 of the agreement should be implemented and the exemption should be available to all counterparties, not solely limited to corporates and SMEs.

***56) In your view, which other aspects, if any, should be considered in the context of the treatment of off-balance sheet exposures? Please provide relevant evidence to substantiate your views.***

N/A

#### **New credit conversion factors (CCF)**

***57) What are the costs and benefits of the new CCF introduced by the Basel III standards? In particular, how does the Basel III treatment of OBS items compare to the current treatment in terms of risk-sensitivity and impact on RWAs. Please provide relevant evidence to substantiate your views.***

The prudential rules should support the financing of global trade where the low-risk nature of trade finance has been demonstrated. Overall the industry supports the current CCFs for OBS items which are linked to trade financing, where the Basel treatment has not been changed, and the transposition of this in previous iterations of CRR should be maintained. In this respect, we support maintaining a 20% CCF for trade related contingent items in the CRR (as was agreed in CRR in 2014). We would note in this instance, according to analysis developed by the International Chamber of Commerce based on real default data from the main trade finance banks<sup>7</sup>, the actual CCF for these kind of transactions is close to 8% for counterparties in default, which is well below the 20%.

Regarding the introduction of a 10% CCF for UCCs, this will impact on end users, as banks look to cover the increased cost of capital. Affected facilities will include trade related products, such as

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<sup>7</sup> <https://iccwbo.org/publication/icc-gcd-performance-guarantee-paper/>



documentary letters of credit and bank facilities that are necessary to provide liquidity for international trade. Ideally, we would therefore recommend the current 0% CCF in CRR maintained.

Regarding the newly created 40% CCF, we propose this is addressed as part of the Level 1 legislative process and legislators directly amend the CRR Annex I by splitting the medium category in two categories – a medium-upper one and a medium-intermediate one – as follows:

2. Medium-upper risk:

(a) trade finance off-balance sheet items, namely documentary credits issued or confirmed (see also 'Medium/low risk');

(b) note issuance facilities (NIFs) and revolving underwriting facilities (RUFs);

3. Medium-intermediate risk

(a) shipping guarantees, customs and tax bonds;

(b) undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year;

(c) other items also carrying medium risk (including short-term self-liquidating trade letters of credit arising from the movement of goods) and as communicated to EBA.

CRR article 111 would be updated as follows: medium-upper risk kept at 50%, medium-intermediate risk (please see below) at 40%, medium/low kept at 20% and low risk set at 10% (exemptions as indicated in footnote 53 would also be transposed).

Regarding the IRB, Article 166 -8: as indicated in paragraph 102 of IRB of d424 December 2017 Basel III text, the CCF would apply as per the standardized approach for F-IRB. Hence, CCF would be as proposed above.

***58) In your view, which other aspects, if any, should be considered in the context of revising the treatment of OBS exposures? Please provide relevant evidence to substantiate your views.***

N/A

**Other provisions**

***59) In your view, which other aspects, if any, should be considered in the context of revising the SA-CR? Please elaborate and rank your answers from the most important to the least important aspect.***

As EU legislators have consistently recognised, SME's are the backbone of the European economy and the SME supporting factor plays a crucial role in banks' offering competitive financing to this sector of the economy. The full scope of the SME SF as agreed in CRR2 should therefore be maintained for both the SA and IRBA as it will ensure stability of prudential treatment of SMEs over time.

#### **Implementation challenges and administrative burden**

***60) Which elements of the revised SA-CR, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.***

N/A

***61) Which elements of the revised SA-CR, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

N/A

### **1.2 Internal Ratings Based Approaches (IRBA)**

#### **Reduction of the scope of internal modelling**

***62) What are your views on the costs and benefits of reducing the scope of internal modelling as described above? In particular, how would this reform impact the robustness and levels of RWAs for the affected portfolios? Please provide relevant evidence to substantiate your views.***

The industry considers the overall impact of moving from the advanced approach to the foundation approach for several exposure classes as a regressive step in terms of assessing risk, especially given the SSM's review of internal models (TRIM) exercise, benchmarking, and the IRB repair work undertaken by the EBA.

We would request the EU exercise their national discretion for modelling of maturity under FIRB to support risk sensitivity instead of fixed 2.5 year. While a one-year-floor exemption for certain short-

term exposures and repo-style transactions is only allowed under AIRB under the finalised Basel 3 framework, we would also request that the EU apply a one-year maturity floor exemption for FIRB.

***63) What other measures could be put in place to improve the robustness of internal estimates for the relevant asset classes? Please elaborate and provide relevant evidence.***

Industry was not supportive of the restrictions to the IRB approach introduced in Basel III revisions. In light of this, we urge regulators to keep, within the remit of the Basel agreement, the widest possible scope available to use internal models as these provide an incentive to maintain a more refined and robust framework when calculating capital requirements.

In this respect, since Basel III was agreed, there have been many measures introduced to address concerns with internal models and undue RW variability including TRIM, IRB Repair and NPL prudential backstops. These should prove sufficient to address regulators post-crisis concerns with the IRB framework. Given the multiple requirements stemming different authorities, it would be helpful to gather / simplify, when possible, the requirements in one document where it relates to the same topic.

***64) In your view, which other aspects, if any, might be considered in the context of the revision of the scope of internal modelling to address RWA variability? Please provide relevant evidence to substantiate your views.***

N/A

**PD – increase of the input floor**

***65) Views are sought on the costs and benefits of increasing the PD input floor to 0.05%. In particular, how does the increased floor compare with the current floor in terms of achieving the aim of decreased RWA variability? What is the impact of this change on RWA levels? Please provide relevant evidence to substantiate your views.***

The introduction of input floors is not considered as useful as the work which has already been undertaken as part of the IRB Repair Work and TRIM to ensure that the level of PD is adequate.

Clarification is required as to whether the PD floor of 0.05% will also apply in the context of PD substitution for guarantees received. Furthermore, paragraph 66 of the Basel agreement states the floor doesn't apply to Sovereign exposures. We would support the EU maintaining its current approach to estimate PDs for sovereigns. (N.B. Paragraph 1.5.1 of the most recent BCBS Consultation

clarifies that BCBS standards “retains the main features of Basel II” which would also therefore support the absence of input floors for Sovereigns).

According to the Basel Committee, input floors are intended to ‘*ensure a minimum level of conservatism in model parameters*’ [BIS, Dec '17, High-level summary of Basel III reforms]. While we understand the underlying intention, a consequence of this will be that expected losses calculated with the respective parameters do not fully reflect the actual underlying risk of the exposure, as it is to a certain extent like a ‘standardised approach’ within the IRB method. Additionally, Article 36(1)(d) of the CRR requires that shortfalls of accounting provisions compared to capital expected losses are deducted from CET1 capital. Since the implementation of IFRS9, accounting provisions are calculated by computing expected losses that try to reflect the true and fair value of the affected exposures. We understand the comparison under Article 36(1)(d) might still want to capture the methodological differences between accounting and prudential modelling (mainly point-in-time vs through-the-cycle approaches), but the conservatism of the input floor creates an unjustified and artificial gap between both.

As such, we deem it necessary that exposures where the regulatory expected loss is calculated using floored parameters are excluded from the application of Article 36(1)(d) of the CRR (as if their capital was calculated using standardised approach). Another alternative would be to perform the comparison required by Article 36(1)(d) with unfloored expected losses. Otherwise, the conservatism arising from the input floor would be applied twice, once in the calculation of the RWA, and again as a capital deduction through Article 36(1)(d).

***66) In your view, how does the increased floor compare with the current floor in terms of achieving the aim of increased conservatism? Would you consider a floor that implicitly assumes that a default occurs once every 2000 years to be sufficiently prudent? Please explain.***

The framework should continue to provide an incentive to still use internal models. The risk parameters estimations are not meant to be conservative but accurate. In this regard, the IRB Repair program / TRIM exercise ensure that the level of estimation is accurate. The EBA Guidelines on PD-LGD estimation (stemming from the IRB Repair catalogue) provides a constraint on and harmonization of the calculation of default rates. If the calculation methodology is deemed appropriate by the NCA, we do not see any merit in having an additional floor. Moreover, there are existing requirements on margins of conservatism in the EBA Guidelines. We therefore question the added value of transposing all the Basel III requirements (e.g. input floors).

***67) What other requirements or safeguards could be implemented in the area of PD estimation to achieve a minimum level of conservatism and/or reduce RWA variability? Please provide relevant evidence to substantiate your views.***

N/A

***68) In your view, which other aspects, if any, should be considered in the context of revising the PD input floor? Please provide relevant evidence to substantiate your views.***

As per Q66, the IRB Repair Work and TRIM are considered sufficient to ensure an adequate level of risk parameters. There is a strong need to assess the impact of such measures when considering the transposition of Basel III revisions in relation to IRB approaches to avoid overly conservative or redundant requirements.

#### **LGD – input floors under AIRBA**

***69) Views are sought on the costs and benefits of exposure-level LGD input floors. In particular, how do the floors compare with the current treatment in terms of achieving the aims of conservatism and RWA variability? What is the impact of this change on RWAs? Please provide relevant evidence to substantiate your views.***

The IRB introduces LGD input floors for Specialist Lending (SL) which were designed for unsecured corporate exposures and have not been subject to a QIS before the publication of the final December 2017 Basel text. Indeed, the changes introduced to the IRB approach to SL during the 2015-17 review were not subject to any impact assessment or formal industry consultation. European legislators should therefore consider further QIS alongside taking into account the changes industry proposes.

As the floors were designed for general corporates exposures and not for SL they are overstated when compared to historical LGDs. The overstatement of the LGD input floors does not reflect the sensitivity of SL internal models, which will negatively impact low risk transactions and could drive banks away from these in favour of riskier transactions to obtain sufficient margin to compensate for the impact of the overly conservative LGD floors. In turn this could impact the financing of critical European infrastructure and renewable energy projects.

Specifically, we consider the 15/25% LGD floor levels are too high for the best quality/ collateralised specialised lending transactions. The Basel III formula is aimed at transactions with liquid collateral and publicly available market prices, however:

- In specialized lending, there is a focus on restructuring and cure. Market value of collateral is not the only protection.
- Moreover, collateral market value is not relevant for project finance in particular, including high-quality infrastructure projects

- In these transactions the strength of contractual commitments and future cash-flows and the step-in rights that would give lenders access to this, the ability to restructure is the primary driver of reduced LGD.
- The formula needs to be adapted to avoid applying unsecured LGD floor (25%) to all these transactions

We therefore propose a direct LGD input floor for SL set at 10%. For unsecured corporate loans, where we would expect a 40% LGD (as seen on capital markets), the floor is set at 25%, i.e. 15 points lower. In the case of project finance, based on S&P average historical LGDs of roughly 25%, we think that a 10% LGD floor would also be 15 points lower than the average level and thus support a calibration consistent with the one applied to unsecured corporate loans.

We believe that this unique and direct 10% LGD input floor for SL is also justified by the fact that in fifty percent of cases, LGDs were below 10% for project finance (source S&P) and low risk transactions should not be penalised by an overstated 25% LGD floor. Regarding aircraft finance, the Basel Aviation Working Group study has shown LGDs around 8%, with an LGD of 1.3% in half of cases also supporting a much lower input floor than the 15-25% ones.<sup>8</sup>

The 10% LGD floor should also be considered in conjunction with removing the 40% collateral haircut as set out in our answer to Q70.

Regarding non-retail exposures, the input floors will impact differently depending on the business models of banks. Moreover, there are also existing requirements on margins of conservatism in these EBA Guidelines on PD-LGD estimation. More generally, we question the relevancy of input floors given the increased conservatism introduced via the IRB Repair Work and TRIM to ensure that the level of LGD is adequate.

***70) As regards the different types of exposures and collateral, to what extent do you consider that the LGD input floors maintain an adequate level of risk sensitivity with respect to the wide range of practices of EU institutions?***

The introduction of input floors will be counterproductive in relation to the work undertaken as part of the IRB Repair Work and TRIM to restore trust in IRB models by ensuring comparability of the estimates of risk parameters, while retaining their risk sensitivity. There is a strong need to assess

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<sup>8</sup> <http://www.awg.aero/wp-content/uploads/2019/10/2.-BASEL-materials-and-submissions.pdf>

And <http://aviationworkinggroup.aero/assets/docs/Basel--AWG-study-on-aircraft-backed-loans-14-October-2016.pdf>

the impact of such measures when considering the transposition of Basel III agreements in relation to IRB approaches.

### **Specialised lending**

In conjunction with our views on the input floors set out in Q69, we support the EBA CfA recommendation CR-IR 13 to apply AIRB collateral eligibility criteria for SL regarding the calculation LGD input floors. It should be noted that the EBA recognises the benefit of the security packages and SL structures. Yet the remaining issue is the fixed 40% haircut on collateral value which was not designed for SL and does not reflect the mixed management of default for SL.

The fixed 40% haircut of collateral in the LGD calculation formula does not differentiate between the quality of collateral and transaction structures. It results in overstated LGD input floors which remove SL internal model risk sensitivity despite the clear decision of the Basel committee to maintain AIRB for SL.

Given the mixed type of recoveries (restructuring in most of the cases, or sale of the asset in other cases and at an adequate moment), the logic of applying a high haircut applied for calculation of the LGD floor based on the asset value does not make sense and poses difficulty in valuing projects as they are analysed in terms of future cash flows.

Hence our proposal in Q69 for a unique 10% direct LGD input floor with no calculation based on an asset value haircut. This 10% LGD floor would be directly compared to the SL internal model LGDs.

#### ***71) What other requirements or safeguards could be implemented in the area of LGD estimation to achieve a minimum level of conservatism and/or reduce RWA variability?***

The current CRR and additional mandates stemming from the EBA are sufficient to ensure the right level of conservatism and/or reduce RWA variability. In particular, the EBA has harmonized the Margins of Conservatism (MoC) in its Guidelines on PD-LGD estimation and the treatment of defaulted assets, which are considered clear. Hence the input floors specifically for specialised lending introduce additional conservatism that should be assessed and recalibrated by the Commission in line with our recommendations.

#### ***72) In your view, which other aspects, if any, should be considered in the context of revising the LGD input floor? Please provide relevant evidence to substantiate your views.***

According to the Basel Committee, input floors are intended to ‘ensure a minimum level of conservatism in model parameters’ [BIS, Dec '17, High-level summary of Basel III reforms]. While



we understand the underlying intention, a consequence of this will be that expected losses calculated with the respective parameters do not fully reflect the actual underlying risk of the exposure, as it is to a certain extent like a 'standardised approach' within the IRB method. Additionally, Article 36(1)(d) of the CRR requires that shortfalls of accounting provisions compared to capital expected losses are deducted from CET1 capital. Since the implementation of IFRS9, accounting provisions are calculated by computing expected losses that try to reflect the true and fair value of the affected exposures. We understand the comparison under Article 36(1)(d) might still want to capture the methodological differences between accounting and prudential modelling (mainly point-in-time vs through-the-cycle approaches), but the conservatism of the input floor creates an unjustified and artificial gap between both.

As such, we deem it necessary that exposures where the regulatory expected loss is calculated using floored parameters are excluded from the application of Article 36(1)(d) of the CRR (as if their capital was calculated using standardised approach). Another alternative would be to perform the comparison required by Article 36(1)(d) with unfloored expected losses. Otherwise, the conservatism arising from the input floor would be applied twice, once in the calculation of the RWA, and again as a capital deduction through Article 36(1)(d).

#### **LGD – regulatory values under FIRBA**

***73) Views are sought on the costs and benefits of the revised regulatory LGD values to be used under the FIRB Approach. In particular, how does the approach provided by the Basel III standards compare with the Basel II standards in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

In addition to the challenges the SA presents in terms of financing corporates, banks will be significantly impacted in respect of their exposures to Corporates (and financial institutions) when they move from applying the AIRB to the FIRB. The 45/40% LGDs in the future framework will impact the provision of day to day banking services for corporates, which is often made of undrawn credit facilities that cannot be replaced by capital markets issuance.

Likewise, the application of the FIRB to financial institutions will adversely impact use of credit insurance products: with the increase expected in RWs as a result of the restricted use of internal models, banks will continue to use, if not increase, credit insurance to mitigate the impact on RWs in the final Basel III framework. However, due to the fixed level of LGD (45%) under the F-IRB which banks will have to apply to financial counterparties such as insurers, this approach is likely to be hindered. It should be recognised that benefiting from an insurance policy is not the same risk as being a creditor to an insurer. Indeed, the Solvency II regime ensures preferential treatment of insurance policy holders. Hence, in the case of an insured deal the bank taking it out would be treated

as super senior, so a 45% LGD would be overstated. Besides this, in the instance where the insured part of a loan benefits from an asset collateral from credit insurance, if the insurer has not fully indemnified the lenders, these insured loans keep the benefit of the asset in security which has to be reflected in RWAs. We note that from the June 2006 BCBS text through to the Dec 2017 Basel III text, all are silent on the treatment of deals which benefit from both a guarantee or an insurance and an asset in collateral. Therefore, we propose that for RW calculation, banks have the option to take into account the PD of the insurer and the LGD related to the secured transaction if lower than that of the insurer, as the lenders retain full security over the asset in the case of the insurer defaulting. The LGD of the secured transaction should be kept in A-IRB as the fact that there is an insurance on it should not change the modelling of the collateral asset.

The F-IRB LGD could also have wide-reaching unintended consequences for the unfunded credit protection, given the majority of protection providers are financial institutions (insurers or banks). Moreover, it is important that insurance remains a way for banks to continue their role of structuring of loans in a European market which relies on bank financing. Reducing the use of internal models for corporates together with the new F-IRB constraint on insurers could lead to bank financing of corporates being reduced. The same issue of 45% F-IRB for banks guarantees would apply in case sub-participation in risk on a loan by a third-party bank.

Furthermore, it should be noted that the FIRB approach has a negative impact on trade facilities, such as those linked to commodities trade finance and documentary credits, that cannot be justified by their low risk nature. Trade facilities are generally very short term (below 1 year), and self-liquidating, and vital in supporting imports and exports in Europe. Trade facilities are either provided to Corporates or Financial Institutions (bank of the counterparty) resulting in a treatment under FIRB. Due to the maturity floor in the FIRB, the risk weights will increase for trade products, the EBA recommendation CI-IR22 provides a positive recommendation on effective maturity in this respect. However, the approach is currently subject to competent authority permission under (A)IRB and should be made available to all IRB treated short term, self-liquidating trade facilities. Additionally, as per the current CRR for A-IRB, the use of the effective maturity in F-IRB should not be floored to 1 year. This is important for trade finance transactions which are shorter than one year.

***74) In your view, are the regulatory LGD values sufficiently prudent in light of the decrease of the regulatory LGD value for unsecured corporate exposures and the changes affecting secured exposures? Please explain and provide relevant evidence to substantiate your views.***

The LGD values are considered sufficiently prudent if you compare regulatory LGDs to historical LGDs stemming from the data used for internal modelling purposes. Such analysis could be provided to, or even undertaken by national competent authorities.

***75) In your view, which other aspects, if any, should be considered in the context of revising the regulatory LGD values to be used under the FIRB Approach? Please provide relevant evidence to substantiate your views.***

Implementation of the Corporate threshold for FIRB application: The move from AIRB to FIRB also presents an operational and implementation challenge in respect of the application to corporates above a €500million threshold which is introduced in the revised standard. Under Basel III banks will no longer be able to model their risk parameter (such as LDG & EAD) to corporates that belong to a group with total consolidated annual revenues greater than €500mn, this is to be assessed on average amounts over the prior three years or on the latest amounts updated every three years by the bank.

The expectations for how banks evidence this will be significant, as it will have a material impact on data requested from clients (in particular non-listed clients), and it will be important to give early and proportionate guidance on supervisory expectations.

Another issue is the scope of the application of the €500m threshold for corporates – this should not be linked to the large exposure connected counterparty framework, so that it is just the largest corporates that are captured as intended. Likewise, it is not clear at what level of consolidation banks are expected to stop aggregating against the €500m threshold. If a bank lends to an entity that is part of an OpCo with consolidated turnover of less than Eur 500m (financials made available because the bank is lending to the entity and the OpCo), this is A-IRB eligible, however, it's not clear if that OpCo is rolling into a large HoldgCo and the bank has no access to the financials. We would also note that the requirement to assess it on the consolidated revenues means that stand-alone corporates (for which banks can use the IRBA) may get better financing terms than corporates that are part of a large parent company despite presenting the same risk to the bank in terms of lending.

Banks will also be required to apply the foundation approach and use supervisory estimates for the LGD, EAD and Maturity. Consequently, banks will likely have to redesign some of their corporate models in order to comply with the new scope of application. Given that it can take at best 1-2 years for models to be approved it is not clear how this new requirement will interact with banks' building of models that include corporates that are close to this threshold – legislators should consider further guidance on this in the rules to ensure smooth implementation.

Another concern regarding banks is the consistency of the application of a 45% LGD and the LGD levels used in other regulatory streams such as BRRD. Industry experience shows that the proposed level of 45% LGD is located within the highest range of LGDs for banks. It is therefore advisable to consider further granularity in regulatory values.

See also CRM clarifications.

## **EAD – introduction of an input floor**

***76) Views are sought on the costs and benefits of exposure-level EAD input floors. In particular, how do the floors compare with the current treatment in terms of achieving the aims of conservatism and RWA variability? What is the impact of this change on RWAs? Please provide relevant evidence to substantiate your views.***

Under CRR, the scope of internal modelling is reduced, therefore, the floors would apply to perimeters which can still be modelled, which remains a rather narrow scope of off-balance sheet exposures. The use of input floors is limited, also given the current level of internal CCFs.

***77) What other requirements or safeguards could be implemented in the area of EAD estimation to achieve a minimum level of conservatism and/or reduce RWA variability?***

The current CRR and additional mandates stemming from the EBA are sufficient to ensure the right level of conservatism and/or reduce RWA variability. In particular the EBA has harmonized the Margins of Conservatism (MoC) in its Guidelines on PD-LGD estimation (this is applied to all risk parameters including CCFs) and the treatment of defaulted assets, which are considered clear.

***78) In your view, which other aspects, if any, might be considered in the context of revising the EAD input floor? Please provide relevant evidence to substantiate your views.***

N/A

## **EAD – Scope of modelling**

***79) Views are sought on the costs and benefits of restricting the use of EAD modelling to undrawn revolving commitments. In particular, how would the removal of EAD modelling for other product types impact the robustness and level of RWAs for those portfolios?***

Based on our reading of EBA answers to Q&As in the current CRR, the scope of CCF modelling is limited to the off-balance sheet items referred to in Article 166(8) of CRR. From a regulatory standpoint, it is therefore limited to:

- Credit lines or undrawn purchase commitments for revolving purchased receivables, which are unconditionally cancellable;
- Short-term letters of credit arising from the movement of goods;

- Other credit lines, note issuance facilities (NIFs), and revolving underwriting facilities (RUFs).

The treatment of off-balance-sheet items other than those mentioned in Article 166(1) to (8) of CRR is specified in Article 166(10) and are therefore subject to regulatory values of CCFs. This vision is different from the Basel III standards – for instance, the use of internal CCFs is prohibited for short-term letters of credit arising from the movement of goods, while it is still permitted under Basel III standards. This list is rather restrictive and there could be room to consider the case of signed commitments (e.g. guarantees).

***80) What other measures could be put in place to improve the robustness of internal estimates of EAD? Please specify and provide relevant evidence.***

On top of the EBA IRB Repair Program and the TRIM exercise, no other measures are deemed necessary.

***81) In your view, which other aspects, if any, should be considered in the context of the revision of the scope of internal modelling of EAD? Please provide relevant evidence to substantiate your views.***

In the context of CRR revision it would be worthwhile considering the drawings after defaults treatment in the modelling, in line with the EBA recommendation CR-IR44, “specifying that in all cases the additional drawings after default should be accounted for only in the LGD, while CCFs should reflect any drawings before default”. We support the EBA’s approach.

#### **EAD – regulatory CCF values**

***82) What are your views on the costs and benefits of using SA CCFs for the FIRB Approach? How would this change impact the robustness and level of RWAs for the affected portfolios?***

Benefits:

- Regulatory CCFs provide a simple approach

Costs:

- Not customized to internal portfolios
- A simpler approach which cannot account for all detailed off-balance-sheet products

The impact:

- The floor on CCFs is a significant change from previous framework which allow a 0% CCF for unconditionally cancellable commitments. This floor will impact all activities without any differentiation. The current possibility in CRR to use a 0% CCF should be upheld if an appropriate level of justification can be provided to the European supervisor (Please see also answers to questions 54, 55 and 57);
- The penalization of activities treated in the current approach with a 20% CCF such as certain types of non-financial guarantees (bid bonds, advanced payments, retention money, performance bonds...). will in particular impact trade finance activities, which involves lending to corporates in their daily activities arising from the movement of goods.

***83) What other measures could be put in place to improve the adequacy of the regulatory CCFs under the FIRB Approach? Please elaborate and provide relevant evidence.***

For off-balance sheet exposures which are not allowed an internal CCF, an exposure value must be a specific percentage of an off-balance-sheet item's value, based on the classification of off-balance-sheet items established in Annex I of CRR as per our answer to Q57.

***84) In your view, which other aspects, if any, should be considered in the context of the revision of the regulatory CCFs under the FIRB Approach? Please provide relevant evidence to substantiate your views.***

For off-balance sheet exposures which are not allowed an internal CCF, an exposure value must be a specific and fixed (aligned between IRB and STD) percentage of an off-balance-sheet item's value, based on the classification of off-balance-sheet items established in Annex I of CRR : see proposals for Annex I in Q57.

#### **Maturity factor – clarifications on the calculation of effective maturity**

***85) What are your views on the costs and benefits of the proposed clarification regarding the determination of effective maturity? In particular, how would the proposed change impact the robustness and level of RWAs under the AIRB Approach?***

Given the far wider scope of application of the FIRB under Basel III to large corporates and financial institutions, the EU should exercise the Basel III national discretion (paragraph 108) for modelling of maturity under FIRB to support risk sensitivity instead of fixed 2.5 years. This national discretion would allow competent authorities to use the cash-flow method under the AIRB and should be adopted as EU-wide to promote risk sensitivity. We therefore support the EBA's recommendation



IR22 for competent authorities being given the power to allow banks to apply the effective maturity calculation for FIRB exposures.

Furthermore, while a one-year-floor exemption for certain short-term exposures and repo-style transactions is only allowed under AIRB under the finalised Basel 3 framework, we would also request that the EU apply a one-year maturity floor exemption for FIRB. In particular, this is important for trade finance related items under Article 162(3)(b) (self-liquidating short-term trade financing transactions connected to the exchange of goods or services with a residual maturity of up to 1 year) where effective maturities below one year should not be floored at 1 year and it should be possible to calculate the F-IRB RWA using a non-floored effective maturity.

See also comments on short term exposures to institutions in Q10.

***86) In your view, which other aspects, if any, should be considered in the context of the treatment of the maturity parameter? Please provide relevant evidence to substantiate your views.***

See answer to Q85.

#### **Sovereign exposures – no substantive change**

***87) Views are sought on the treatment of sovereign exposures proposed in the BCBS consolidated framework referred to above. In your view, how would the exemption from the removal of the IRBA and from the input floors, on the one hand, and the implementation of the remaining reforms of the IRBA, on the other hand, impact the robustness and levels of RWAs for sovereign exposures treated under the IRBA?***

We think that the current position is positive:

- Leaving the opportunity to apply IRBA to sovereign exposures
- No input floors on sovereign exposures
- No application of the 1.06 scaling factor

We do not consider it necessary to change any further elements in relation to the treatment of sovereigns. The exemption of sovereign exposures is widely shared and understood between national competent authorities within Europe.

#### **Sovereign exposures – public sector entities (PSEs) and regional governments and local authorities (RGLAs)**



***88) What are your views on the costs and benefits of the proposed treatment of PSEs and RGLAs resulting from the changes applicable to exposures to central governments and exposures to institutions compared to the current framework? Please elaborate and provide relevant evidence.***

We think that PSEs and RGLAs should remain in IRBA, as their specificities justify this preferential treatment. We therefore support the intention of the EBA CfA recommendation CR-IR8 in relation to treatment of PSEs and RGLAs. However, we think that further discussion with the industry could be undertaken to make sure that more practical considerations are taken into account (e.g. more accurate updating the EBA list of PSEs).

***89) In your view, are there other ways to achieve more robust RWA estimates for exposures to PSEs and RGLAs that would mitigate the potentially significant differences in treatment described above? Which are they and what would be their costs and benefits and their prudential justification?***

N/A

***90) In your view, which other aspects, if any, should be considered in the context of the revision of the treatment of PSEs and RGLAs? Please provide relevant evidence to substantiate your views.***

N/A

#### **Additional enhancements of IRB risk parameter estimation practices**

***91) What are your views on the proposed enhancements of IRB risk parameter estimation practices?***

Some of the proposed modifications in the Basel framework are already more strictly applied in the current CRR or harmonized through the EBA publications of the IRB Repair work.

The EBA recommendation CR-IR 28 implies that rating systems should be applied to type of "facilities" instead of type of "exposures". This has an influence on the level of estimation of LGD / CCF / EL. More generally, the application by facility is very granular and does not lead to better understanding of the model architecture. Moreover, one may question the calculation of LGDs at facility level: the level of calculation should be in line with the recovery process, and at the level of obligor if applicable.

The EBA recommendation CR-IR 33 asks for more clarification on the definition of a "model", which does not yet exist in CRR. We would like to bring to the Commission's attention that other jurisdictions are more advanced in such definition. For instance, the FED considers that a model "refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates." ("Supervisory Guidance on Model Risk Management" known as SR Letter 11-07 dated 04/04/2011). In order to avoid multiple definitions and potential inconsistencies, we suggest consistency (to the possible extent) with other existing regulation.

Regarding EBA recommendation CR-IR 34, we think that the EBA Guidelines on PD-LGD estimation provide sufficient detail on Margins of Conservatism (MoC). We do not see any adding value in putting such detailed definition directly in the CRR. In particular, any concerns over underwriting standards, risk appetite, collection and recovery policies should remain in soft law.

***92) What other measures could be put in place to improve the robustness of internal estimates? Please elaborate and provide relevant evidence.***

Since the introduction of CRR in 2013 industry has implemented the IRB Repair package, the CRR amendment for an NPL prudential backstop, CRR2 and now CRR3. Following this we recommend a period of regulatory stability for banks to implement and assess the robustness of the new measures for internal modelling.

***93) In your view, which other aspects, if any, should be considered in the context of the revision of estimation practices to address unwarranted RWA variability? Please provide relevant evidence to substantiate your views.***

N/A

## **Other provisions**

***94) In your view, which other aspects, if any, should be considered in the context of revising the IRBA? Please elaborate and rank your answers from the most important to the least important aspect.***

**The Supervisory Slotting approach (Specialised Lending):** In footnote 3 of the [high-level summary of Basel III](#) reforms, the Committee will review the slotting approach for specialised lending in due course, we welcome early clarity on when this will take place and urge for the wider SL framework to also be re-considered as per the our concerns in questions 16-19 and 69-75. Regarding the review of the slotting approach, it would be necessary to introduce more risk sensitivity. When

the Basel review is completed, the Commission should prioritise consulting industry, with a view to implementing in the EU.

Regarding the granularity of the slotting approach, the five categories in the slotting criteria are not granular or risk sensitive enough for low risk exposures. The first “Strong” category is too broad, as it includes exposures that correspond to a wide “BBB- or better” ratings range (there should not be a single category representing the whole investment grade spectrum). The 70% risk weight for exposures for this “strong” category therefore penalises exposures which have a much higher credit than the BBB- rating.

The current CRR is also not fully reflective of the Basel framework in terms of the best aligning of capital to the risk of SL. Namely, the national discretion for the assignment preferential risk weights on exposures under “strong” and “good” categories is included in the CRR only for exposures with remaining maturity of less than 2.5 years, but not considered when banks’ underwriting and other risk characteristics are substantially stronger than specified in the slotting criteria for the category. The national discretion to apply 50-70% RWs for strong exposures should therefore be applied EU wide and the EBA should give more guidance on what specific underwriting and strong risk characteristics would qualify for use of preferential risk weights.

Regarding the Basel review of the slotting approach should also review splitting the “strong” category and establish a more risk sensitive range of slots (e.g. up to 5) which should correspond to the banks’ risk assessment of the exposure with a range of RWs from 20-100%. In addition, the national discretion to assign preferential risk weights for categories up to “good” should be maintained and respect the current reduction of RW of 20 points for each category. This preferential risk weight should be implemented in full in the CRR.

Additionally, we consider there is need for clarity on the use of how to take into account UCP (Unfunded credit protection) for the supervisory slotting approach. The CRR is silent on whether UCP (other than those already specified in the slotting approach like completion guarantees or guarantees provided by public entities in PPPs), can be recognised for specialised lending exposures treated under supervisory slotting. The EBA’s slotting guidelines also do not take into account the treatment of additional guarantees, i.e. other than those already specified in the slotting approach, such as those provided by Export Credit Agencies for political and commercial risk or insurance policies covering the risk of a loan. Regarding ECA guarantees that effectively convert the guaranteed exposure to ECA or sovereign risk – we would like to understand how their impact can be reflected in the slotting approach. The current framework allows this to be done only through PD and LGD adjustments, but under the slotting methodology there is no PD/LGD to adjust. This anomaly could potentially be adjusted by either tranching the exposure in the context of ECA guarantees and risk weighting the guaranteed portion per the PD and LGD of the eligible guarantor, and using the Slotting risk weight

for the uncovered portion and by revisiting the granularity of the slotting approach to allow for other risk mitigation to be reflected better in the risk weights.

It is also necessary for the CRR3 to develop how to assign guarantees (both personal and non-personal) which are not included in the project securities package. These guarantees either are only considered in the rating, or they are lost, even if they would provide mitigation if they were under the SA. It does not make sense that under a more advanced approach than the SA (which recognizes these guarantees) they are not taken into account.

Finally, the expected loss of the slotting is not aligned with the expected loss of the internal model for provisions, which produces a large difference in the comparison of Article 159 of expected loss vs provision. Due to the fact that this approach is more similar to the SA, we propose removing them from this comparison with the expected losses, treating them in a similar way to project finance exposures under the SA.

**Double counting:** The implications of the IFRS 9 standard and the double counting of expected loss in capital between IFRS9 and the standardised credit risk weights should be reviewed. Amendments to eliminate the double-counting should be made to the risk weights ahead of implementation of the Basel rules, so that they are included in Pillar 1, rather than being left to Pillar 2.

In addition to this, we also consider there is double counting in relation to expected credit loss - in CRR2 a provision was introduced that banks must deduct expected credit loss from own funds (less provisions and valuation adjustments) (CRR Articles 36(d), 158 & 159). However, for fair valued positions this represents a double count because the expected loss is already reflected in the accounts with gains and losses flowing through earnings. In other jurisdictions expected credit loss for fair valued positions is set to zero. We recommend that Expected Credit Loss for fair valued positions should be set to zero, in line with the US version of the rule:

*ECFR, Title 12, Chapter II, Subchapter A, Part 217, §217.2 Definitions.*

*Expected credit loss (ECL) means:*

*(1) For a wholesale exposure to a non-defaulted obligor or segment of non-defaulted retail exposures that is carried at fair value with gains and losses flowing through earnings or that is classified as held-for-sale and is carried at the lower of cost or fair value with losses flowing through earnings, zero.*

**Interaction with NPL backstop:** We think that the EC should recognise the impact of NPL prudential backstop on calibration of parameters, especially on the estimation of LGD-in-default. IRB shortfall is

recognised in the reach of the backstop. However, the granularity of the backstop which is calculated exposure by exposure is not line with the philosophy of the level of calculation of the IRB shortfall.

## **Implementation challenges and administrative burden**

***95) Which elements of the revised IRBA, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.***

### IT challenges

- The calculation of RWAs in both STD and IRB approaches. Should the aggregate output floor be binding, institutions would face a challenge to properly allocate internally the RWA surcharge between the business lines.
- The detection of consolidated revenues above 500M€ for Large Corporate requests clarification and will be an issue for consolidating corporates for which revenues are not available on a regular basis.
- Regarding CRM framework, it remains unclear how institutions should handle the mix of regulatory approaches they will be faced with. For instance, for bank guarantees which are a common type of CRM.
- The cost of greater disclosure and reporting.

***96) Which elements of the revised IRBA, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

In order to simplify process for banks, we think there should be limited notification as per Regulation 529/2014 – Model Change Policy - to the supervisor when changes are made to internal models in relation to Basel III (e.g. changes on portfolios when shifting from IRBA to FIRB). We therefore endorse the EBA recommendation CR-IR3 to allow reversal to less sophisticated approaches ahead of scheduled timelines and the process should be made as simple as possible.

## 1.3 Credit Risk Mitigation – SA-CR

### **1.3.1 Removal of own estimates of haircuts and use of supervisory haircuts**

***97) What are the costs and benefits of replacing own estimates of haircuts with the use of supervisory haircuts? Please compare the approach under Basel III in terms of risk- sensitivity,***

*comparability, impact on RWAs and operational burden with the current CRR treatment. Please provide relevant evidence to substantiate your views.*

N/A

*98) Do the revisions affect certain exposure classes more than others? Please elaborate and provide relevant evidence to substantiate your views.*

N/A

**1.3.2 Specific operational requirements for credit derivatives: restructuring as a credit event**

*99) What are the costs and benefits of the recognition of credit derivatives in cases where restructuring is not specified as a credit event? Please compare the approach under Basel III in terms of risk-sensitivity, comparability, impact on RWAs and operational burden with the current CRR treatment. Please provide relevant evidence to substantiate your views.*

We support recognition of credit derivatives in cases where restructuring is not specified as a credit event.

*100) Do the revisions affect certain exposure classes more than others? Please elaborate and provide relevant evidence.*

N/A

**1.3.3 No recognition of nth-to-default products as eligible CRM technique**

*101) What are the costs and benefits of not recognising nth-to-default credit protection? Please compare the approach under Basel III in terms of risk-sensitivity, comparability, impact on RWAs and operational burden with the current CRR treatment. Please provide relevant evidence to substantiate your views.*

N/A

**1.3.4 Other Provisions**

*102) In your view, which other aspects, if any, should be considered in the context of revising the CRM framework under the SA-CR? Please specify and rank your answers from the most important to the least important aspect.*



Collateral that is recognised as eligible as credit risk mitigation for the standardised approach is limited to financial collateral which limits the risk sensitivity of the framework. This does not recognise the risk reducing properties of other types of collateral, such as ships and planes in the shipping and aviation industries respectively, as well as cars, machines, goods, and claims and receivables, thereby penalising these industries, despite the collateral providing legitimate and effective credit risk mitigation. Other forms of collateral that are eligible under IRB should also be considered for SA-CR for the same reasons.

### **Specialised lending:**

Risk weights also do not fully consider security packages and covenants which allow for control over future cash flows. Greater granularity should be considered to reflect the quality of the project, transactions, contractual structure, LTVs (where appropriate for the SL sub-sector) and structuring features (e.g. reflecting self-liquidating trade related exposures) - for example, the differentiation afforded to commercial real estate exposures under standardised approach should also be extended to aircraft and ships as commensurate to the risk posed, with a range of risk weights based on loan to value (LTV) and the materiality of cash flows from the asset. The eligibility criteria should also be adapted.

### **On Balance Sheet Netting**

In the EBA Report on Credit Risk Mitigation Framework, the EBA makes clear that in relation to the treatment of OBSN with regard to currency mismatch, there is no intended limitation of eligibility with regard to currency mismatch. In particular, it is specified that loans and the deposits should also be treated as cash collateral when there is a currency mismatch, with the only difference being that under the FCCM a volatility adjustment for currency mismatch applies in line with Article 224(1) of the CRR, Table 4. We support this clarification and the proposal to amend Article 219 of the CRR as follows:

*Loans to and deposits with the lending institution subject to on-balance sheet netting are to be treated by that institution as cash collateral for the purpose of calculating the effect of funded credit protection for those loans and deposits of the lending institution subject to on-balance sheet netting ~~which are~~ **denominated in the same currency.***

### **Unrated debt securities**

It should be clarified that in the case of unrated debt securities against which there is eligible UFCP, the credit rating of the protection provider can be applied to the original obligor exposure, such that the external rating of the protection provider can then be used to assess eligibility of the debt security



in accordance with CRR Article 197(1). For example, where a bond has UFCP where the guarantor is the central government, the external rating of the central government should be used to assess the eligibility of the debt security being guaranteed.

### **1.3.5 Implementation challenges and administrative burden**

***103) Which elements of the revised of the CRM framework under the SA-CR, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.***

We recommend aligning the standardised approach to the IRB approaches with respect **to the collateral that can be considered eligible for credit mitigation purposes**. The alignment is of great importance given that the output floor is calculated as a percentage of the standardised approach (the difference between risk weighted assets under the IRB and the standardised approach does not reflect only discrepancies due to modelling practices, but also inconsistencies between the two frameworks in terms of credit protection recognition).

***104) Which elements of the revised CRM framework under the SA-CR, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

N/A

## **1.4 Credit Risk Mitigation – IRBA**

### **1.4.1 Unfunded credit protection (UFCP) – the treatment of AIRB exposures secured by SA-CR or FIRB guarantors**

***105) What are the costs and benefits of the revised treatment of AIRB exposures secured by SA-CR or FIRB guarantors? Please compare the approach under Basel III in terms of risk- sensitivity, comparability, impact on RWAs and operational burden with the current CRR treatment. Please provide relevant evidence to substantiate your views.***

**Application of the FIRB to financial institutions will adversely impact use of credit insurance products:** with the increase expected in RWs as a result of the restricted use of internal models, banks will continue to use, if not increase, credit insurance to mitigate the impact on RWs in the final Basel III framework. However, due to the fixed level of LGD (45%) under the F-IRB which banks will have to apply to financial counterparties such as insurers, this approach is likely to be hindered. It

should be recognised that benefiting from an insurance policy is not the same risk as being a creditor to an insurer. Indeed, the Solvency II regime ensures preferential treatment of insurance policy holders. Hence in the case of an insured deal, the bank taking it out would be treated as super senior, hence a 45% LGD would be an overstatement. Besides this, in the instance where the insured part of a loan benefits from an asset collateral from credit insurance, if the insurer has not fully indemnified the lenders, these insured loans keep the benefit of the asset in security which has to be reflected in RWAs. We note that from the June 2006 BCBS text through to the Dec 2017 BCBS revised Basel III text, all are silent on the treatment of deals which benefit from both a guarantee or an insurance **and** an asset in collateral. Therefore, we propose that for RW calculation banks have the option to take into account the PD of the insurer and the LGD related to the secured transaction if lower than that of the insurer, as the lenders retain full security over the asset in the case of the insurer defaulting. The LGD of the secured transaction should be kept in A-IRB as the fact that there is an insurance should not change the modelling of the collateral asset.

The F-IRB LGD could have wide reaching unintended consequences for the unfunded credit protection, given the majority of protection providers are financial institutions (insurers or banks). Moreover, it is important that insurance remains a way for banks to continue their role of structuring of loans in a European market which relies on bank financing. Reducing the use of internal models for corporates together with the new F-IRB constraint on insurers could lead to bank financing of corporates going down. The same issue of 45% F-IRB for banks guarantees would apply in the case of sub-participation in risk on a loan by a third-party bank.

**A-IRB exposures secured by SA guarantors:** In the case of A-IRB exposure values guaranteed by SA guarantors, it should be clarified that guaranteed portion of the RW should be calculated in accordance with SA-CR, whilst the guaranteed portion of the exposure should be calculated per A-IRB. This would ensure a consist treatment to A-IRB exposures guaranteed by F-IRB guarantors; for F-IRB guarantors, only the RW of the guaranteed part is determined according to the F-IRB approach, while the exposure value of the guaranteed part is based on the A-IRB approach i.e. own estimates of CCF may be applicable if the exposure is an off-balance sheet exposure.

***106) Would you deem further refinements or clarifications necessary in this context to ensure consistency across the Union? Please elaborate and provide relevant evidence.***

We would like to raise awareness on the implication of changes to the CRM techniques:

- In CRR2, usage of CRM framework for the purpose of the Large Exposure Framework will be aligned with usage for RWA purposes. The EC should consider and assess any unintended consequences.
- For the output floor calculation, banks will have to assess the RWA using the standardized approach for all of their exposures, meaning banks will have to implement CRM techniques

both in Standardised and IRB approaches. In addition to the implementation challenges and burden, there are still strong uncertainties on the outcomes.

#### **1.4.2 UFCP – relevant risk weight function and input floors to be used under the substitution approach**

***107) What are the costs and benefits of the revised treatment of UFC under the substitution approach? Please compare the approach under Basel III in terms of risk-sensitivity, comparability, impact on RWAs and operational burden with the current CRR treatment. Please provide relevant evidence to substantiate your views.***

With respect to the use of the **Substitution approach**, we welcome the clarification of Basel on the RW function to be used under the IRB. In particular, we welcome the specification that in the case of exposures under the F-IRB approach guaranteed by an IRB protection provider, that for the covered portion of the exposure the RW is derived by using the RW function appropriate for the type of the protection provider and by replacing the PD of the obligor with the PD of the protection provider. In relation to the treatment under AIRB, we would favour the possibility of using the RW function of the protection provider aligning the requirements with those foreseen for FIRB in paragraph 93 of the final Basel III framework. We believe the use of the RW function of the protection provider ensures consistency with the rationale behind the substitution approach, which is that the institution can treat the guaranteed exposure as if it were a direct exposure to the protection provider - this interpretation is also recommended by the EBA in their CfA (CR-IR25). However, the EBA also specifies that “the use of the substitution approach should not imply a change of the exposure class to which the covered part of the exposure is assigned”. On this aspect, we would raise some concerns as the migration of the guaranteed part of the exposure class towards the guarantor asset class should also be admitted.

Also, with respect to the substitution approach as it relates to a secured transaction (with eligible collateral) which also has unfunded credit risk mitigation, the CRR should clearly specify that the post-substitution exposure can be considered secured.

#### **1.4.3 Eligibility and treatment of conditional guarantees**

***108) What are the costs and benefits of the limited recognition of conditional guarantees? Please compare the approach under Basel III in terms of risk-sensitivity, comparability, impact on RWAs and operational burden with the current CRR treatment. Please provide relevant evidence to substantiate your views.***

- We are supportive of the EBA's recommendation with respect to the timely payment criterion and the continuation of guarantees considered eligible despite the payment being realised only after the end of the workout process. As such, the link between timeliness of payment and conditionality of the guarantees included in the final Basel III framework is not perceived as appropriate in the context of the A-IRB approach, where the timeliness of payment should be considered in modelling the effect of the guarantee on the risk parameters rather than as an eligibility criterion.
- The EBA makes proposed changes to the concept of irrevocability. In this context, we request confirmation that nuclear exclusions (which are market standard in credit insurance policies) do not render a guarantee either conditional or ineligible. This would allow for the new rules to maintain alignment with the BCBS (on excluding conditional guarantees) by extending the scope of non-conditional guarantees.

#### **1.4.4 Other provisions**

***109) In your view, which other aspects, if any, should be considered in the context of revising the CRM framework under the IRBA? Please specify and rank your answers from the most important to the least important aspect.***

We are concerned by the future impact on recognition of collateral in the modelling of LGD. The application of Input floor and haircut on AIRB models proposed within the Basel III revision framework is overly punitive, as the formula used to determine the floor considers the haircut according to the comprehensive approach (under the foundation approach), thereby leading to increasing capital absorption despite better quality collateral.

There are also several uncertain aspects for which greater clarity is needed so that banks can implement in their internal approaches to CRM:

- **PD input floor:** Clarification is required as to whether the PD floor of 0.05% will also apply in the context of PD substitution for guarantees received. Furthermore, paragraph 66 of the Basel agreement states the floor doesn't apply to Sovereign exposures, early confirmation of this approach would be welcomed (N.B. Paragraph 1.5.1 of the most recent BCBS Consultation clarifies that BCBS standards "retains the main features of Basel II" and which would also therefore confirm the absence of input floors.)
- **Double default:** The joint probability of default of an underlying obligor and a protection provider is smaller than the individual default by either party. This should continue to be reflected in the capital framework for the different forms of unfunded credit protection which can be used to mitigate

credit risk exposures. Examples include corporate or bank guarantees received in support of bank lending (both the obligor and the guarantor must default prior to a loss risk), or issuance of a Confirmation on Export Documentary Credits (both the Importer and the Issuing Bank must default prior to a loss risk), and Trade Credit Insurance policies which function in a manner similar to a guarantee received from an insurer. Removing double default from the choices for calculation of credit risk mitigation ignores the inherent diversification benefit where the probability of default of an obligor is not correlated to the probability of default of a security provider.

- **On-Balance Sheet netting (OBSN)** – The Basel 3 text requires that OBS is recognised in EAD under all approaches and removes the ability for it to be recognised by AIRB banks in LGD estimates. Improvements could be made to the drafting of the CRR in this area as it has led to different interpretations amongst banks on how to recognise OBSN under the AIRB approach. We support the Basel 3 change as recognition via EAD, as it better relates to this type of CRM.

- The CRR is silent on how **unfunded credit protection (UFCP) for specialised lending exposures** should be treated under the CRM framework. UFCP should be recognised for specialised lending treated under supervisory slotting via inclusion of a risk weight substitution method similar to that under the Standardised approach.

- The calculation of the LGD input floors uses a formula which requires institutions to use the haircuts under foundation approach and consequently means the collateral will need to be eligible under the F-IRB. This will significantly restrict the scope of eligible collateral compared to the current A-IRB framework for the purpose of the calculation of the LGD floor.

- **Supervisory slotting approach for specialised lending:** There is need for clarity on the use of how to take into account UFCP for the supervisory slotting approach. The CRR is silent on whether UFCP (other than those already specified in the slotting approach like completion guarantees or guarantees provided by public entities in PPPs), can be recognised for specialised lending exposures treated under supervisory slotting. The EBA's slotting guidelines also do not take into account the treatment of additional guarantees i.e. other than those already specified in the slotting approach, such as those provided by Export Credit Agencies for political and commercial risk or insurance policies covering the risk of a loan. Regarding ECA guarantees that effectively convert the guaranteed exposure to ECA or sovereign risk – we would like to understand how their impact can be reflected in the slotting approach, when the framework allows this to be done only through PD and LGD adjustments, but under the slotting methodology there is no PD/LGD to adjust. This anomaly could potentially be adjusted by either tranching the exposure in the context of ECA guarantees and risk weighting the guaranteed portion per the PD and LGD of the eligible guarantor, and using the Slotting risk weight for the uncovered portion and by revisiting the granularity of the of the slotting approach to allow for other risk mitigation to be reflected better in the risk weights.

In addition to the above, we acknowledge the progress made by the EBA in writing draft Guidelines on CRM. However, some areas should be reviewed in order to take into account an accurate profile of risk in assessing the exposure (see concerns laid out in question 105).

#### **1.4.5 Implementation challenges and administrative burden**

***110) Which elements of the revised CRM framework under the IRBA, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.***

N/A

***111) Which elements of the revised CRM framework under the IRBA, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

CRM approaches which are affected by the finalization of Basel III should be considered jointly with the changes related to the EBA's proposed GLs on Credit Risk Mitigation<sup>9</sup> for institutions applying the IRB Approach with own estimates of LGDs, to avoid excessive model volatility within a very short timeframe.

One of the main challenges will be achieving the required IRB changes (such as implementing the Guidelines) by the 2021 deadline, which will be further compounded by the changes to models which will come as a result of Basel III. Many EBA IRB repair model changes will be redundant once Basel 3 is binding. For example, the ability to model LGD and EAD is removed for certain portfolios, and, in relation to CRM, indirect exposures to guarantees not just insurance guarantees. As well as the preference to have certainty regarding the requirements over time, industry would welcome more harmonised implementation of changes within an acceptable and considered timeframe so that these can be incorporated in model (re-) development in one go instead of incrementally.

This request also reflects the fact that the current timeline for supervisors to approve models is long, often being drawn out over multiple years. In addition, ECB prioritisation of on-site inspections adds to the turnaround time for approving model changes. Generally, model approval changes take 12 months at best, more often than not 24 months +, especially where joint decisions are needed. Taking all of the points raised above into account, if there is to be an adjustment to the Guideline implementation deadline of 2021 to align with the Basel III implementation, the additional time

<sup>9</sup><https://eba.europa.eu/regulation-and-policy/model-validation/guidelines-on-credit-risk-mitigation-for-institutions-applying-the-irb-approach-with-own-estimates-of-lgds#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d>

available will need to be available to both banks and regulators. An adjustment for regulators alone will not give banks time needed to combine the Basel III reform and IRB repair changes to their models and make single applications per model to their regulators. Industry would welcome clarity on this from the EBA and Commission as soon as possible. This would be useful given the knock-on effect this may have on bank implementation programmes and planning, at a time where banks and clients are facing a number of uncertain headwinds.



## 2. Securities financing transactions (SFTs)

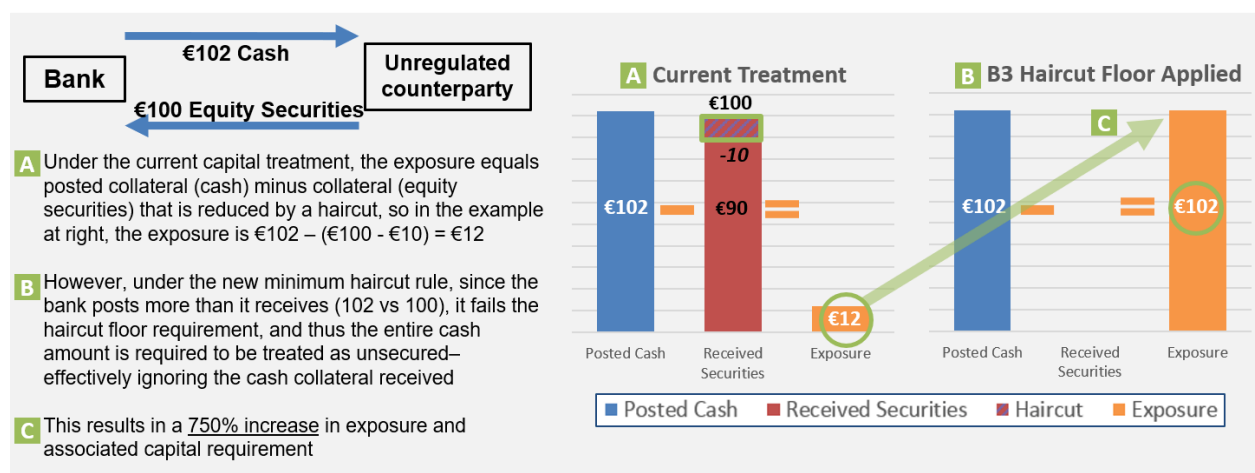
### 2.1. MINIMUM HAIRCUT FLOORS FOR CERTAIN SFTS

***112) How do you view the potential effectiveness of minimum haircut floors with regard to achieving their prudential objectives? Would the incentive provided by the framework be sufficient to encourage institutions to meet the minimum level of over-collateralisation?***

The associations and our members support the objectives of the minimum haircut framework for SFTs as envisaged by the FSB, which is “to limit the build-up of excessive leverage outside the banking system”.

The revisions to Basel III introduced the minimum haircut framework into the BCBS credit risk framework in a way that expanded the scope of transactions caught by the rules, which were not envisaged during the FSB consultation process. In addition, by addressing only transactions between banks and non-banks, implementing the Basel III framework as designed may result in more activity and intermediation transferring from banks to less-regulated institutions.

The treatment of failures to meet the SFT minimum haircuts requirements in the haircut framework does not consider the risk-mitigation benefits of collateral that has nevertheless been taken, but rather it imposes unsecured loan treatment. While it is appropriate to impose some penalty and there should be strong incentives for maintaining minimum haircuts, overly punitive capital charges such as those introduced by the minimum haircut framework cast an unneeded overlay on the SFT market by ignoring the risk-mitigating benefits of the remaining collateral. Such an approach is neither warranted by the policy goals of global standard setters, nor consistent with the overall capital framework and could unnecessarily dampen activity in this important market. The example in the picture below demonstrates the punitive nature of the rule.



**113) Would the introduction of minimum haircut floors particularly affect certain types of in scope SFTs or certain counterparties with which institutions conduct in-scope SFTs? If so, which effects would you expect and how could prudential regulation address them?**

While the minimum haircut framework seeks to limit leverage and, more specifically, “to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage”<sup>10</sup>, it does not sufficiently distinguish between those SFTs that are financings (and, thus, increase leverage) and those that are for another purpose. Many SFTs are done not to provide financing but rather to source a specific security and these transactions are not clearly scoped out from the minimum haircut framework. This unnecessarily impacts transactions that are outside the scope of global standard setter concern, thus unnecessarily limiting these important transactions. This issue may be addressed by specifically excluding SFTs entered into to obtain a specific security and where the cash is provided to the securities lender as collateral rather than as financing.

AFME’s global affiliate GFMA and ICMA analysed the impacts of regulation on repo markets, including the potential impacts of the SFT minimum haircuts. It concluded that unless revised, the SFT haircuts framework could increase SFT RWAs by 61% under the advanced approach and by 63% under the standardised approach, with over half of that impact coming from securities borrowing<sup>11</sup>. This would have detrimental impacts on the securities lending and broader financial markets:

<sup>10</sup> FSB: Transforming Shadow Banking into Resilient Market-based Finance, Strengthening Oversight and Regulation of Shadow Banking, Regulatory framework for haircuts on non-centrally cleared securities financing, 12 November 2015. <http://www.fsb.org/2015/11/regulatory-framework-for-haircuts-on-non-centrally-cleared-securities-financing-transactions-2/>

<sup>11</sup> <https://www.gfma.org/correspondence/the-gfma-and-icma-repo-market-study-post-crisis-reforms-and-the-evolution-of-the-repo-and-broader-sft-markets/>

- Securities lenders, typically long-term investors, may have to accept significantly lower returns for their portfolios due to lower demand;
- Dealer banks may not be able to provide the same level of liquidity in case their ability to borrow securities to meet client demand is limited due to the haircut rules;
- Short-sellers may need to seek out alternative ways to “short” securities and improve the price discovery process;
- Increased costs and reduced capacity for transacting with regulated counterparties could ultimately lead to increased costs for investors in pension funds and mutual funds.

***114) Would you deem further clarifications necessary, for instance, concerning the scope of application of the framework or the formulas that identify in-scope SFTs non-compliant with the minimum haircut floors? If yes, please specify.***

#### Regulated counterparties

The minimum haircut framework focuses on preventing the build-up of leverage in the non-regulated financial sector. It achieves this by imposing minimum haircuts on the provision of financing through SFT transactions which are not centrally cleared and in which the counterparty is a non-regulated entity. However, the description used to designate non-regulated entities---“counterparties who are not supervised by a regulator that imposes prudential requirements consistent with international norms”—is not clear and, in practice, would not allow for the exemption of SFTs between banks and appropriately regulated counterparties. Such counterparties may include broker-dealers, insurance companies, pension funds, 40 Act mutual funds in the US, EU regulated UCITS and other similarly structured open-ended funds. Indeed, this approach may include in the framework entities with a sufficiently robust regulatory overlay which specifically prevents the build-up of excessive leverage. A more targeted approach would specifically and clearly exempt entities that are already regulated and that have regulatory restrictions on leverage. This would better target transactions with the non-regulated sector that could contribute to the build-up of excess leverage.

#### Netting Issues

The minimum haircut framework incorporates a mechanistic netting formula, which in some cases leads to anomalous results (see annex A for examples). In some cases it would cause a transaction that on its own would meet the requirements of the framework to instead be treated as non-compliant because of the netting calculation. This approach fails to consider and capture the range of legitimate factors that influence asset and liability collateralisation practices and is fundamentally flawed. A more appropriate approach would be to develop a multi-step supervisory review process. Such an approach would consider the degree of under-collateralisation in an SFT, with enhanced capital requirements scaled in proportion to the size of the shortfall. This approach would both apply a penalty and incentivise proper risk management around the resulting exposure.

***115) As an alternative option to implementing minimum haircut floors for in-scope SFTs in the prudential framework as provided by the Basel III standards, such floors could be implemented via a market regulation. How would you compare the two alternative options in terms of achieving the prudential objectives? Would one of the two options affect more significantly the SFTs market? Please provide relevant evidence to substantiate your views.***

The Associations and our members believe that market regulation may have some benefits over the option of prudential regulation as it would also limit the build-up of excessive leverage between non-regulated entities rather than solely for transactions between banks and non-regulated entities. However, this approach does not on its own resolve the issue of the overly broad scope of entities to which it is applied, nor to the issue of SFTs (mainly securities lending/borrowing) that are not financing transactions.

We fully agree with the EBA that it is critically important for market functioning to ensure that the scoping of a potential market regulation approach is appropriate.

***116) In your view, which other aspects, if any, should be considered in the context of the possible implementation of minimum haircut floors in the Union? Please specify and provide relevant evidence.***

The main concerns, as explained in the above responses are the scope of regulated entities, scope of impacted products and the highly punitive impact of non-compliance.

## **2.2. OTHER REVISIONS TO THE CALCULATION OF THE EXPOSURE AT DEFAULT FOR SFTS**

***117) What are your views on the expected effects of these revisions with regard to risk sensitivity, recognition of netting, impact on RWs and comparability across institutions? Please provide relevant evidence to substantiate your views.***

In respect of minimising the impact of the SA on corporate financing through the adoption of a more appropriately risk sensitive framework, we would urge legislators to reflect on the risk associated with short-term exposures. Namely, RWs in the SA do not take into account short maturity as they do under the IRB maturity adjustment factor, which reflects short-term maturity as a risk mitigant. Only in the case of Exposures to Banks with original maturity < 3 months is a favourable RW is permitted. No such favourable RW is taken into account in the Corporate exposure category in Basel III. This will also significantly affect capital markets transactions such as SFTs, which are normally short-term exposures of < 1year and therefore the RW is counterintuitive given the shorter - and thus

safer - duration, and the overall SFT business. Legislators should therefore consider aligning the RWs for short-term exposures (e.g. for corporates) with that for banks with a < 3-month maturity.

***118) Would these revisions particularly affect certain types of SFTs or counterparties with which institutions conduct SFTs? Please support your view with specific evidence to the extent possible.***

N/A

***119) Would you face any operational burden to implement these revisions, particularly those revisions restricting the use of internal modelling? If so, please elaborate on the possible change and its underlying reasons.***

N/A

***120) In your view, which other aspects, if any, should be considered in the context of implementing the revisions to the calculation of the exposure value for SFTs in the counterparty credit risk framework? Please specify and rank your answers from the most important to the least important aspect.***

N/A

### **2.3. IMPLEMENTATION CHALLENGES AND ADMINISTRATIVE BURDEN**

***121) Which revisions related to SFTs, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.***

N/A

***122) Which revisions related to SFTs, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

N/A

## Annex A: Examples of anomalous outcomes resulting from the application of the Minimum SFT Haircuts formula

### SFT Haircut Floors: Netting Set Examples

Positive Value = Exposure/Provides Leg Negative  
Value = Collateral/Receives Leg Collateral A has a  
6% haircut floor

### Portfolio Haircut:

$$\frac{\sum C_t - \sum E_s}{\sum E_s} \geq f_{\text{Portfolio}}$$

### Portfolio Floor:

$$f_{\text{Portfolio}} = \left[ \left( \frac{\sum E_s}{\sum E_s \times (1 + f_s)} \right) \middle/ \left( \frac{\sum C_t}{\sum C_t \times (1 + f_t)} \right) \right] - 1$$

Netting Set 1 - Low Haircuts					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Repo (out of scope)	-98	100	-2%	N/A	N/A
Reverse Repo (in scope)	100	-103	3%	6%	Fail
Net trades	Cash	Collateral A	Haircut	Floor (f)	
Net Trade	2	-3	50.0%	6.0%	Pass

Net lent (Es)	2
Net borrowed (Ct)	-3
fs (net lent floor)	0%
ft (net received floor)	6%
Es/(Es*(1+fs))	1
Ct/(Ct*(1+ft))	0.943396
Divide then - 1	6.0%

Netting Set 1 demonstrates that low haircuts on both the in-scope and out-of-scope transactions can result in a large haircut on a net basis that exceeds the floor, highlighting the illogical outcomes of the framework

Netting Set 2 - Weighted Towards Repos					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Repo (out of scope)	-1000	1065	-6%	N/A	N/A
Reverse Repo (in scope)	100	-112	12%	6%	Pass
Net trades	Cash	Collateral A	Haircut	Floor	
Net Trade	-900	953	-5.6%	-5.7%	Pass

Net lent (Es)	953
Net borrowed (Ct)	-900
fs (net lent floor)	6%
ft (net received floor)	0%
Es/(Es*(1+fs))	0.943396
Ct/(Ct*(1+ft))	1
Divide then - 1	-5.7%

Netting Set 2 shows that because the in-scope reverse repo is part of a netting set with a large out of scope repo, the amount of collateralization required to pass the haircut floor on the reverse repo (12%) is considerably higher than standard market practices

Netting Set 3 - Weighted Towards Reverse Repos					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Reverse Repo (in scope)	1000	-1060	6%	6%	Pass
Repo (out of scope)	-100	107	-7%	N/A	N/A
Net trades	Cash	Collateral A	Haircut	Floor	
Net Trade	900	-953	5.9%	6.0%	Fail

Net lent (Es)	900
Net borrowed (Ct)	-953
fs (net lent floor)	0%
ft (net received floor)	6%
Es/(Es*(1+fs))	1
Ct/(Ct+(1+ft))	0.943396
Divide then - 1	6.0%

Netting Set 3 demonstrates that despite the in-scope reverse repo exceeding the haircut floor in isolation, when combined with a significantly smaller out-of-scope repo transaction, the net effect results in a haircut below the floor

Netting Set 4 - Error					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Repo (out of scope)	-100	104	-4%	6%	Pass
Reverse Repo (in scope)	100	-107	7%	N/A	N/A
Net trades	Cash	Collateral A	Haircut	Floor (f)	
Net Trade	0	-3	-100.00%	#DIV/0!	Error

Net lent (Es)	0
Net borrowed (Ct)	-3
fs (net lent floor)	0%
ft (net received floor)	6%
Es/(Es*(1+fs))	#DIV/0!
Ct/(Ct+(1+ft))	1
Divide then - 1	#DIV/0!

Netting set 4 highlights a mechanical problem in the netting formula when the bank provides and receives equal amounts of cash, creating a computational error on a net basis



### 3. Operational Risk

***123) How would exercising the discretion affect the link between capital incentives and management of operational risks? Please elaborate.***

The Industry believes that the European Commission should exercise the national discretion offered by the Basel standard and set the Internal Loss Multiplier (ILM) to 1, i.e. disapply it, for the entire EU. We provide our reasoning why the ILM should not be implemented in Europe below. If the co-legislators however conclude despite the reasons stated below to include the ILM into the EU framework, we recommend a phase-in period aligned with the implementation of the output floor to be applied. We will explain both the reasons why we strongly believe the ILM should be set to one and the fallback phase-in option in more detail below. We also provide a short section on the background of industry communications and positions during the Basel process at the end of this answer.

The industry prefers the ILM to be set to one in the EU

The Associations and our members believe that, despite the long preparation, the operational risk framework developed by the BCBS does not fully achieve all the stated objectives of the review, in particular because it does not promote efficient operational risk management. The framework lacks a forward-looking component that would allow for dynamic risk sensitivity and adequate capitalisation, especially on risk areas that have yet to materialise losses, such as in the cyber space, other new technologies, unauthorised activities and operational resilience. In our view, the regulatory framework in general should promote active and forward-looking risk management, adjusted to the bank's risk profile and appetite at any given time. Instead the new Standardised Measurement Approach relies solely on a size-based metric and an optional institution specific loss multiplier that draws on losses over the past 10 years.

Academic literature, expert research and empirical evidence suggests that past operational risk events are not an accurate predictor of future performance and thus the ILM is the wrong type of risk sensitivity factor:

- Curti and Migueis<sup>12</sup>, suggest that the information value of past losses, as predictors of future losses, reduces significantly as such losses become older than three years and that the frequency and severity of losses as indicators of potential future exposure behave differently.

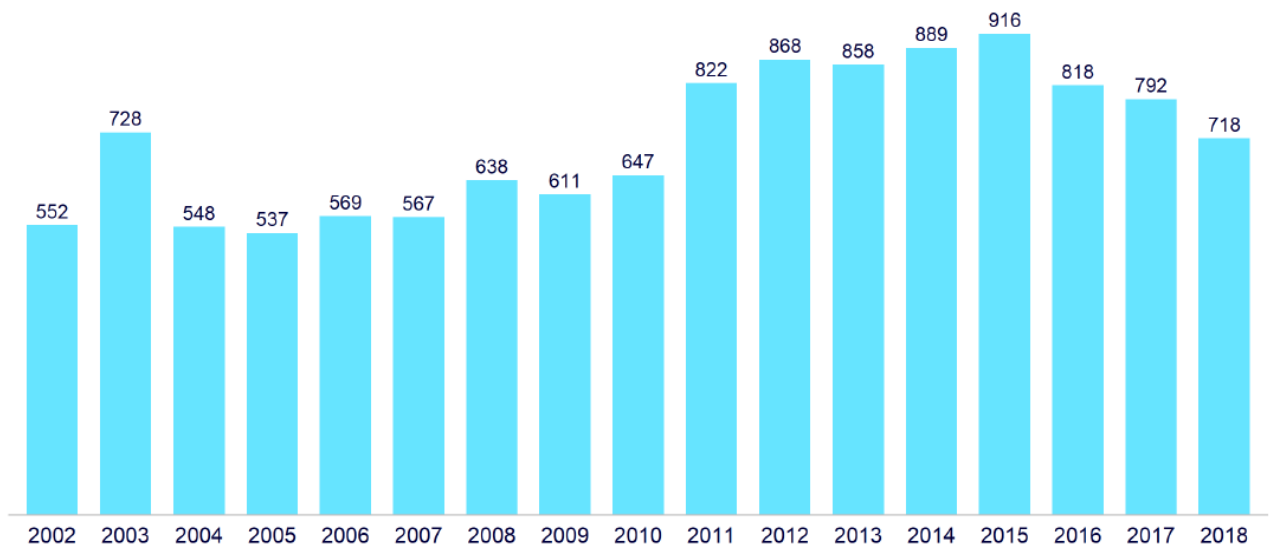
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<sup>12</sup> The information value of past losses in Operational Risk, April 2019: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3353446](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3353446)

While recent loss frequency data and changes in average frequency perform better as future loss indicators, the severity component is more volatile (for example, due to large conduct related fines) and thus is a less reliable indicator. Curti and Migueis observe that treating frequency and severity separately results in better information of likely future losses compared to relying solely on past loss totals, as the ILM does.

- The Institute and Faculty of Actuaries has noted the value of factors in addition to internal loss data in order to better estimate the appropriate level of operational risk. In particular, it observed that “a key limitation of both internal and external loss data is its historic perspective of loss exposure. A forward-looking perspective of operational risks is required, which has regard to changes both in gross exposure and in the controls environment. Business Environment and Internal Control Factors (BEICF) can contribute such a perspective.”<sup>13</sup>
- It is evident by observing the industry-wide operational loss history in the run up to the 2008 financial crisis that consistently low losses are not a safe predictor of ensuing upheavals. (see below tables mean annual loss frequency and mean annual gross loss from 2002 to 2018 for ORX banking members reporting operational risk data\*).

**Mean annual loss frequency per bank<sup>14</sup>:**

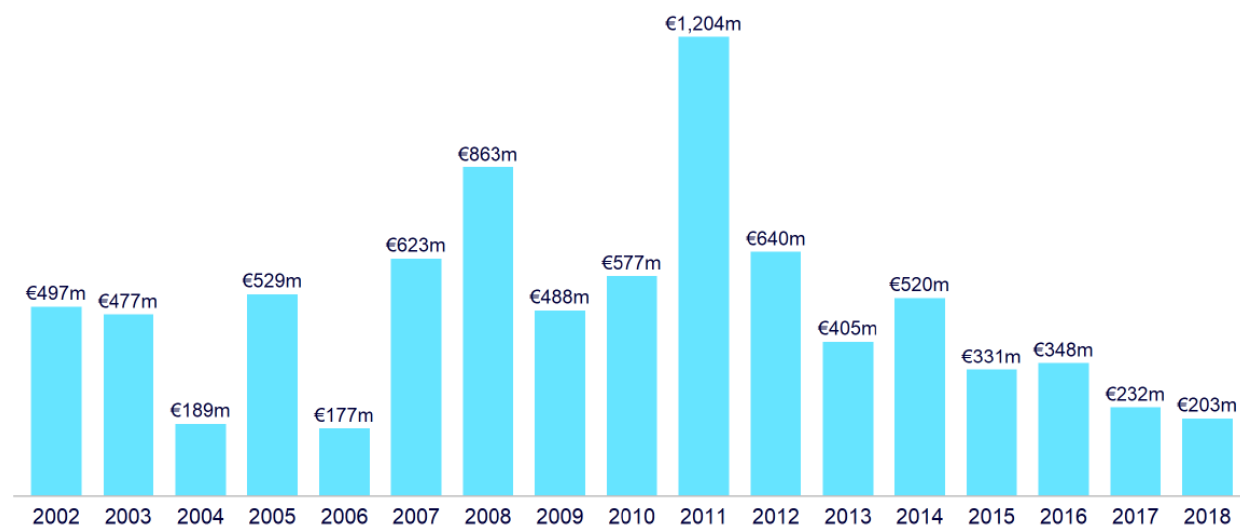


<sup>13</sup> <https://www.actuaries.org.uk/system/files/field/document/FINAL%20PAPER%20FOR%20WEBSITE.pdf>

<sup>14</sup> report from ORX available on request from <https://managingrisktogether.orx.org/loss-data/annual-banking-loss-report>

Source: ORX

**Mean annual gross loss per bank:**



Source: ORX

As shown above, the ILM and the underlying loss component draw on loss history of extended duration and of reduced information value. Indeed, the Operational Risk capital resulting from a variable ILM does not seem to reflect neither the quantitative nor the qualitative level of Operational Risk that banks are actually facing or are intending to assume through their business model, current and future exposures. In that point, the EBA Policy Advice<sup>15</sup> partially admits as much. It notes that *“[i]t is assumed that exposure to operational risks is increasing[...]; therefore, any gains in competitiveness that may result from setting the ILM equal to 1 in the short run for some banks could eventually be offset by insolvency issues or capital shortfalls in the long run.”* It is, however, unclear how the ILM, being backward looking, could help authorities and banks predict such increasing risks and how it could help to avert capital shortfalls.

The predictability of past losses and the lack of it relates to the changing external environment in which banks operate, while SA-OR seems to assume a static world. Indeed, past failures are often addressed by regulatory reforms, such as for instance the change in the calculation of benchmark rates (IBOR transitions), as well as Market Abuse, Senior Managers Regime (covering global FX code

<sup>15</sup> <https://eba.europa.eu/file/113256/download?token=R3Q2uetO>

of conduct in some jurisdictions) and the MiFID regulation that have directly addressed many of the conduct risks that were big contributors to past losses in the aftermath of the financial crisis. Although new methods could give rise to different problems, it is assumed that reforms ensure the same type of issues will not arise again. Conversely, the changing technological and economic environment brings forward entirely new risks, e.g. cyber-risks, which could at some point materialise in loss events for some banks.

The SA-OR with a variable ILM also fails to capture and even incentivise bank-specific improvements following loss events, apart from divested activities. Such improvements include revised risk management, enhanced legal analysis, additional client and transaction vetting on origination, increased training and compliance scrutiny. In fact, because of the 10-year duration, the SA-OR with variable ILM creates incentives for inertia in Operational Risk management in the short-to-medium term.

The question of incentives is of paramount importance for our membership. Indeed, the EBA Policy Advice observed “a certain persistency of a bank’s risk profile over time” but would not have been able to consider a counterfactual situation where a risk metric offers sufficient incentives for changing Operational Risk profile. Against this background, implementing a variable ILM in the EU could result in a misallocation of Operational Risk capital in both directions, i.e. undercapitalisation for some banks and overcapitalisation for others.

The Associations therefore recommend that the EU exercises the discretion provided in the Basel standard and sets the ILM at 1 across the Union. Such a metric would at least provide a common base on which banks would set their Operational Risk, using their size as a proxy, which is partially reflective of their exposure and activity.

Given the shortcomings of SA-OR<sup>16</sup> and to underpin the Pillar 1 capital requirements, the EU should consider a Pillar 2 framework to capture excessive and likely recurring losses, as well as forward looking institution specific risks related to cyber, technology and unauthorised activities. The framework should also contain recognition of risk management and risk mitigation, such as insurance policies. To make the framework consistently applicable, it should be well defined in the Level 1 text and through an EBA RTS mandate, as appropriate, to ensure that supervisors and banks have the tools to address operational risks more appropriately and consistently. The framework should appraise the approach to emerging risks, such as cyber and non-financial risks, which

supervisors are increasingly focused on. Transparency and objectivity of the criteria would ensure that it does not result in uneven playing field with other jurisdictions.

In addition, we believe that the SA-OR should be reviewed by the Basel Committee of Banking Supervision (BCBS), in order to improve the risk sensitivity of the international standard and provide incentives to active operational risk management. We expect the Basel Committee to do more work and consult on issues relating to operational risk as well as operational resilience in quarter one 2020.

#### Phase-in period as a second option

As explained above, we believe that the ILM does not introduce the right kind of risk sensitivity nor does it address the forward-looking regulatory concerns or incentivise prudent operational risk management. However, if the co-legislators conclude that the full ILM should be introduced in the European Union, we propose as a fallback option that a phase-in period as suggested by the EBA's advice, aligned with the gradual introduction of the Output Floor is applied.

Similarly, to the phase-in already planned for the output floor, the one for operational risk should introduce the BCBS SA-OR progressively over a 5-year period. This phase-in would allow for sufficient time to the financial institutions to fully comply with loss data collection requirements and implement appropriate strategies for management of operational risk RWAs based on the updated framework.

We believe that this is a simple way to introduce the SA-OR gradually, without a significant cliff-effect to some firms with larger historical losses.

#### Background

AFME's global affiliate the GFMA, together with the IIF, provided our feedback during the BCBS consultation process, highlighting how the proposed framework could be improved in various areas, such as better recognition of insurance protection and the use of a forward-looking risk component. However, we are supportive of the EU adopting the Basel standard and our comments on adoption of the rules relate to (a) the supervisory discretions available in the global standard and how they should be applied in the EU, and (b) some further operational concerns discussed below.

Several remaining issues relating to the international standard, which should be carefully considered in the European implementation as well as in the wider Basel process, include:

- The operational risk standard developed by the BCBS focuses on past concerns as it solely relies on a size-based historical financial data metric and past operational risk losses to determine the amount of regulatory capital to be set aside for potential operational risk losses in the future.
- The Internal Loss Multiplier (ILM) is based on past loss history and does not necessarily capture the operational risks that many of the supervisors are increasingly concerned about, such as cyber, technology, fraud/unauthorised activities and operational resilience.
- The ILM is also subject to volatility that can result in significant changes to the SA-OR operational risk capital requirements when large losses, due to, for example, regulatory fines, roll off the loss history. Finally, the standard's focus on past losses over a 10-year historical period provides little incentive for banks to change behaviour or innovate in the short- to medium term due to a missing link to risk management.
- There are also concerns that recording of operational losses is not standardised across the industry. The new framework's strong link to past losses cannot prevent further divergences amongst firms in recording and disclosing losses, leading to uneven playing field and divergences in capital measurement against otherwise similar levels of operational risk.
- To compensate for these weaknesses in the BCBS framework, significant supervisory discretions are provided in the BCBS operational risk rules, compared to the BCBS standards developed for credit and market risks. These discretions, however welcome by our members can lead to significant divergences across jurisdictions in the SA-OR's application and its results.
- In addition, as noted, the operational risk framework under the SA-OR separates from other risk categories by not recognising any forward-looking risk mitigation, such as insurance. The industry considers that the lack of forward-looking risk mitigation in the new standard is a flaw that could hinder the effectiveness of operational risk management and measurement.

Applying an insurance scheme, which in most cases has been validated by the supervisor, has multiple positive aspects and allows for the pricing of operational risk against a protection-selling third party with opposite economic incentives. The standard's recognition of insurance recoveries in netting past operational risk losses does not address the above-mentioned deficiency as it results in only past losses and recoveries being considered rather than taking into account the risk transfer allowed by an effective insurance framework. Hence, we recommend that the treatment of risk mitigation be revisited as part of the EU and global legislative processes.

***124) Would you deem it necessary to mitigate possible cliff effects that might derive from the introduction of an institution specific ILM? If so, which measures should be considered, for how***

***long should they be applicable, and what would be the prudential rationale to implement them?  
Please elaborate***

As explained above, we believe that the ILM does not introduce the right kind of risk sensitivity nor does it address the forward-looking regulatory concerns or incentivise prudent operational risk management. Therefore, the industry preference is to set the ILM to one. However, if the co-legislators conclude that the full ILM should be introduced in the European Union, our preferred option is to implement the SA-OR gradually, as per EBA's recommendation.

We propose that the potential phase-in period is in line with the Output Floor, as we highlighted earlier in this comment letter. We suggest a formula for calculating the phase-in period RWAs as:

- For each year  $i = 1, \dots, 5$ , calculate  $\Delta(i) = \max(\text{SA-OR}(i) - \text{Current}(i), 0)$
- Then **Capital Requirement (i) =  $\min(\text{SA-OR}(i), \text{Current}(i) + \text{percentage}(i) * \Delta(i))$**
- Where  $\text{percentage}(i)$  is an increasing function of the year  $i$ , such that  **$\text{percentage}(i) > 0\%$  and  $\text{percentage}(5) = 100\%$**

For the first 5 years of the application of the new framework (in case the new standard based RWAs exceed the current), a maximum capital increase is determined, with respect to the current methodology (either AMA or standardised approach), as an increasing percentage of the difference between SA-OR and current methodology the bank uses, reaching the full SA-OR calibration at end of the 5<sup>th</sup> year.

***125) What are your views on how a loss data threshold that is increased for some institutions may affect the soundness and risk-sensitivity of the operational risk framework, the volatility of the ILM, its comparability between institutions, and the incentive to carefully manage small to medium-sized losses? Please specify your views.***

We do not generally support diverging loss capture thresholds applied across the industry. However, with regards to the loss threshold, there may be instances where larger institutions should be subject to higher thresholds. At the same time, we highlight that smaller losses are already taken into account in the annual budget. Any potential deviations from a harmonised loss capture threshold should be very well justified and not result in any competitive disadvantages.

***126) If the discretion was retained, which conditions and criteria should be introduced in order to ensure a level playing field in its application by supervisors? Please elaborate.***

As mentioned above, the framework should consider what are expected and accounted for losses and unexpected losses that should be capitalised.



**127) Which threshold (EUR 20,000 or EUR 100,000) would better reflect the current threshold used for your loss data collection? Please elaborate and provide relevant evidence.**

This is institution specific question and as Associations we are therefore unable to fully respond to this question.

**128) What are your views on how this discretion might affect the overall level of own funds for operational risk of bucket 1 institutions and the comparability within bucket 1? Please elaborate your views.**

N/A

**129) If the discretion was retained, which conditions and criteria should be introduced in order to ensure a level playing field in its application by supervisors? Please elaborate.**

N/A

**130) If the discretion was retained, do you consider this could help smoothing the transitioning of institutions from Bucket 1 to Bucket 2? Please elaborate.**

N/A

**131) What are your views on the discretion for supervisory authorities to request the institutions to use less than 5 years of loss data (when the ILM >1)? In which circumstances would such a request be justified? Please elaborate and provide relevant evidence.**

We consider that currently, losses to be included in the ILM calculation diverge too much between institutions and using a 5-year period would even exacerbate those divergences.

Instead, we recommend maintaining the loss period at 10 years. This discretion should be exercised under BCBS conditions (d424 Paragraph 19 a): *“Internally generated loss data calculations used for regulatory capital purposes must be based on a 10-year observation period. When the bank **first moves to the standardised approach**, a five-year observation period is acceptable on an exceptional basis when good-quality data are unavailable for more than five years.”*

EU Supervisors should exclude specific losses from the loss history, based on the BCBS d424 (§27-28-29) discretion where excluding losses should be **rare, supported by strong justification, approved by supervisors and publicly disclosed**, with a broad scope of exemptions where “settled legal exposures and divested businesses” are presented as “examples”. However, the additional BCBS

constraints that “A request for loss exclusions is subject to a materiality threshold to be set by the supervisor ... losses can only be excluded after being included in a bank’s operational risk loss database for a minimum period to be specified by the supervisor...” seem not appropriate. Indeed, the amplitude and the implementation date of the remediation plans for instance are better indicators to trigger the exclusion of one exceptional loss.

**132) What would you consider to be the appropriate thresholds for allowing a request for exclusion of loss events from loss data history, for current and divested activities? Please explain and provide relevant evidence to substantiate your views.**

We do not support the idea that loss exclusions should be based on a threshold, the exclusion should instead be based on assessment that determines whether those losses are going to occur again given that they derive from interrupted businesses. If a certain class of operations has produced losses in the past and the entity has terminated the business operations, the size of those losses is irrelevant, as there is not possibility of them occurring again. We consider that the conditions should be based on the entity’s ability to demonstrate that the losses are not going to occur again.

**133) What would be in your view an appropriate minimum retention period for the losses that will be excluded from the loss dataset? What would be an appropriate starting point of this period? Please explain and provide relevant evidence to substantiate your views.**

The Associations and our members recommend aligning the retention period with the BCBS standard and the FAQ published by the BCBS as per below.

*Such losses should be excluded from the calculation of the loss component of the operational risk capital (ORC) immediately after the supervisory approval. If supervisors only require the operational risk standardised approach calculation to be updated annually, but the exclusion is approved prior to an intermediate (e.g., quarterly) update of the bank’s total risk-weighted assets that precedes the annual update of the operational risk standardised approach, banks should report the revised operational risk risk-weighted assets in the first update of total risk-weighted assets post-exclusion. Relevant provision: paragraph 27 of the framework (OPE25.30 of the consolidated framework effective as of 1 January 2022).*

**134) What are your views on retaining the aforementioned CRR provisions and adapting the corresponding CDR provisions with a view to maintain their binding status?**

Neutral.

***135) Does your institution already comply with the relevant requirements? Please list the requirements that are not currently applicable to your institution and whether there is any additional operational burden associated with achieving compliance.***

Neutral.

***136) Are there any concerns in terms of proportionality that you would consider important to raise? Which threshold would you consider appropriate for the applicability of the governance and organisational requirements? Please elaborate.***

Not relevant to our industry membership.

***137) What are your views on requiring the inclusion of the abovementioned elements (internal loss data, scenarios, external loss data and key risk indicators) in the ICAAP for operational risk? Please explain your reasoning in case of disagreement (separately for each element).***

Generally, financial institutions use the same type of model both in Pillar I and in Pillar II. With the introduction of the SA-OR, the link between risk assessment and regulatory capital will be broken. as Furthermore, the operational risk governance framework has evolved to go beyond the calculation of regulatory requirements over time.

However, we are not supportive of mandatory requirements in terms of internal capital computation. Indeed, as per the ECB's Guide to the ICAAP process of November 2018, "the purpose of the internal capital is to serve as a risk-bearing component under the economic perspective. Therefore, the definition of internal capital is expected to be in line with the economic capital adequacy concept of the institution" and "it is the responsibility of the institution to implement an adequate definition and methodology for its internal capital."

Secondly, and for the purposes of calculating and allocating the economic capital to the organizational units, we promote risk sensitivity in the form of comprehensive supervisory assessment at individual bank level to address any idiosyncratic forward-looking operational risks, whilst maintaining a capital safety net through a minimum and consistent level of Pillar 1. We recommend that supervisors establish more comprehensive forward-looking assessment for operational risk in the Pillar 2 capital framework as part of the supervisory toolkit. We would recommend that a Pillar 2 framework be forward-looking and allow for appropriate risk mitigation and control.

***138) Would you deem further refinements or clarifications necessary concerning the ICAAP for operational risk, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.***

See answer to question 137.

***139) What threshold would you consider appropriate for the applicability of the aforementioned ICAAP requirements for Pillar 2? Please elaborate.***

Neutral

***140) What are your views on the costs and benefits of using FINREP templates as a reference for a harmonised identification of BIC items in the EU? Please substantiate your views with relevant evidence.***

We deem appropriate to use FINREP templates as a reference for a harmonised identification of BIC items in the EU.

***141) What are your views on introducing a mapping table via Level 2 measures to allow for timely updates in case the corresponding FINREP standards change? Please elaborate.***

We broadly support alignment with the FINREP standards in order to reduce operational burden. Do we want to say anything else? Need to check with accounting departments

***142) In your view, which other aspects, if any, should be considered in the context of mapping BIC components and FINREP items? Please elaborate.***

N/A

***143) In your view, which other aspects, if any, should be considered in the context of revising the operational risk framework? Please elaborate and rank your answers from the most important to the least important aspect***

We strongly believe that banks should be incentivised to manage operational risk through investment in insurance policies, technology and process enhancements that would result in lower realised losses in the future.

We strongly support the inclusion of insurance into the SA-OR capital calculation to maintain the ability which is currently afforded under the AMA (20% RWA). This constitutes a recognition of the risk mitigation provided by insurance policies that is in both the previous BCBS (Basel II par 677) and EC (CRR Article 323(5)) standards. We would recommend that the CRR provides a mandate to the EBA to develop guidelines for such recognition to ensure it applies consistently across the Single Market.

Similarly, the framework has no risk sensitivity to any potential future losses that supervisors are increasingly concerned about, such as cyber, technology, unauthorised activities and operational resilience, while it relies solely on a size based metric and an institution specific loss multiplier that draws on losses over the past 10 years.

We understand that the Basel Committee is in process of releasing a consultation on operational risk and resilience during the first quarter of 2020. This consultation should focus on reviewing the ILM component, to better align it with information value of past losses and more importantly to emerging risks that the institutions are likely to face in the future.

***144) Which elements of the revised SA-OR, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.***

N/A.

***145) Which elements of the revised SA-OR, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

N/A.

## 4. Market risk

### Executive Summary

The Industry remains concerned by certain elements in the Basel III reforms and the significant impact the package will have on capital requirements for specific product and risk categories. The implementation of the Fundamental Review of the Trading Book (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.

The CRR II EU framework introduced a reporting requirement for market risk leaving the capitalization to be defined in the CRR III banking package as envisaged by this consultation. As firms prepare for both this reporting phase and for applying the market risk framework as a binding capital requirement, concerns on the impact remain significant. These concerns are supported by the EBA's Call for Advice report published in December 2018, which stated that the impact of the 2019 FRTB standard is, on average, 105% higher relative to current RWA levels for the same risks. Banks with internal models approach (IMA) approval, in particular, experience a 108% increase in RWAs under the FRTB standard. The results highlight that the issues identified in the IMA are still relevant, even if one assumes that banks' trading desks achieve the same level of approvals as under the current standard.

It can be expected that the model outputs evolve and new issues may emerge during the implementation process, which depends on the EBA developing a suite of RTSs in line with its planned roadmap. The Industry acknowledges that as firms' systems and interpretations improve, they may also unearth efficiencies that reduce the RWA impact. Nevertheless, even if taking into account such potential efficiency improvements, on balance, Industry anticipates that the intended 22% increase in market risk (MR) RWA estimated by Basel will be exceeded materially<sup>17</sup>.

Alongside the results from the EBA impact study and the incentives created by problematic IMA components (e.g. NMRF), the earlier implementation timeline for SA reporting equally accentuates concerns with some components of the SA.

The Industry wishes to highlight a few key topics which have been identified as priorities for remediation in the FRTB framework.

1. **Collective Investment Undertakings** (CIU'S / Equity investment in funds): various components of this framework raise significant interpretive and operational challenges. For example, the current look-through requirements in IMA and SA are operationally impracticable and as a result, the Industry recommends alternative approaches that provide more flexibility.

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<sup>17</sup> [https://www.bis.org/bcbs/publ/d457\\_note.pdf](https://www.bis.org/bcbs/publ/d457_note.pdf)

2. **EU Implementation:** a globally consistent and simultaneous implementation of the FRTB framework is a key concern and we urge the EC to take strong leadership in ensuring remaining issues are dealt with as much as possible in an internationally coordinated fashion.
3. **Residual Risk Add-On (RRAO):** the RRAO charge continues to be a concern with respect to its product scope, the risk insensitivity embedded in the aggregation and the potential double count across the SA framework.
4. **Correlation trading portfolio ("CTP"):** rules remain ambiguous and require further clarifications. The Industry stresses that decomposition for all exposure types across CSR and DRC is the only way to align capital outcomes within MR-SA with the underlying risk.
5. **SA DRC – LGD:** the Loss Given Default (LGD) of non-securitization instruments with multiple underlyings is inconsistent with the LGD of those with a single underlying; the framework is also missing an appropriate LGD for senior secured debt.

In addition to the above key topics, the recommendations found in the Industry response cover a variety of areas, and fall into two categories: (a) those where the CP specifically sought feedback and (b) those that have not been addressed expressly but nevertheless warrant attention. We list areas from category (b) under the response to question 147. These additional recommendations are included in order to better align the regulatory standards to risk management principles; our proposals mitigate inconsistencies, clarify ambiguity, and reduce operational complexity.

The concerns regarding implementation are compounded by the impact of the Output Floor (OF). It may cause the standardized approach (SA) to become the binding constraint for market risk, once banks allocate the increased capital costs down to the underlying business lines that create the additional capital requirements. The extent of the constraint imposed on banks by the OF has negative implications for the Basel Committee on Banking Supervision (BCBS) and EU regulators' objectives in their pledge to preserve the use of risk-sensitive internal models.

Additionally, the Industry reiterates that consistency is important both across European institutions and globally across regions. Therefore, whilst developed for Europe, standards should also align globally to avoid any unintended fragmentation. 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 would result in reduced capacity and fragmentation in the markets.

Lastly, the Industry notes the EBA recommendation published in its Policy advice on the Basel III reforms<sup>18</sup>, which advises the European Commission to mandate an RTS on the subject of hypothetical portfolio construction for CIUs (MR 13). We believe that additional prescription would in turn create operational constraints and increase the difficulty of implementation and therefore, the Industry does not support such a mandate to the EBA.

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<sup>18</sup> <https://eba.europa.eu/eba-updates-estimates-impact-implementation-basel-iii-and-provides-assessment-its-effect-eu-economy>



In the following section, we summarise our recommendations while bearing in mind the European Commission's objectives<sup>19</sup>.

#### I. Trading Book/Banking Book (Section 4.1 - Question 146)

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.

**Restrictions/ Capital surcharge resulting from TB/BB switch:** switches across the trading / banking book boundary that are outside the direct control of the bank should be exempt from calculating a Pillar 1 surcharge.

**ALM Mandate:** Trading / Banking Book re designation procedures are not suitable for efficient ongoing ALM activities.

**Net Short Credit / Equity:** the net short rule [RBC 25.6] should not cause hedges, such as CDS used to hedge credit exposures, to be reassigned into the trading book.

**CIU classification:** the rule that requires funds containing banking book positions to be classified as Banking Book clashes with Undertakings for the Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Managers (AIFM) directives<sup>20</sup>, which allow a certain amount of Banking Book investments in funds.

**De minimis exceptions to prescriptive lists:** Rigid enforcement of the prescriptive list would result in operational complexity and fragmentation of risk management without discretion for national competent authorities to permit firms to include some de minimis compulsory banking book instruments in their trading book.

**Legal impediment:** Banks may be forced to classify instruments, which are effectively Trading Book instruments into the Banking Book.

**Own credit spread (OCS):** Own issuances in the banking book should be exempt from any boundary discussion, as they are generated for funding purposes without trading intent.

**Prescriptions on the Accounting representation - bifurcation:** Accounting practices can vary among institutions and bifurcation should not be assumed as a necessary element of the regulatory representation and capitalization of trading book instruments.

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<sup>19</sup> Please also note that, where possible, the responses reference CRR II articles; in cases where the questions specifically ask for comment on Basel standards or where the topics discussed have not yet been transposed into law under CRR III, however, we instead reference the 2019 Basel standards.

<sup>20</sup> EU directive 2009/65/EC & EU directive 2014/91/EU.

**Internal risk transfers (IRTs):** the requirement for “exact” externalization of IRTs severely limits banks’ capacity to macro-hedge.

## II. Alternative Standardized Approach (Section 4.1 - Question 147)

The Industry feels it is beneficial to point out certain aspects relating to prescribed calibrations and methodological assumptions within the Standardized Approach.

**Risk weights:** Industry notes an overall conservative treatment of equity and commodity risk weights within SA.

**Collective Investment Undertakings (CIU’S / Equity investment in funds):** The SA treatment for equity investments in funds is very punitive (especially when they cannot be fully or partially decomposed) and this will contribute to a higher overall FRTB capital impact.

**Residual Risk Add On:** the 1% charge continues to penalize well-hedged portfolios. Only truly exotic underlyings should be subject to the RRAO charge.

**CTP:** there is an implication in the Basel FAQs that for the purposes of CSR, only a certain type of index exposure (single name) may be decomposed. Industry stresses that decomposition for all exposure types is the only way to align capital outcomes within MR-SA.

**Equity Maturity Mismatch:** Allow alignment of maturity of offsetting derivatives and equities to 3 month or to 1 year, so that derivatives <1 year do not result in net position risk if hedged with cash equity positions.

**SA DRC:** the prescribed LGDs for certain types of instruments under SA DRC do not factor in accurate recovery rates.

## III. IMA (Section 4.1 - Question 147)

The Industry highlights lingering issues within IMA, such as failures in the PLAT caused by well-hedged portfolios or Liquidity Horizon caps. We also state issues specific to the EU, such as inconsistencies in the implementation of Backtesting under CRR II.

**PLAT:** The Industry welcomes the revisions to the PLA test proposed by the BCBS and recommends that the regulator review the thresholds once banks can produce reliable data for Risk Theoretical P&L (RTPL) and Hypothetical P&L (HPL).

- Well-Hedged portfolios: evidence has emerged that portfolios with lower degree of hedging have a higher probability of passing the PLA test than well hedged portfolios. More specific evidence will need to be collected during the IMA reporting phase.

**NMRFs:** capitalization of NMRFs remains a concern and a source of uncertainty in the FRTB framework.

- Rho parameter – there is potential to adjust Rho to bring impacts in line with Basel’s 20-30% target for NMRFs.
- NMRFs in Backtesting – CRR II introduces an inconsistency with respect to the Basel text in excluding NMRFs from Backtesting.
- NMRFs in Expected Shortfall – there is a potential to improve operational efficiency and allow more adequate modelling by including NMRF in ES and preserving their capitalization as NMRF.

**PD Floor:** The Industry reiterates its proposal to remove the 3 basis-point floor for Sovereigns under DRC.

**Liquidity Horizons:** the Industry re-emphasizes the need to realign the wording of the article 325bd(4) on Liquidity Horizon capping with the original spirit of the Basel paper and keep the option to override the capping to avoid an artificial increase in broken hedges.

#### IV. CIUs (Section 4.3 – Questions 149 to 154)

The Commission has requested information on the implementation of the Basel rules on CIUs. The Industry finds that there are severe complications with the proposed approaches, as outlined below, and recommends amendments to the rules which would remove unnecessary levels of conservatism.

**Look-through Approach:** the Industry notes the significant operational complexity that this approach would entail, to the point of making the approach untenable, and makes the following recommendations:

- IMA – Industry recommends not imposing the look-through approach for IMA.
- SA – Industry recommends introducing sufficient flexibility, such as the usage of NAV sensitivities provided by third parties (CIU management companies), assuming such data is readily available.

**Mandate Approach:** the Industry notes the lower quality of risk management of this approach and its tendency to over-capitalize, as it does not factor in the diversification benefits of a fund.

**Unrated Equity Approach:** Industry believes that the most appropriate approach to the treatment of Funds under SA within the existing framework is to allow them to be treated along the lines of the equity indices.

- Introduce a dedicated bucket, in line with the equity index bucket (15% RW), for funds which meet prescribed diversification criteria (Article 325i).
- Additionally, consideration of the rules is required for IMA and SA DRC.

#### 4.1. Converting the reporting requirement into an own funds Requirement

**146) What considerations should be taken into account regarding the implementation of the revised trading book boundary?**

***Please specify and provide relevant evidence to substantiate your views.***

***a) Restrictions/ Capital surcharge resulting from TB/BB switch***

[RBC 25.14] imposes strict limits to the ability to move positions across the trading / banking book boundary at the bank's discretion after initial designation. In particular, the Basel rule seems to suggest that only re-designations at the bank's discretion, i.e. moves not required based on [RBC25.5 – RBC25.10], have to be subject to the process in [RBC 25.15 to RBC 25.16] (i.e., calculation of a pillar 1 capital surcharge, public disclosure requirement and senior management as well as supervisory approval). However, the industry is still concerned that FAQ1 & 2 to [RBC 25.15]<sup>21</sup> creates additional burden on banks' processes and infrastructure. We believe the intent of the rules is to standardize products or positions that ought to be subject to TB capital treatment and vice versa.

Examples of such switches triggered by the operation of [RBC 25.5 to 25.10] are fairly common, and might include: a listed equity becoming permanently delisted (TB to BB); information on a fund investment becoming available, such that it meets the criteria in [RBC 25.8(5)] (BB to TB). However, the process described in [RBC 25.15 and 25.16], which will be operationally challenging to implement and maintain, seems to be designed for moves between TB and BB initiated at the bank's discretion, which would be relatively rare.

**Industry Recommendation**

Switches across the trading / banking book boundary that are outside the direct control of the bank and triggered by the operation of [RBC 25.5 to RBC 25.10] should be exempted from the process described in [RBC 25.15 and 25.16]. This principle should be also clearly stated in the text.

***b) ALM mandate***

The industry appreciates that movements between Trading and Banking Books are not permitted as they could constitute regulatory arbitrage. However certain ALM activities require significant interaction between banking and trading books.

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<sup>21</sup> [https://www.bis.org/basel\\_framework/chapter/RBC/25.htm?tldate=20220101&inforce=20220101](https://www.bis.org/basel_framework/chapter/RBC/25.htm?tldate=20220101&inforce=20220101)

Generally banks designate centralized function to be responsible for measuring, monitoring, reporting and managing banks' liquidity, funding and structural interest rate and foreign exchange risks, as well as executing the banks' capital plan. Such centralized function contributes to the safety and soundness of financial institutions.

Such a function extensively interacts with the trading business, which transacts in products such as securities, derivatives, deposits and repo in their banking book portfolios. Neither the IRT treatment nor the re-designation provisions are fully suitable for allowing these ongoing ALM activities being carried out across the TB/BB Boundary, e.g. securities and repos for the liquidity buffer, and FX instruments for managing currency imbalances.

### **Industry Recommendation**

We propose an option for banks to have explicit recognition of ALM mandate under pre-defined policy to recognise the need for 'ongoing' transactions to be conducted across the TB/BB Boundary – and exempted for general requirements of instruments moving between regulatory books and internal risk transfer.

The following oversight and controls for ALM related activities should be in place:

- internal review by senior management and external approval by national supervisors for policies around ALM activities
- activities conducted in compliance with bank policy and fully documented
- periodic review of arrangements (i.e. annual)

### ***c) Net Short Credit/Equity in the Banking Book***

The BCBS 457 standards retain the mandatory TB classification of “instrument that would give rise to a net short credit or equity position in the banking book” with the original accompanying footnote.

A “net short credit position” (as defined) can arise in instances where credit default swaps (CDS) are used to hedge credit exposures (such as loans, commitments or other unfunded exposure) held in the banking book. The industry remains concerned that the implementation of this requirement may reassign hedges used to protect against default risk in the banking book into the bank's regulatory trading book activity. This reassignment would contradict other parts of existing regulations.

It is very important that a bank can continue to effectively hedge its loan portfolio to manage its risk. For that purpose, it requires certainty that this is recognized as a mitigant in capital calculation and would not increase capital costs and result in undue operational complexities.

Similarly, the definition of net short equity position penalises economic hedges of equity risk in the banking book. This is because the text defines a net short equity position as one where the “present value of the banking book increases when an equity price decreases”. The implication is that only single name hedges with an exact match of issuer are permitted to be included in the banking book.

Thus in circumstances where an exact match of issuer is not possible – for example, when seeking to hedge a portfolio of private equity investments – an economic hedge such as an index put option would be forced to get a market risk charge, thus disincentivising prudent risk management.

Industry view is that:

- (i) Net short credit position is interpreted as the combined credit position of loans and lending related commitments, along with their associated credit hedges in the Banking Book, as seen in FAQ 2 to [RBC 25.6].
- (ii) Net short equity position should be redefined to include scenarios where the “present value of the banking book increases when a group of equity prices decreases”, to allow economic hedges (where there is not an exact match of issuer) to remain in the Banking Book.
- (iii) The net short rule should not disincentivize hedging risks in Banking Book, e.g. by splitting hedges: loans and lending related commitments in Banking Book, and hedges in Trading Book. Such a split would lead to incremental capital charges.
- (iv) Indeed, both instruments (loan, lending related commitments + hedge) are part of the banking book with no trading strategy, and should be classified as such. Otherwise, the net short rule would result in bringing the banking book hedges into the trading book, which is in conflict with the credit risk mitigation rules (where these hedges are permitted to remain under the banking book classification).

The industry agrees that non-negligible net short credit or equity positions should be capitalised as Trading Book – complexity will remain in terms of aggregation with other Trading Book positions, but without forcing instruments to be re-classified subject to paragraph [RBC 25.16], which in this context imposes undue complexity / uncertainty around capital outcomes.

Managing credit risk or equity risk in the banking book is essential and undue complexity / uncertainty would disincentivize hedging activity, with ultimate consequences to provide financing to the economy

With regards to Net Short Credit/Equity in the Banking Book:

1. Industry recommends that the net short rule should not force credit or equity hedges (e.g. CDSs which hedge loans, commitments and other unfunded exposures in the banking book, or hedges where there is not an exact match of issuer, such as index hedges), into Trading Book.
2. Instead, non-negligible net short credit or equity positions should be capitalised as Trading Book – complexity will remain in terms of aggregation with other Trading Book positions, but not forcing instruments to be re-classified subject to paragraphs [RBC 25.15-& 25.16].
3. Industry also proposes replacing continuous monitoring with an assessment at inception and subsequent periodic monitoring, to balance the operational burden and ensuring adequate controls. Implementation details (definition of non-negligible, frequency of monitoring) should be left for banks to agree with supervisors.



4. Given the definition of “net short credit” will continue to evolve as this is a new concept under FRTB that such positions fit the TB “purpose”, we would recommend that paragraph RBC 25.10 (which allows some deviation subject to regulatory approval) to also apply in this circumstance as we believe that some flexibility would be required by national supervisors.

***d) Equity Investments in a Fund Trading/Banking Book Classification***

As set out in questions below, final Basel rules regarding Equity Investment in Funds allow funds where look-through is possible to be subject to IMA treatment, and funds where a daily price and mandate are available, to be subject to the SA. If neither is possible, rules require banking book treatment.

However in Paragraph [RBC 25.8] there is a requirement that equity investments in a fund that:

- (i) Contain Banking Book positions (with no de minimis exception) would cause the entire fund to be classified as Banking Book, per [RBC25.8(7)]
- (ii) Are “Hedge funds” would be classified as Banking Book, per [RBC25.8(6).]

Given the IMA/SA treatment rules, there is no need to include [RBC 25.8(6) or (7)] on the banking book prescriptive list in the EU text. Furthermore, including these will conflict with UCITS and AIF directives which allow certain amounts of investments that would be considered banking book.

**Industry Recommendation**

1. Hedge Funds should be excluded from the Banking Book list when [RBC 25.8] items are proposed into EU text
2. A fund’s de minimis Banking Book exposures shouldn’t preclude firms from classifying that fund into TB. This prescriptive list item [RBC 25.8(7)] should also be omitted.

***e) De minimis exceptions to prescriptive lists***

In the past, the industry has suggested that prescriptive lists, such as those in [RBC 25.6 and 25.8], while useful as a guide, are overly restrictive and instead the rules should focus on intent. We would like to highlight the following examples where the rigid enforcement of a prescriptive list results in operational complexity and fragmentation of risk management. These examples are not intended to be exhaustive:

***(i) Unlisted equities – [RBC 25.8(1)]***

While in many cases the requirement to place unlisted equities in the banking book is unproblematic as there may not be any trading intent, in some cases a holding in an unlisted equity can arise out of genuine trading activity. An example of this would be a distressed debt trading activity which largely trades in distressed and defaulted loans, but where holdings in unlisted equities arise as a result of loan workouts and the conversion of debt into equity.



*(ii) Equity investments in a fund – [RBC 25.8(5)]*

A common activity for a bank's trading book is to meet client / investor demand for fund-linked derivatives, such as an option on a fund or a TRS on a fund. In order to hedge such derivatives, a bank will often purchase the underlying fund so that the market risk is neutralised. Where the vast majority of funds on which a bank provides such services are trading book eligible (i.e., there is adequate look-through or daily price quotes) but a handful of positions relate to non-eligible funds (e.g., there is no look-through and the fund only prices weekly) it would seem disproportionate to force a bank to set up a separate banking book for the non-eligible positions.

**Industry Recommendation**

Assuming CRR III follows the Basel approach of having prescriptive lists, it would be helpful if there was some discretion for national competent authorities to permit firms to include some de minimis compulsory banking book instruments in their trading book where these are managed as part of an integrated trading strategy with similar instruments in the trading book.

*f) Legal impediment*

[MAR 25.3] cites that "Banks may only include a financial instrument, instruments on FX or commodity in the trading book when there is no legal impediment against selling or fully hedging it." This wording represents a change from Basel 2.5.

**Industry recommendation**

Lock-ups or time-limited trading restrictions would not necessarily be considered a legal impediment for these purposes. Otherwise, banks may be forced to classify instruments, which are effectively Trading Book instruments, into Banking Book. When trading restrictions no longer apply, banks will need to re-classify these instruments into Trading Book, which in turn will be operationally very complex.

*g) Treatment of Own Credit Spread*

CRR II Article 327, and similarly BCBS [MAR 11.5.1], seem to maintain that Own Credit Spread (OCS) risk should not contribute to the Market Risk capitalization.

Industry view is that OCS should be excluded from Market Risk capitalisation, otherwise simulation of OCS would clearly be detrimental of the quality of the resulting Market Risk figures in that:

- an instrument issued for funding purposes would be influencing the market risk measurement of the trading book
- scenarios where the credit quality of the institution improves would generate a loss
- this loss could potentially dwarf any other loss scenario in case the issuance size is significantly higher than the Trading Assets.

Additionally, for own liabilities issued out of the Banking Book (i.e. funding rather than trading intent), which naturally embed a short credit position in OCS, absence of OCS exemption could lead to further ambiguity around the quantification of the net short credit position as in RBC 25.6(2).

**Evidence.** It was observed that for an institution with MR RWA/ Total RWA ratio <5% the inclusion of OCS in market risk capitalisation would lead to a manifold increase of the MR RWA (dependent on the size of the issuance), with a left tail fully dominated by scenarios of OCS tightening. The stressed window was also shifted to a period of markets rallies and credit spread compression.<sup>22</sup>

### **Industry Recommendation**

The Industry recommendation is that OCS is excluded from Market Risk capitalisation, and therefore e.g. from the quantification of the net short credit position as in [RBC 25.6(2)].

#### *h) Prescriptions on the Accounting representation: Bifurcation*

**Paragraph [RBC 25.6(2)]** presumes that options including embedded derivatives be trading book instruments. Note 5 clarifies that embedded derivatives are components of hybrid notes that **should** be bifurcated.

**Industry Recommendation:** Bifurcation (or any other accounting representation) should not be assumed as a necessary element of the regulatory representation and capitalization of trading book instruments.

Accounting practices can vary among institutions and there cannot be an expectation that they are changed to comply with a Prudential Regulation. In particular, a change in such representation would mean the re-statement of the public accounting records of the Bank, which is clearly not possible.

Similarly, different accounting representations effectively yielding the same economic result (e.g. IRT that emulate the effects of bifurcation) should not be discriminated.

#### *i) Restrictions on IRT*

Internal Risk transfer is only allowed between Banking and Trading Book and it should serve the purpose of moving market risk where it can be better managed and hedged, i.e. Trading Book.

Under the 2019 Standards, it is often required that for an IRT to be recognized for regulatory capital purposes an exact externalization must eventually be carried out from the TB to the Street. This type of restrictions seems to be defeating the purpose of a BB→TB IRT since the TB would then not be managing the risk but would simply externalizing it.

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<sup>22</sup> The above is an indicative generalization, observed by institutions in the Industry working group. More details available upon request.

Additionally this is in many respects different from the current Banking practice and would hence require changing business models and managing legacy position towards the new standard, sustaining significant unwinding costs.

Spillovers on the Business are expected in that exact externalization (i.e. micro-hedging) will on the one hand **reduce natural hedge opportunities** within the TB and on the other hand will require **frequent access to the OTC market** with all the **costs** ingenerated by the need to find a Counterparty willing to exactly match the payoff to be externalized.

#### **I. Equity/Credit positions in the Banking Book ([RBC 25.21])**

When a bank hedges a BB equity (credit) exposure via an IRT to the TB, paragraphs [RBC 25.21 (1) and (2)] provision that the equity (credit) exposure in the banking book is deemed to be hedged for capital requirement purposes **if and only if** the trading book enters into an external hedge from an eligible third-party protection provider that **exactly matches the IRT**.

**For Banks that issue equity/credit linked structured notes from the Banking Book** this requirement – when read in conjunction with the prescription that net short equity (credit) are not allowed in the BB – effectively requires the **perfect externalization of such risks**, without any possibility to manage them from the Trading Book.

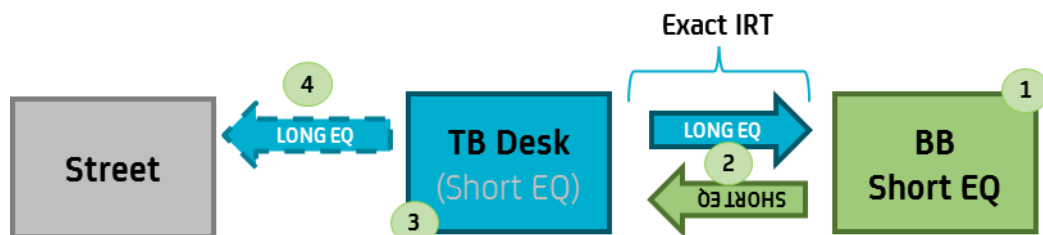
**For Banks that issue equity/credit linked structured notes from the Trading Book** the prescription would instead not be binding in that no IRT would be required to manage those risks.

#### **Relevant Evidence.**

- It is not uncommon for Banks to issue their **Own Liabilities** from the **Banking Book** (short Credit risk) and these can also be **equity linked** (short Equity risk) such as **Certificates**. When the bifurcated representation is not employed (host note + derivative), **IRT** is used to transfer risk where it can be **managed**: the Trading Book.
- The IRT is typically as accurate as possible in trying to insulate the equity linked component from the note and transferring it to the Trading Book. This is effectively a sort of **synthetic bifurcation**<sup>23</sup> where the (short) equity risk is fully transferred out of the BB into the TB and only the hosting note is left in the BB. The accounting representation would however still see the structured note as a unique element.
- In these situations **exact externalisation** of the IRT on the OTC Market is however **never the case**: it might be difficult to find a Counterparty willing to exactly match the pay-off of the Certificate or the price at which it can be willing would **spoil the economics** of the deal.
- In case the IRT is not recognised, the short EQ Position would stay in the BB and existing hedges would all of a sudden become naked open positions

<sup>23</sup> Clearly, as per fully-fledged accounting bifurcation, not all the structured notes allow a clean split between the embedded derivative and host. E.g. the hosting note of an Autocallable will still have its maturity linked to the level of the related equity exposure. This effectively means we can have a small net short equity (or credit) position sitting in the Banking Book without any means of transferring them to the Trading Book.

- However, according to [RBC 25.6], this is not possible and the whole structured note would need to be included in the Regulatory TB with all the undesirable consequences of having an own liability credit spread included in the risk measures (unless exception is granted).



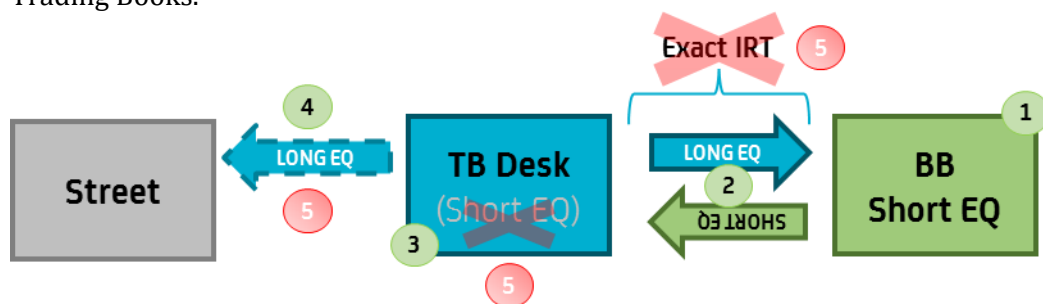
1. EQ Certificate Issued from BB
2. Exact IRT of the Short EQ Risk
3. As a result Short EQ Risk in TB
4. In case exact externalization IRT valid

**Equity Linked Liabilities** are popular forms of stable **Funding** for banks (maturity around 5Y), are typically MREL eligible and offer a **yield enhancement** associated to **capital protection** to investors. This makes them very appealing from a variety of points of view.

In practice the TB Desk actively manages the risk transferred from the BB through delta hedging and pays Own Funds Requirement proportionally to the residual open risk.

Requiring perfect externalization of such short equity (object of the IRT) would completely spoil the business in that **hedging costs** would undermine the profitability of the placements.

Additionally, if we look at the request from an Industry perspective the risk would simply be sitting in another balance sheet rather than de-risked, increasing the interdependencies among the banks' Trading Books.



5. In case TB position is **Delta Hedged** only, the **IRT is not valid**. The TB has a naked Long EQ exposure with the Street and the Short EQ stays in the BB

Since notes are medium-long term, they come into force of an obligation of full externalization **will pose serious problems in the management** of the legacy positions that would require the identification of Counterparties for the micro-hedging in a context in which all the OTC players will be facing the same issue.

Clearly the accounting treatment cannot be changed after origination of the Liability, i.e. **fully-fledged accounting bifurcation** cannot be introduced for the existing stock, since it would require the restatement of past Financial Statements.

#### Industry Recommendation

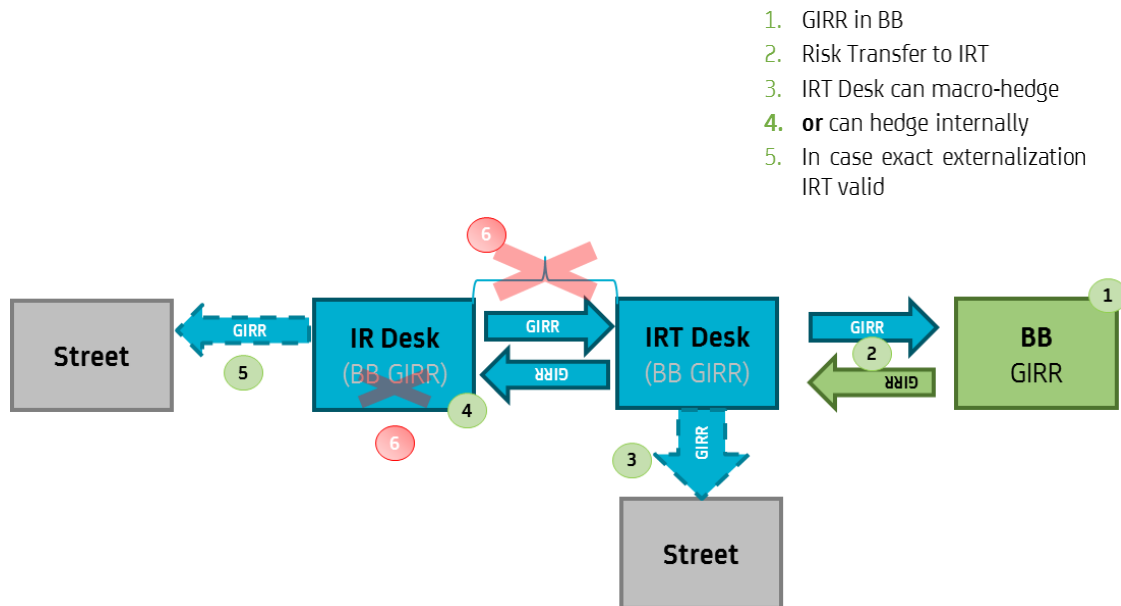
- Once a IRT has successfully transferred relevant risks from the BB to the TB, there should not be any additional restriction (i.e. exact externalization) in the way Trading Book manages its risks, as long as any open risk is properly capitalized.
- Indeed an accurate IRT of the equity(credit) risk **effectively operates as a synthetic bifurcation** that should not attract additional constraints.
- This is essential for effective handling of existing stock of (i.e. certificates that were not initially issued under a bifurcated accounting representation) that would give rise to net-short equity exposure in the BB in case the IRT was deemed not valid. This would attract the whole structured note in the Regulatory TB (25.6), with all the undesirable consequences of having an own liability included in the risk measures, unless specific **exemption** is granted **along the lines of CRR II Article 327**.

## II. GIRR Internal Risk Transfer Desk ([RBC 25.26 & 25.27])

Paragraphs [RBC 25.26 and 25.27] set the rules for the IRT of IRRBB and in so doing require that any internal risk transfer between the IRT Desk and other Trading Book desks can only be considered for Regulatory Capital purposes in case of subsequent **exact externalization**. Additionally, IRT Desk has to be capitalized on a **stand-alone basis**.

As for the Equity/Credit restrictions, these requirements will pose serious issues to existing banking practices since, whenever IRRBB is transferred to the **TB** to be (macro) hedged, it is not uncommon that:

- any natural-hedge opportunity available across other desks in the TB is exploited, before deciding the exact size of the externalization;
- different TB Desks, according to the type of risk being externalized, are used for the (macro)-hedging. E.g. short end of the curve handled by Treasury, long end of the curve by Flow Rates Desk, optionality by Vanilla Rates Desk.



1. GIRR in BB
2. Risk Transfer to IRT
3. IRT Desk can macro-hedge
4. **or** can hedge internally
5. In case exact externalization IRT valid

6. In case IR Desk **Delta Hedges** only, the **IRT is not valid**. The IR Desk has a naked GIRR exposure with the Street and the transferred BB GIRR stays instead in the IRT Desk.

### Relevant Evidence:

[RBC 25.27] allows IRT Desk to close internal deals with other Desks: “Alternatively, the internal risk transfer desk may obtain the external hedge from the market via a separate non-internal risk transfer trading desk acting as an agent”; with the condition, however, that the Desk **perfectly externalizes** it with the Market.

This last requirement **spoils any natural hedge** opportunity inducing the insurgence of **hedging costs** that would not be otherwise sustained by the Bank. It can even create the odd situation where the IRT desk closes with the Market a hedging trade  $T_1$  while a different Trading Desk closes with the Street the opposite hedge  $(-T_1)$ , crossing the Bid/Ask twice rather than matching the risks in house.

Also in this case Industry as a whole would not be de-risked: risks will be moved around increasing the interdependencies among the Bank’s Trading Books.

The internal trades between IRT Desk and any other Trading Desk can be equally documented as those between Banking Book and IRT Desk so the visibility on how IRRBB is managed can be easily preserved.

## Industry Recommendation

The goal of having visibility on how IRRBB is transferred to the TB is well understood, and so is the requirement to have a centralized desk handling it. Nevertheless, Industry would strongly encourage an approach that minimizes the costs (e.g. hedging) implied by the transition to the new set up.

This can be achieved by **not requiring the exact externalization** of any IRT between IRT Desk and other TB Desks but rather an **accurate documentation** of the risks being transferred, similarly to what is prescribed in [25.25(1)]

**147) What considerations should be taken into account in implementing any other revised elements of the FRTB framework, finalised by the BCBS in 2019?**

*Please specify and provide relevant evidence to substantiate your views.*

## Standardized Approach

The revised SA published by the BCBS in January 2019 addresses many shortcomings of the earlier standard, which has been acknowledged to have been more conservative than intended. The Associations strongly supports the proposals to increase the risk sensitivity of the SA, however we believe that further changes are necessary to avoid further reduction in bank market-making capacity, along with ensuring that the SA remains a credible fall-back to the internal model approach.

### a. Risk weights

#### i. Equities

At the risk class level, the industry notes the over conservative treatment within the SA. In particular, equity risk weights have not been reduced in the final FRTB framework, which was expected from the March 2018 BCBS consultation paper<sup>24</sup>.

#### Related Evidence:

If we focus on the pure Equity Risk, as represented in the new framework by the marginal EQ Expected Shortfall (x 1.5)<sup>25</sup>, and we compare it to the pure EQ-SBA charge that results from the

<sup>24</sup> <https://www.bis.org/bcbs/publ/d436.pdf>, BCBS, Revisions to the minimum capital requirements for market risk.

<sup>25</sup> IMCC capital is obtained by scaling ES by 1.5. This is to be consistent when performing the comparison with SA with the way in which ES is used in the IMA.



2019 Standards risk weights, a **real life Equity Business Line**<sup>26</sup> would be showing these proportions (excluding the Funds Business).

OFR	ES-EQ	2019 EQ RW	2018 EQ RW
Equity Business	1	4.39	3.20

### Industry Recommendation

Revise the Equity risk weights to be in line with the March 2018 BCBS CP proposal.

#### ii. Commodities

Forward markets provide a stronger conceptual and empirical foundation for calibrating FRTB SA risk weights for Electricity and Natural Gas than spot markets. Market participants often hedge their forward commodity exposure:

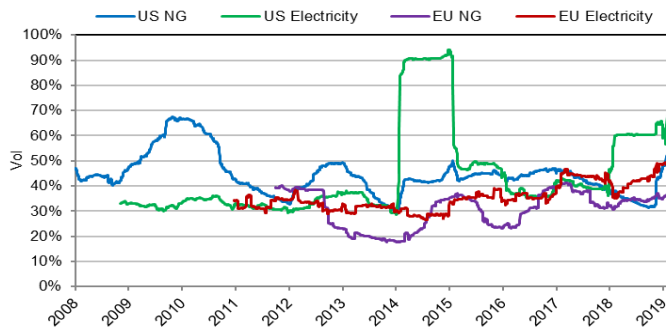
- To plan for future capital expenditures, such as power plant construction.
- Electricity wind farms may execute ten-year energy forward contracts with banking organizations to “lock in” supply prices in support of lending covenants necessary to obtain financing for building new turbines.
- In addition, banking organizations’ energy derivative exposures typically have maturities far beyond day-to-day fluctuations in spot markets.

These medium- to long-term plans require hedges in the corresponding time frame. We recommend that FRTB SA risk weights represent the periods of risk being managed rather than spot market prices

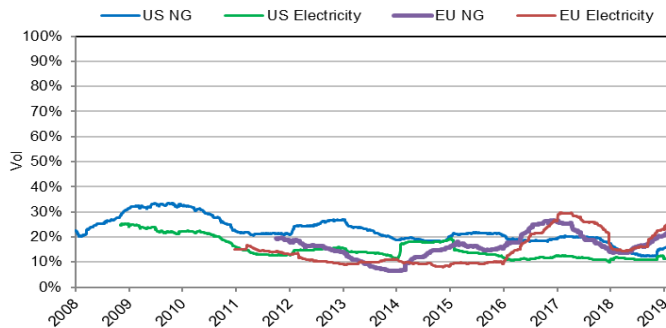
Electricity and Natural Gas over the historical period have demonstrated relatively low volatility when measured using forward market history (see charts below)<sup>27</sup>.

<sup>26</sup> Additional details upon request. The figures are indicative results based on a consensus of Industry member feedback provided to the FRTB Working Group.

<sup>27</sup>Source for US NG (Henry Hub), US Electricity (PJM peak), EU NG (NBP) time series: Morgan Stanley internal data; source for EU Electricity (German baseload) time series: Bloomberg; For two-year forward EU Electricity (Germany baseload) uses a front two calendar year assumption, rather than nearby 24 months used for US Electricity (PJM peak)



**Energy asset class front month contract market volatility**  
(November 2008-December 2018)



**Energy asset class front two years forward market volatility**  
(November 2008-December 2018)

Both the final FRTB rules and previous Basel Committee releases have stated that the calibration of risk weights in the sensitivities-based method is intended to be consistent with stressed ES calibration, accounting for variations in liquidity horizons.

This consistency holds if the risk weights for each bucket are chosen such that  $RW \approx 2.33 * \sigma_{LH}$ , where  $\sigma_{LH}$  is the volatility of risk factors in a bucket over the prescribed ES liquidity horizon (20 days for Energy and carbon emissions trading price)<sup>28</sup>.

<sup>28</sup> Based on BCBS intent to match RW calibration to stressed ES calibration: *Minimum capital requirements for market risk*, MAR21.40 (January 2019 (rev. February 2019)): “The prescribed risk weights and correlations in [MAR21.41] to [MAR21.89] have been calibrated to the liquidity adjusted time horizon related to each risk class.” and *Explanatory note on the revised minimum capital requirements for market risk*, Section 3.3 (January 2016); (rev. February 2019); assuming normal distribution of returns.

This relationship can be adjusted using time scaling similar to the ES approach to  $RW \approx 2.33 * \sigma_{250} * \sqrt{(LH/250)}$ .

Evaluating ten calendar years of market data to identify the most stressful periods of market volatility in the average two-year forward contract markets involving electricity and natural gas and converting to corresponding FRTB SA RW using the above formula supports that a risk weight of 20% for a new **combined** bucket is still conservative:

Asset category	Calendar year of greatest volatility	St. dev of forward markets in calendar year of greatest volatility	Implied FRTB SA risk weight	FRTB prescribed risk weight
<b>Electricity</b>	1/1/16-12/30/16	26%	<b>17%</b>	<b>60%</b>
<b>Natural gas</b>	1/1/09-12/31/09	32%	<b>21%</b>	<b>45%</b>

While calendar years are used for ease of reference, the results of forward market data would be broadly consistent across any two-year time series within the 2008 to 2018 period. Historical correlations of North American Electricity and Natural Gas are found to be greater than the prescribed correlation parameters, even if they are moved to the same bucket.

### Industry Recommendations:

Risk weights have the highest impact on Commodity capital charge and as such, we recommend that:

- the FRTB SA Electricity and Natural Gas risk weights are reduced to 20%;
- buckets be revised such that commodities currently in Bucket 3 and Bucket 6 be placed in the same global bucket, subject to a risk-weight of 20% and a minimum intra-bucket correlation factor of 75%.

### *b. Collective Investment Undertakings (CIU'S / Equity investment in funds)*

We appreciate the European commission has specifically raised this as a topic per chapter 4.3 of the consultation paper, however we wish to reiterate more specifically the impact from the SA rules, which have been negatively affected by the final changes in the FRTB standards. Given the possible interpretation of the latest standards that such CIUs are eligible for inclusion in IMA only if they are decomposed as if its constituents were directly held by the bank (where there is concern that such an approach has significant operational complexities associated with implementation), some banks may have included non-Look-through CIU positions in SA. Since the SA treatment for equity investments in funds is very punitive (especially when they cannot be fully or partially decomposed), this will contribute to a higher overall FRTB capital impact.

We would like to furthermore draw attention to ongoing developments, both at the industry-level and BCBS, where a global FAQ process is underway to address interpretation ambiguities or potential rule “deficiencies” stemming from the final FRTB requirements published in

January 2019. This FAQ process, led by ISDA, coordinates across global and regional banks to consolidate feedback on where BCBS text needs to be further clarified. This feedback was shared with the market risk group (“MRG”) at BCBS at the end of June 2019<sup>29</sup>.

### **Industry Recommendation**

Revise treatment of CIUs in line with recommendations in Section 4.3. “Treatment of investments in collective investment undertakings (CIUS)”

#### **c. *Residual risk add-on (“RRAO”)***

The Associations would also like to highlight that the RRAO continues to be a concern, and note that the lack of risk sensitivity penalizes well-hedged portfolios and leads to double counting of capital charges.

In a footnote in [MAR 23.3], future realized volatility is categorized as an exotic underlying, which implies that volatility and variance swaps are subject to the maximum 1% RRAO, even though their risk can be mostly hedged via vanilla options. The 1% charge is extremely punitive, and we therefore encourage EBA to ensure that only truly exotic underlyings are subject to this charge when they develop the RTS on exotic underlying due on 28 June 2021.

In addition, the RRAO on yield curve spread options can make it uneconomical for banks to continue offering this product to clients such as pension funds, life insurance companies, corporates, and asset managers etc.

The Basel rule is not clear with respect to netting, except for exactly matching third-party transaction. Per [MAR 23.8(2)], “RRAO is the simple sum of gross notional amounts of the instruments bearing residual risks, multiplied by a risk weight.” However, this contrasts other areas of the Standardized Approach where net long and short notional exposures can be netted down.

### **Industry Recommendation**

1. Ensure that only truly exotic underlyings are subject to the 1% RRAO charge, e.g. exclude future realized volatility from this category and thereby let volatility and variance derivatives be subject to the 0.1% RRAO charge.
2. For interest rate yield curves options: a reduction of RRAO charges to 0.01%, defining a risk-sensitive notional, or an allowance to recognize positions that materially hedge the price risk of the exposure subject to RRAO.
3. Provide clarity as to whether long and short positions with same underlying risk can be netted.

<sup>29</sup> ISDA-002: For funds that meet all the conditions in [MAR 21.31], under which a multi-underlying instrument is allowed the non-look-through treatment, an institution may opt not to apply the look-through approach and use buckets 12/13 (for funds with equity underliers) or 17/18 (for funds with debt underliers) instead. The choice of buckets 12 vs 13 will follow the same approach for equity indices (i.e. based on advanced/emerging economies, and large/small cap) while the choice between buckets 17 vs 18 will follow the same approach for credit indices (i.e. IG/HY).

*d. Correlation trading portfolio (“CTP”)*

Banks continue to be concerned about the ambiguity around the rules for CTP, as well as the excessive impact arising from CTP products, in particular if decomposition across CSR and DRC were not allowed.

**I. CSR**

Paragraph [MAR21.34(2)] seems to imply that for the purpose of CSR, indices and index tranches may not be decomposed in single name exposures while bespoke tranches may.

It would imply that:

- Netting of sensitivities from almost identical index positions is not allowed. For example, in CDX NA IG, there are only 2 different names between series 28 and 29 and therefore not recognising any netting benefits is overly conservative. Similarly, netting of sensitivities stemming from non-index products with sensitivities of index products is prevented, despite there generally being a high degree of overlap in the underlying single names of the bespoke tranches and the corresponding index.
- This fundamentally breaks the hedge relationship between index and non-index products and across indices with only minor differences in composition to the extent that risk-reducing hedging activity increases capital charges.
- As per paragraph [MAR21.11(2)(a)], the risk factor is defined along two dimensions, the “relevant underlying credit spread curves” and vertices. This language is consistent with [MAR21.9(1)(a)] for non-securitization risk factors where clearly the relevant underlying credit spread curve refers to the constituent. As such, [MAR21.34(2)] appears to contradict the definition of the CSR CTP risk factors in paragraph [MAR21.11(2)(a)].
- The bucket to which an index product should be mapped to is unclear for risk weight and aggregation purposes. In particular, the CSR index buckets are not available for CTP as per [MAR21.58(1)].

**Industry Recommendations:** Clarify the rule and continue to allow decomposition to constituents to ensure a capital outcome that is more aligned with the underlying risk for better recognition of hedging.

**II. DRC**

The industry would like to emphasize that the reason decomposition is critical is that, unless [MAR22.39(4)] is revised, it is the only way to net across tranches, single names, and untranch indices of different series. Allowing decomposition would better align the capital

outcomes within the standardized framework to the day-to-day risk management of CTPs and serve to reflect the actual net default risk of the underlying.

More information on JTDs can be found in **Appendix B**. Examples are provided on:

- Decomposition of JTD into single names for a given tranche and identify the relative drivers of JTDs (i.e., Mark-to-Market (MtM) effect vs cash flow effect).
- Comparison between total gross decomposed JTDs across different tranches of the capital structure, gross JTD of an undecomposed tranche, and gross JTD of an untranching index.
- Comparison of the securitization approach and the decomposition approach.
- LGD assumption for calculating JTDs within CTP.

#### **Industry Recommendations:**

- CTP securitisations should be decomposed to single name equivalent exposures;
- The default risk weight as described in the non-securitisation methodology [MAR 22.24] should be applied;
- Bucketing and capital charge calculation should follow the non-securitisation approach. This means that buckets should not be defined by index family but as corporates, sovereigns and local governments / municipalities as per section [MAR22.22];
- Banks should be allowed to adjust JTDs for non-securitisation and JTDs for decomposed tranche exposure based on LGDs similar to [MAR 22.12].

### **III. RRAO**

#### **Industry Recommendations:**

Securitisations that make up the full capital structure should be exempted from the RRAO charge.

#### **e. Equity Maturity Mismatch**

The scaling of equity exposures is punitive for well-hedged cash and derivative positions < 1 year, due to mandatorily weighted JTD by the ratio of exposures' maturity to 1-year capital horizon. [MAR22.19(3)b]. In practice, exposure with short maturity usually will be rolled over when expired to keep the hedging relationship intact. Clarification or rule adjustment is required in order to receive full credit for derivatives < 1 year against their respective cash equity hedges,

#### **Industry Recommendation:**

Allow alignment of maturity of offsetting derivatives and equities to 3 month or to 1 year, so that derivatives <1 year do not result in net position risk if hedged with cash equity positions.

**f. SA DRC – LGD for Senior Secured Debt**

FRTB SA DRC separates LGD into non-senior (100%), senior (75%) and covered bonds (25%) – however the framework is missing an appropriate LGD for senior secured debt.

Currently the framework has no bifurcation between secured and unsecured LGD assumptions. Senior secured debt experiences lower losses on default owing to the senior (first lien) pledge of specific assets, details of which can be seen in the table below.

**Senior secured vs senior unsecured long-run avg recoveries<sup>30</sup>**

	Moody's
1 <sup>st</sup> Lien Loan	64%
1 <sup>st</sup> Lien Bond	54%
Sr. Unsec Loan	na
Sr. Unsec Bond	33%

The traded loan market is a significant component of the global credit market. In the US as of year-end 2018 the market totalled \$1.15 trillion, and \$181bn in Europe (source: S&P Leveraged Loan Primer). The market is the predominant source of funds to lower rated (BB and lower) corporate borrowers.

Failing to factor in the higher recovery rate for secured debt unfairly penalises lower rated corporates. These corporates already see very high default probability (risk weights) in the SA DRC, leading to excessive RWA.

Additionally, the FAQ<sup>31</sup> specifying 75% LGD for Agency MBS is very punitive.

Similar to covered bonds, Agency MBS is backed by pools of mortgages, providing significant credit enhancement over and above senior unsecured debt.

High DRC capital charges for holding Agency MBS will raise costs associated with issuance and secondary trading of these securities, likely resulting in additional mortgage costs for homeowners

**Industry Recommendation**

- Agency MBS should use 25% LGD like covered bonds.
- Add an addition LGD category for senior secured debt with an LGD of 40%.

<sup>30</sup> Source: iMoody's Annual Default Study 2017: Volume-weighted recoveries 1983-2017

<sup>31</sup> [https://www.bis.org/basel\\_framework/chapter/MAR/22.htm?tldate=20220103&inforce=20220101](https://www.bis.org/basel_framework/chapter/MAR/22.htm?tldate=20220103&inforce=20220101)



**Calibrating LGD for senior secured. Indicates a 40% LGD<sup>32</sup>**

	<b>Moody's</b>	<b>Volume</b>
1 <sup>st</sup> Lien Loan	36%	291bn
1 <sup>st</sup> Lien Bond	46%	136bn
Weighted Average LGD	39%	427bn

Proposed Text (new bullet 3 added in italics):

22.12 For calculating the gross JTD, LGD is set as follows:

- (1) Equity instruments and non-senior debt instruments are assigned an LGD of 100%
- (2) Senior debt instruments are assigned an LGD of 75%
- (3) *Senior secured debt instruments are assigned an LGD of 40%*
- (4) Covered bonds, as defined within [MAR21.51], are assigned an LGD of 25%
- (5) When the price of the instrument is not linked to the recovery rate of the defaulter (e.g. a foreign exchange-credit hybrid option where the cash flows are swap of cash flows, long EUR coupons and short USD coupons with a knockout feature that ends cash flows on an event of default of a particular obligor), there should be no multiplication of the notional by the LGD.

**g. SA DRC – LGD**

FAQ1 to [MAR22.14]<sup>33</sup> seems to suggest that the decomposed JTD of a multiple underlying non-securitization instrument is calculated assuming zero recovery.

*"The JTD equivalent is defined as the difference between the value of the security or product assuming that each single name referenced by the security or product, separately from the others, defaults (with zero recovery) and the value of the security or product assuming that none of the names referenced by the security or product default."*

The concern is that this would be inconsistent with single-name exposures where prescribed LGDs as per [MAR22.12] should be used.

Example:

The bank is long a credit index, e.g. iTraxx Europe Main index and short each of the constituents in identical amounts, with all underlyings referencing senior unsecured instruments. If LGD

<sup>32</sup> Source: Moody's: Annual Default Study 2017: Volume-weighted recoveries 1983-2017. Where  $LGD = 1 - \text{recovery}$

<sup>33</sup> [https://www.bis.org/basel\\_framework/chapter/MAR/22.htm?ldate=20220103&inforce=20220101](https://www.bis.org/basel_framework/chapter/MAR/22.htm?ldate=20220103&inforce=20220101)

assumptions are not consistent across the longs and shorts, the bank would in this case reflect a DRC charge when in reality it is flat default risk

### **Industry Recommendation**

JTDs of multiple underlying non-securitization instruments should be calculated based on the prescribed LGDs as per [MAR22.12].

### **Internal Model Approach (“IMA”)**

The Associations appreciate the revisions to the IMA published by the BCBS in January 2019. However, the IMA capital requirements are still punitive compared to the expectations from an overall capital increase perspective, and have a negative effect on incentives for banks to develop internal models for market risk.

#### ***h. Profit and loss attribution (“PLA”)***

The Associations welcomes the revisions to the PLA test and significant enhancements to the framework, including more appropriate treatment of data alignment, improved test frequency requirements, revised test metrics and an enhanced penalty function. It is crucial that the determination of appropriate thresholds for PLA is based on tests using real portfolios.

### **Industry Recommendation:**

The industry strongly recommends that the European Commission review the thresholds once banks are able to develop the system capabilities to produce reliable data for both the risk theoretical and hypothetical profit & loss.

#### ***i. Non-modellable risk factors (“NMRF”) Rho parameter***

The Associations appreciate all the significant changes made across the IMA, focused on NMRF. The introduction of a simple correlation parameter (Rho) for NMRFs has contributed to an increase in diversification benefits. We welcome the introduction of Rho parameters as a simple way to align the impact of FRTB to be more in line with expectations, without requiring radical changes in the FRTB framework.

Despite these improvements, NMRF capitalisation remains a concern and source of uncertainty in the FRTB framework, as NMRFs could account for a disproportionate amount of the market risk capital requirements. This could result in overcapitalization and poor alignment with the underlying risks, and will have a negative effect on incentives for banks to develop internal models for market risk.

One key driver of this impact is the loss of diversification inherent in the different parts of the framework. Examples of this include bifurcation of the firm-wide portfolio into IMA and SA sets,

where there is no diversification between delta/vega/curvature within SA, limited diversification within SA default risk charge (“SA DRC”), and across asset classes in expected shortfall (“ES”) and across NMRFs etc. There is an indirect effect of pulling non-modellable risk factors from models that significantly reduce hedging and diversification between modellable and non-modellable risk factors.

Separately, the current calibration of NMRF rho only recognizes limited diversification benefits of systematic components of non-modellable risk factors despite these risk factors being charged based on a stress loss that tends to occur at different times.

The limited diversification incorporated through the NMRF rho parameter could incentivize concentrated exposures in NMRFs which carry additional risk.

**IMCC Rho:** We understand the calibration of IMCC rho was a response to less realized diversification during the financial crisis; however, the current calibration reduces correlation across multiple aspects of the framework. The stressed expected shortfall already reflects stressed conditions over the entire extreme tail, which therefore assumes a higher correlation. Furthermore, the different liquidity horizons across risk factors increases the weight on less liquid risk factors, which can reduce diversification.

The limited diversification incorporated through the IMCC rho parameter could lead to riskier concentration of exposures in a particular asset class

#### **Industry Recommendation:**

Industry would like to highlight that the levers currently embedded in the standards of IMCC Rho and NMRF Rho parameters can be leveraged either individually or in combinations, and have a direct impact on the IMA capital.

Industry recommends continued monitoring of industry impacts, with the potential to adjust rho parameters to in order to reduce the impact of the NMRF in the IMA capital charge

#### ***j. NMRF in Backtesting and Expected Shortfall***

##### ***i. NMRF in Backtesting***

The Industry is concerned about the complexities of the use of NMRF in backtesting and how a coherent definition of VaR is clearly important for a meaningful use of the back-testing (BT) results. An accurate definition of P&L associated to an inconsistent definition of VaR would give rise to back-testing exceptions due to the difference in the definition of the input parameters.

More specifically, while the definition of Hypothetical (HPL) and Actual (APL) P&L include Modellable (MRF) and Non-Modellable Risk Factors (NMRF)<sup>34</sup>, there is some ambiguity on the definition of VaR.

In all its previous versions (2016<sup>35</sup>, 2019<sup>36</sup>) the Basel Text presented the modellability assessment – i.e. the classification of the risk-factors that are part of the Risk Management model into either MRF or NMRF - as a step that only takes place **after**<sup>37</sup> back-testing and PLAT have led to the identification of the desks that are amenable to the Internal Model Approach. This implies that BT and PLAT are designed to statistically assess the quality of the Risk Management model with all the risk factors that it includes, irrespective on how they will be subsequently capitalized (i.e. ES vs SES).

This is clear also from the Market Risk terminology section of Basel where Back-testing is defined ([MAR 10.28]) as the process of comparing daily actual and hypothetical profits and losses with model-generated VaR measures to assess the conservatism of risk measurement systems.

[MAR 99.6] confirms that to the extent that back-testing programs are viewed purely as a statistical test of the integrity of the calculation of the risk measures, it is appropriate to employ a definition of daily trading outcome that allows for an uncontaminated test. It would hence appear necessary that, coherently with HYP and ACT PL definitions, VaR used in BT incorporates both MRF and NMRF.

The final version of CRR II<sup>38</sup> seems instead to be taking the opposite view and introduces an internal inconsistency in the modellability assessment process. More in detail, CRR II prescribes (Article 325be) that the modellability assessment needs to be conducted on IMA eligible desk only (i.e. those that passed BT and PLAT) and thus is consistent with Basel text. However it then introduces the explicit requirement (CRR II Article 325bf(1.b)) that VaR used for BT purposes should use MRF only. This clearly introduces an incoherence in the process since BT should be informed about the modellability outcome before it is actually supposed to have taken place.

<sup>34</sup> BCBS 457 standards (MAR10.31-MAR10.33), CRR II (Art 325bg 3.a) and the EBA Consultation Paper (§3.2.1) where no mention of the modellability requirement is made.

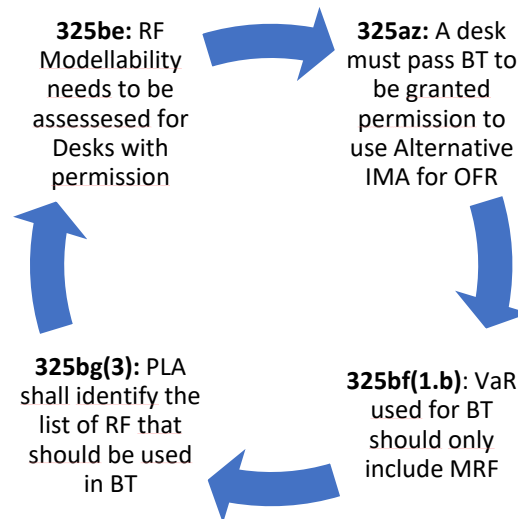
<sup>35</sup> <https://www.bis.org/bcbs/publ/d352.pdf>

<sup>36</sup> <https://www.bis.org/bcbs/publ/d457.pdf>

<sup>37</sup> In BCBS 352 the flowchart in the Executive Summary of the document clearly distinguished between the PLA and BT step where all risk factors in the model are used for the assessment (Step 2) and the subsequent step (Step3) where Risk Factor Eligibility Test (RFET) is used to identify those risk factors with an IMA Desk that can be capitalized under ES and those that need to be capitalized under SES.

In BCBS 457 exactly the same concept is expressed in words rather than with a flow chart in paragraph MAR30.4 (3).

<sup>38</sup> Regulation (EU) 2019/876 of the European parliament and of the council of 20 May 2019. Art 325be, Art 325bf.



**Figure1:** CCR2 introduces several circular references in limiting VaR to MRF

Additionally CRR II introduces another requirement that seems incoherent. Article 325bg(3) suggests that PLAT should provide an indication on which risk factors should be used in back-testing. However if VaR was defined as only including MRF while PLAT compares HPL and RTPL both including all risk factors it seems difficult to understand how one test should provide indications to the other test. This requirement, albeit never mentioned in Basel text, could only be coherent in case BT was also incorporating all risk factors in the model.

In conclusion, the current formulation of the Level 1 text could lead to different interpretations and could impair any effort made for the accurate definition of P&L. All the Red, Amber & Green (“RAG”) boundaries classifying the BT outcome can only be considered statistically significant if the definition of the model producing the forecast and the P&L providing the results are aligned. A VaR model only simulating MRF would not be comparable to results in which all risk-factors are included.

#### **Industry Recommendation:**

Since the Trading desk risk management model (pertaining to in-scope desks) as defined by §10.30 “includes all risk factors that are included in the bank’s ES model with supervisory parameters and any risk factors deemed not modellable, which are therefore not included in the ES model for calculating the respective regulatory capital requirement, but are included in NMRFs”, the VaR metric computed from the risk management model should also include both MRF and NMRF.

Firms should be allowed to include NMRFs, where sufficient data is available, into the VaR model used for back-testing purposes. This would avoid issues highlighted and improve quality and usefulness of the VaR Model.

*ii. NMRF in Expected Shortfall*

Industry believes that risk factors that are already part of VaR models should not be excluded from ES solely because of a failure to pass RFET; especially if those risk factors satisfy principles of modellability. Current modelling guidelines (e.g. ECB Guide to Internal Models) is robust with regards to data quality and the appropriateness of risk factors used in VaR models. Risks that are difficult to model or cannot be properly modelled are managed in the RNiV framework and excluded from VaR.

**Industry Recommendation:**

We recommend allowing the inclusion of NMRF in ES, while preserving their capitalization as NMRF.

Inclusion of NMRF in ES would achieve the following benefits:

- Operational efficiency - no ES model change required other than calculation of NMRF charge if risk factors become NMRF
- More adequate modelling (e.g. reflecting historical move of entire volatility surfaces)
- Analysis of ES trends as well as capital forecast by removing volatility in ES due to introduction and removal of NMRFs

*k. Well Hedged Portfolios in PLAT*

IMA eligibility is subject to PLA Testing which is itself articulated in two tests: the degree of Spearman Correlation between HYP and RTPL time series and the Kolmogorov distributional test. While cliff effects have been smoothened on both tests with the introduction of an Amber Zone that removes the binary consequences of exiting the Green area, some additional considerations are worth making on the possibility that a desk fails the Spearman Correlation test simply because it is well hedged.

Indeed, as RTPL implementations are evolving and becoming more refined, evidence of directional desks passing the Spearman Correlation test in more instances than well hedged portfolios are starting to emerge. In particular it can be observed that desks in which main positions and their hedges individually pass PLAT (suggesting the risk model is able to adequately capture most risk drivers) can then fail the Spearman Correlation test once applied to the resulting series of hedged P&Ls.

Hedging is designed to immunize the portfolio's performance from the movements of the underlying risk-factors. A well-hedged portfolio will show comparatively small P&L both in case underlying risk-factors significantly increase or decrease. In this context, the ranks of the P&Ls generated from the 250 scenarios over which the test is conducted can be the result of the residual noise after hedging, impairing correlation levels between RTPL and HPL time series.

This implicitly means that a less well-hedged portfolios could have a higher probability of being IMA eligible than ones in which risks are fully hedged.

When establishing the rules according to which desks could enter or exit the IMA perimeter as a result of the outcome of PLAT and BT, a strict automatism might not be the most appropriate choice. Some allowance should be introduced in case the RED outcome can be proved to derive from the well hedged nature of the portfolio with main positions and hedges individually passing the test.

### **Industry Recommendation:**

We would hence recommend that during the IMA reporting phase specific evidence is collected on the described phenomenon and that the implications of a RED PLAT outcome are considered in case this materially affects the IMA scope.

#### ***1. PD Floor***

The proposed floor for the probability of default (PD) in the IMA default risk charge is set at 3 basis points<sup>3940</sup> across all issuer types. The floor is not risk-sensitive which puts disproportionately high capital requirements on bonds issued by high credit quality issuers, e.g. AAA and AA rated government and covered bonds, which could impact liquidity negatively.

The European Union is naturally comprised of many sovereign issuers, a number of which are highly rated AAA/AA rated including, Belgium (AA), Denmark (AAA), Finland (AA+), France (AA), Germany (AAA), Luxembourg (AAA), Netherlands (AAA), Sweden (AAA), United Kingdom (AA). Regional banks active in markets dominated by AAA and AA rated issuers are particularly affected.

Under BCBS FRTB and the EUs CRR certain products are treated as a distinct exposure class when calibrating credit spreads and LGDs for the purpose of the standardised approach, and therefore to ensure consistency there should be a distinct exposure class treatment when calibrating the PD parameter in the IMA DRC calculation. Covered bonds are one notable example that falls into this category, reflecting their distinct characteristics and risk profile.

Furthermore, the liquidity of these assets (sovereigns and covered bonds) needs to be considered in the context of a 1-year PD horizon. In practice, given that these are typically high-quality liquid assets, a bank will have the ability to manage such portfolios if credit quality deteriorates.

### **Industry Recommendations:**

**The industry reiterates its proposal to remove the 3 basis-point floor for Sovereigns.**

<sup>39</sup> <https://eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/article-id/1596>

<sup>40</sup> MAR 33.24: <https://www.bis.org/bcbs/publ/d457.pdf>.



The application of a PD floor is inconsistent with the banking book treatment, included within the finalisation of Basel III. Removing the floor would therefore ensure consistency between the Trading Book and the Banking Book.

**More appropriate calibration for Covered Bonds, reflecting their distinct characteristics and risk:**

We recommend that Covered Bonds should be considered (i) as a separate risk exposure class under IMA DRC just like under SA (for LGDs and Credit Spreads), and (ii) the 3 bp floor is not appropriate and should be calibrated downwards.

As a final note, we encourage the European Commission to take the changes that result from the final analysis back to the BCBS, and obtain the necessary revisions to the relevant BCBS standards. Changes at the Basel level are necessary to facilitate consistent implementation on a global basis.

*m. Liquidity Horizons*

One area that requires further thought is the cap on liquidity horizons as defined in CRR II Article 325bd(4). The industry wants to stress this concern in our response. We believe that capping the LH for a risk factor to the maturity of the related instrument should be an option, and not a requirement. From a theoretical standpoint, the maturity cap applies that no position shall be renewed beyond the expiry date, which does not reflect the nature of trading and client behaviour whereby positions are often rolled over at maturity of the contract. From the coherence of the framework perspective, it is inconsistent with the general constant risk assumption prevailing in the ES formula itself, in which risk factors (from 0d to 10d, from 10d to 20d, from 20d to 40d, etc.) is deemed constant throughout the life of the positions in spite of the portfolio ageing. Added to that, it contradicts the allowance provided in the FRTB to increase the LH of a broad risk factor category at the desk level to avoid breaking of hedges. Finally, this capping requirement will create added operational and computational burdens to implement. We recommend that banks should be allowed to assign all instruments to the regulatory LH; capping at instrument maturity should be an option.

The FX market is a good and important example of why the above maturity cap issue matters. FX-Spot trades (having a few days to maturity) for non-specified currency pairs are often used to hedge the FX spot risk of associated options. Under the proposed treatment, the FX spot risk factor of such a trade would be assigned a Liquidity Horizon of 10 days, hence creating a broken hedge for the FX Spot risk in the 20 days Liquidity Horizon bucket.

We therefore recommend that the mapping of risk factors to Liquidity Horizons is aligned with the following steps. This is as prescribed as in the Basel framework although it reverses the

order of applying the Liquidity Horizon capping and allowing to potentially extend Liquidity Horizons at the desk level:

1. Banks must map each risk factor on to one of the existing risk factor categories using consistent and clearly documented procedures (see (1) of [MAR 33.12] of the Basel paper);
2. Banks must cap Liquidity Horizon at the maturity of the related instrument; and
3. On a desk-by-desk basis, the Liquidity Horizon can be increased relative to the values as assigned via above steps 1 and 2 (i.e. the liquidity horizon specified below can be treated as a floor). Where the Liquidity Horizon is increased, the increased horizon must be 20, 40, 60 or 120 days and the rationale must be documented and be subject to supervisory approval.

### **Industry Recommendation**

The industry recommends revising the CRR II Article 325bd(5) and align it with [MAR 33.12] of the Basel Document as proposed in the text above.

## **4.2. Introduction of the simplified standardised approach**

***148) What are your views on the introduction of the simplified SA-MR, in particular the revised calibration proposed by the BCBS?***

***What would be the impact on RWAs and which types of activities or transactions, if any, would be particularly affected by the revised calibration?***

***Please provide relevant evidence to substantiate your views.***

### **Scope/application**

A key objective of the Committee's proposal is to encourage and support those jurisdictions that wish to apply the Basel framework and to further the goal of international harmonization of prudential capital standards. Therefore the Associations wish to propose that a jurisdictional application is appropriate for the Simplified Alternative.

Access to the Simplified Alternative would encourage continued participation of larger banking groups in those jurisdictions in which they have moderate market risk activities by limiting their local compliance burden. This would ensure a deeper market for relevant trading products, provide greater liquidity for users of these products and facilitate the development of the capital markets in what, in many cases, will be emerging market economies.

Allowing use of the Simplified Alternative at a jurisdictional level could also benefit certain local supervisors as it will reduce the supervisory burden of assessing compliance with the revised

standardized approach when the extent of trading activities of market participants may not, of itself, justify the resource investment in this capability.

#### **Industry Recommendation:**

Industry recommends that the Simplified Alternative can be applied at a legal entity level within each jurisdiction.

The industry would further recommend that where a bank adopts the use of the Simplified Alternative in the local jurisdiction (and is permitted to do so by the local regulator), they should also be permitted to use the Simplified Alternative for that jurisdiction's activities in the group's consolidated capital adequacy calculations. This would reduce the compliance burden and avoid a bank having to invest in two separate calculations: one for local purposes and one for consolidated reporting.

In addition, it is noteworthy that the simplified SA-MR has not been transposed in the CRR II specific reporting requirements and that no particular threshold triggering its use has been set out in the Jan 19 BCBS standards. Depending on what thresholds are eventually proposed in the draft CRR III to be issued by the end of June 20, the Industry invites the Commission to adjust the criteria set out in Article 325a so as to reduce as much as possible the time period and the operational burden by which the subsidiaries/entities that target the simplified SA-MR for CRR III would be compelled to report own funds requirements as per the SA-MR approach, at the expense of a temporary yet costly implementation.

### **4.3. Treatment of investments in collective investment undertakings (CIUs)**

***149) What are your views on the costs and benefits of implementing the conditions provided by the Basel III standards for allocating investment in CIUs to the trading book?***

***Please provide relevant evidence to substantiate your views.***

**2016 Standards.** Most of the Industry's concerns around the 2016 Standards revolved around the strict pre-conditions for the admissibility of the CIU business lines under the Trading Book. Lack of daily look-through information or lack of daily real prices were both sufficient conditions for mandatory assignment to the Banking Book.

A stringent daily look-through requirement is perceived by the Industry as almost impossible to attain since Asset Managers would be very reluctant to publish information that might be revealing of their allocation strategy. Additionally, any information that might be disclosed would be typically published with some time lag (e.g. monthly information on the composition disclosed with three- or four-week delay).

However, for those funds meeting the conditions for Trading Book eligibility no specific treatment was mandated for the modelling under IMA; in particular there was no prescription on how the look-through information was to be used when modelling a fund or a product referencing a fund within IMA. This appeared coherent with the typical modelling freedom allowed in the context of Internal Model Approach.

**2019 Standards.** Under the final standard the Industry's concerns around the daily look-through pre-condition to Trading Book eligibility have been addressed. Indeed the daily look-through frequency has been replaced by "sufficient and frequent information, verified by an independent third party". This wording allows for sufficient flexibility to accommodate for current standards and practices of the Asset Management Industry (which might well evolve over time).

Custodians of the assets under management appear ideal candidates for the role of independent third-party information provider.

Additionally, "sufficient and frequent information" on the composition of the fund is no longer a necessary precondition (just a sufficient one) for investment in CIU to be part of the Trading Book. Indeed, knowledge of the fund's mandate in conjunction with the access to its daily price quotes are now sufficient for the inclusion in Trading Book. Knowledge of national regulation governing such investments is also required, however in EU it would be mostly referring to the UCITS Directive.

In conclusion, the 2019 Standards mark a significant improvement over the 2016 ones with respect to the conditions for the inclusion in the Trading Book of investments in Funds. Such conditions now adequately reflect publicly available information on Funds (mandate, detailed composition at some frequency, daily prices) and effectively make it possible for Funds Trading Desks to be part of the Trading Book.

#### **Industry Recommendation:**

Unfortunately, the 2019 Standard contextually introduces a very burdensome mandatory approach to the treatment under IMA, and three options for the SA capitalization cannot be considered as really viable for a variety of reasons. More on this in Q152 and Q153.

***150) What are the proportion and characteristics of the CIUs where a look-through is possible and how frequent is this possible?***

***Please provide relevant evidence.***

Frequency and availability of Look-through information is typically defined by the Asset Manager. Currently most Asset Managers would release monthly reports on the Fund composition (i.e. end of month reports) where detailed information of the portfolio composition is made available. However, it is not uncommon for such information to be released with a three/four-week delay with respect to the end of month.

We would expect such frequency of information to be available for all Funds under UCITS.

Banks with strong business relations with external Asset Managers (i.e. Asset Managers not belonging to the same Banking Group) could also try to negotiate a more frequent and dedicated information flow (e.g. weekly); however this cannot be generalized.

It is additionally important to highlight that the type of information provided when looking-through might vary across Asset Managers (i.e. it is not a standardized report) and this will also be an important element to understand the response to Q152.

***151) What are the proportion and characteristics of the CIUs traded in the EU for which the mandate of the CIU is available and daily price quotes can be obtained?***

***Please provide relevant evidence.***

Funds operating in the EU are either regulated under UCITS or AIFMD.

All UCITS funds are required to publish certain information in their prospectus, including a “Description of the common fund’s investment objectives, including its financial objectives (e.g. capital growth or income), investment policy (e.g. specialisation in geographical or industrial sectors), any limitations on that investment policy and an indication of any techniques and instruments or borrowing powers which may be used in the management of the common fund.”<sup>41</sup>

UCITS also specifies controls for maximum leverage, type of assets held and minimum diversification. The details within each of these controls are relevant factors when considering the mandate-based approach, as they allow one to construct a hypothetical portfolio which is both risk-sensitive and a fair reflection of the holdings in the fund.

It is worth noting, however, that a fund’s mandate is a **broad** description of the type of assets a fund can invest in. Some examples include:

- Max. 50% equity investments
- Up to 25% of the fund's net assets may be exposed to emerging market equities
- Min 50% in fixed income and money market instruments
- Bond investments in emerging markets may not exceed 25% of the net asset
- The Fund may invest in debt instruments with a rating below investment grade. The weighted average rating of the bonds held directly by the fund or through investment in funds shall be at least investment grade according to at least one of the major rating agencies.

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<sup>41</sup> EU directive 2009/65/EC, Annex I, Schedule A

- The equity allocation remains below 49 % at all times and consists primarily of large-cap blue chip stocks. Small- and mid-cap companies may also be acquired after careful examination on a case-by-case basis.
- The investment focus is on bonds with very good credit ratings (investment grade).
- The fund management can also invest to a small extent in high-yield bonds with low credit ratings.
- Investments in distressed securities, Contingent Convertible bonds (CoCo) and asset-backed securities are permitted up to a maximum limit of 10% of the Fund assets.
- The regional investment focus is on the OECD countries.

UCITS funds must establish the net asset values (NAV) of their units, communicate them to the competent authorities at least twice a week and publish them twice a month. This is a minimum requirement, and in practice, most UCITS publish either their NAV/price daily. Daily quotes can be sourced from exchanges (for ETFs), or from the Custodian of the assets under management.

Funds under AIFMD must also provide a description of the investment strategy and objectives, but AIFMD is typically less prescriptive than UCITS. For example, in an alternative investment fund (AIF), the assets are valued and the net asset value per unit or share is calculated at least once a year. There are also fewer restrictions on the type of assets an AIF can hold, or the amount of leverage.

Further discussion and evidence are provided in Q153.

***152) Would you consider that the revised conditions for the application of the IMA for CIUs would significantly affect investments in those instruments?***

Yes

***152.1) If yes, would there be any solutions to address this issue prudentially?***

***Please explain and provide relevant evidence.***

The 2019 Standard introduces the prescriptive use of the look-through information ([MAR 31.11]) in the risk representation of Fund's under IMA.

- 1) For funds that meet the criterion set out in [RBC25.8](5)(a) (i.e. **funds with look-through possibility**), banks must consider the risks of the fund, and of any associated hedges, as if the fund's positions **were held directly** by the bank (taking into account the bank's share of the equity of the fund, and any leverage in the fund structure). The bank must assign these positions to the trading desk to which the fund is assigned



2) For funds that do not meet the criterion set out in [RBC25.8](5)(a), but meet both the criteria set out in [RBC25.8](5)(b) (i.e. **daily prices and knowledge of the mandate of the fund**), banks must use the **standardised** approach to calculate capital requirements for the fund.

The requirement effectively imposes a prescriptive modelling approach on Funds within IMA. This is itself an uncommon requirement in the context of the Internal Models where a Bank is normally free to choose the preferred modelling approach, as long as it stands the challenge of competent Authorities.

The problem with the prescribed approach stems from the **operational complexity** of the mandated representation of the fund. As many of these funds have thousands of underlying assets, the composition changes regularly. This will create an undue operational burden on calculating P&L attribution and NMRF frequency. It needs to be additionally considered that such a constraint is introduced in the context of a reviewed IMA that is itself computationally much more demanding than Basel 2.5 (see Relevant Evidence below).

#### Relevant Evidence

- A real-life example of such complexity is represented by a portfolio hosting options written on 30 UCITS Funds and their delta hedges (consisting in positions on the Funds themselves).
- Look-through is indeed available at monthly frequency and, according to the reports for end of June 2019 (available around the 10th of July), the 30 Funds should be exploded in about 35K instruments. This means that under IMA scenarios should be produced for 35K risk-factors instead of 30. **Risk-Factors: 30 -> 35k (i.e. x1,100)**
- Such significant increase occurs in the context of a reform that introduces the requirement of full revaluations (250 FC + 250 RC + 250 RS = 750) under five Liquidity Horizons (x5) and six Broad Risk Categories (x6). Compared to the current VaR+sVaR number of revaluations (e.g. 250 + 250) this means up to 22,500 revaluations even before look-through is applied to the underlying funds. **Revaluations: 500 -> 22,500 (i.e. x45).**
- The major obstacle in the implementation of such an algorithm is related to the re-sizing of the IT infrastructure that would be needed.
  - The scenario size to be used in each of the re-pricings would increase by three orders of magnitude, inducing massive increase of bandwidth utilization for file transfers to the grid and their storage.
  - The pricers will need to change their interfaces exposing the constituents' risk-factors as relevant risks as opposed to just showing the value of the fund. Such pricing complexity will additionally increase whenever a fund contains instruments (e.g. bonds) that themselves depend on risk-factors (e.g. credit spread, interest rates, fx). This would be the case for each of the revaluations required by FRTB (already a factor up to x45 compared to Basel 2.5).



- Additionally, the significant increase in the number of risk-factors will generate an **unmanageable maintenance complexity** - with associated costs - related to the:
  - identification and processing of the metadata associated to each risk-factor;
  - identification and processing of the modellability associated to each risk-factor;
  - acquisition of the time series required to model each risk-factor;
- Notably, all these additional efforts are required in the context of additional flexibility of the daily look-through requirement, implicitly allowing the use of a less frequent decomposition of the fund. The extent to which daily Look-through will result in a more accurate risk capture of the fund is not obvious.

Under the 2019 Standard there is virtually no possibility that a Fund Desk can be capitalised under IMA. It would be simply be too costly to set up and maintain.

### **Industry Recommendation**

The industry recommends not imposing any mandatory representation of the Fund in the IMA approach. As for any other instrument in the Bank's Trading Book, the Bank should be adopting the risk representation that best suits the product in its risk framework, provided that it can justify it to the satisfaction of the competent authorities.

It is however important to also highlight that the TRIM Guide explicitly identifies the use of **daily liquid NAV** as a valid modelling approach for VaR/SVAR (hence ES). This should indeed be identified as a valid modelling approach also under FRTB, or at least should not be dismissed by construction (e.g. imposing Look-through).

Analogously, the treatment of Funds under DRC should allow for a non-Look-through representation that adequately reflects the high degree of diversification of the portfolio the fund represents. Specifically, under IMA a Bank should be allowed to use an LGD that suitably represents the diversification and composition of the funds, e.g. calibrated from the published monthly reports or equal to the one used under SA DRC (see Q 153.1), leaving the JtD 0 treatment only to those funds for which **no information** is available.

In analogy with SA DRC treatment, the PD of funds should reflect the fact that scenarios in which multiple fund's components default (with limited impact on fund's NAV as discussed above) could be in general quite frequent.

### ***152.1) If no, please elaborate on your response to question 152***

N/A

***153) Would you consider that the revised approaches for calculating the own fund requirements for CIUs in the SA-MR would significantly affect investments in those instruments?***

Yes. The excessive layers of conservatism provide wrong incentives and will therefore likely distort fund markets e.g. by derivative investors deciding to short funds more than today. For example, the mandate-based approach often will rely on vague/generic mandate language by which firms will have to assume conservative hypothetical portfolios to run the SA. As covered elsewhere in this response, firms should instead be free to adopt a suitable alternative that better replicates the likely fund strategy (e.g. index treatment or better).

***153.1) If yes, would there be any solutions to address this issue prudentially?***

***Please explain and provide relevant evidence.***

A waterfall of three approaches is foreseen for Fund-related products under SA-MR, the preferred option being also the Look-Through.

**1. Look-Through Approach**

The Look-Through representation of a Fund is the designated representation in the presence of frequent information of the Fund's composition (CRR II Article 325j (1.a)). This is equivalent to what is mandated under IMA.

While the computational intensity of the SA-MR is not comparable to the IMA-MR, and in normal conditions does not pose particular concerns, the significant increase in the number of risk-factors (as a result of the Look-Through) will necessarily stretch the IT resources required to execute the Delta, Vega, Curvature calculations for SA-MR.

**Relevant Evidence**

If we return to the previous question's real-life example, it is easy to see that moving from 30 to 35k risk-factors will generate an increase in the number of revaluations needed to compute SBA by a factor **x1,100**. Delta, Curvature and Vega are the instrument risk-factor sensitivities, and a x1,100-fold increase in risk-factors will have an even larger impact on the number of sensitivities that must be computed.

- While this clearly affects only a limited set of instruments (i.e. those of the Fund Desk), the number of additional revaluations can easily reach a count large enough to dwarf the number of revaluations required to run sensitivities for the *whole* Bank. In our real-life example, this would correspond to about **x10** the **number of sensitivities** that are produced daily on the whole **Equity Business**.
- Even if the calculation is not performed daily, the IT investment required to scale the infrastructure would be disproportionately large for a Standardised Approach calculation.

- Additionally, there would be some considerable data maintenance effort, albeit limited to the identification of metadata for the 35k risk-factors (and not to the modellability assessment or time series acquisition).

CRR II Article 325j (1) allows for exception to the adoption of the Look-Through representation:

- 1) Funds containing indices that meet the low concentration requirements established by CRR II Article 325j (2) can avoid looking through the index → practically a very marginal benefit since Look-through would still be required for all the other instruments in the fund.
- 2) Funds that are tracking an index benchmark with a tracking error less than 1% can use the index bucket.

In practice, the two exemptions cover a limited number of cases and do not significantly change the problematic picture depicted above.

Without some flexibility, it is hard to consider the Look-through approach to be a practical solution for the Fund business under the Standard Approach, particularly since it was meant to be designed for less sophisticated Institutions.

### Industry Recommendation

In order to avoid such issues and operational burdens, it would be beneficial to introduce some flexibilities, for example:

- When available, permit institutions to rely on sensitivities provided by a third party, such as the CIU management company, where such sensitivities are based on audited data/processes.

It should be noted that:

- This approach is already allowed by the Article 132 of the Regulation (EU) No 575/2013 for the treatment of CIU in the non-trading book;
- The technology required to get funds' NAV sensitivities has already been developed by CIU management companies to meet the needs of insurance companies regarding the market Solvency Capital Requirement (SCR) computation in the context of Solvency II.

This Industry Recommendation is based on preliminary data from only a subset of banks; NAV sensitivities may not be available in all jurisdictions and for banks whose UCITS fund portfolio does not have the adequate scale to obtain this data from asset managers. Further investigation into this matter is required in order to assess evidence of the availability of this data for a larger set of banks.

## 2. Mandate-Based Approach

CRR II Article 325j (1.b) provides two alternatives that should be used where **Look-through is not available** but where mandate and daily prices are both available:

- 1) **Index bucket:** For index trackers with low tracking error, the allowance is again to use the index bucket.
- 2) **Mandate-based representation:** The allowance is to represent a CIU as a hypothetical portfolio, emulating the worst possible composition permitted within the mandate. Such a portfolio would be capitalised on a stand-alone basis.

While the first option represents a solution only for a very specific type of CIU (specifically, index trackers), the mandate-based representation poses conceptual concerns under a narrow interpretation of ‘mandate’. Interpretation of ‘mandate’ should be broader than merely the ‘investment objective’ or ‘investment policy’, as these are typically high level. See below and also the response to Q151 for examples:

- With no further restrictions applied, based purely on the investment objectives and investment policy, a hypothetical portfolio would be an **extremely concentrated** or **undiversified** representation of the original fund, with only a few holdings. Investment objectives typically do not prescribe minimum bounds on the number of holdings. Notwithstanding, these bounds do exist, for example CIUs regulated under UCITS have diversification requirements that ensure there are a *minimum* of sixteen different holdings.
- Similarly, any such hypothetical portfolio, would be of a **much lower quality** or **higher risk** than the original fund as the investment objectives also do not typically specify risk factor boundary conditions, which boundary conditions *also* frequently exist. For example, if the investment objective does not quantify the maximum duration permitted, a bond hypothetical portfolio will contain a portfolio of infinite duration bonds.
- Such boundary conditions are needed in order to construct a suitably representative hypothetical portfolio; a mandate interpretation that is broader than the ‘investment objective’ or ‘investment policy’ can provide this information:  
CIUs typically contain anywhere from 40 to several 100 individual holdings, diversified across at least one of geography, asset class, sector or some other attribute. Representing such a diversified CIU as a concentrated portfolio of a few instruments of the lowest quality and highest risk misrepresents its risk profile and its volatility. If we think of a fund that might be made of hundreds of instruments, implying the CIU’s volatility (which would typically be in the region of 7%-10% per annum) from the volatility of portfolio of 4-5 constituents of the lowest permitted quality will result in a misrepresentation of its riskiness.
- For the default risk charge (DRC), a fund’s constructed diversification will result in a limited erosion of value due to default events. A hypothetical portfolio constructed of a few underlyings would materially overstate the risk of and losses arising from default.
- In combination with the requirement for standalone capitalization, the strict mandate-based approach misrepresents CIUs, one of the most diversified products in the market, as a low-quality, poorly diversified portfolio. A broader mandate-based approach is therefore recommended.
- The mandate-based approach requires calculation of CCR and CVA charges on the derivatives of the hypothetical portfolio. This requires the use of CCR and CVA calculation engines, workflows and systems that are usually independent from Market Risk systems. Linking these systems will be extremely complicated and costly. Furthermore, it is unclear how one will create a hypothetical portfolio of derivatives with hypothetical counterparties.

### 3. 'Other Sector' i.e. Unrated Equity exposure

The Other Sector (RW 70%) appears as the inevitable landing point for a fund that, despite being fully transparent in its composition and mandate and showing daily prices, will be

- Not manageable through Look-through under the IMA due to the numerical / operational complexity of the task (i.e. its disproportioned implementation costs);
- Similarly not manageable via Look-through under SA;
- Attracting an extremely punitive capital add-on (standalone charge) in conjunction with the complexity of setting up and maintaining Hypothetical Portfolios

If we add to this that a JTD 0 capitalization is currently envisaged under DRC, Funds can be expected to attract a charge that easily bypasses the Full Deduction.

#### Relevant Evidence

The table below<sup>42</sup> summarizes the capital charge for the **real-life portfolio** described in previous examples.

OFR I(D)RC]	[no	Basel 2.5	IMCC-LT	IMCC-NAV	SBA-LT	SBA-Mndt	SBA-70%
Funds		100	N/A	185	234	2,700	4,100

A few considerations on relative impacts:

- Daily NAV is currently used also in VaR and SVaR. Under IMCC the capitalization increases significantly due to the convexity effects triggers by the 10-day changes used in place of 1-day changes and the Liquidity Horizon (in case funds are allocated to the 60day LH)
- SBA-LT was estimated using an average RW stemming from the Fund's composition and ignoring any contribution from curvature (that would be virtually zero if the curvature shift is applied to each of the hundred constituents of the fund).
- Under SBA-Mandate, Funds are represented as hypothetical portfolios made of 4 constituents.

#### Industry Recommendation

Industry believes that the most appropriate approach to the treatment of Funds under SA within the existing framework is to **allow them to be treated along the lines of the equity indices**.

Indeed, in the final BCBS standards, a dedicated bucket was introduced for Indices meeting prescribed diversification criteria (Article 325i)). We believe that Funds should be allowed to be capitalized under such a bucket, if it can be established that they meet the same diversification standards<sup>43</sup> either via look-through, from their mandate, or from government regulation of the

<sup>42</sup> Additional details upon request. The figures are indicative results based on a consensus of Industry member feedback provided to the FRTB Working Group.

<sup>43</sup> In line with CRR II 'Article 325i 3. (b) to (d): the funds holds at least 20 different positions, no one (ten) of which represent more than 25% (60%) of the fund's total assets.

funds' investments. With reference to the real-life portfolio above, a 15% RW in line with assignment to equity index bucket 12 would yield a capitalization of **SA-15%=400**.

Funds that either cannot be looked through, cannot use the mandate-based approach, and do not meet the diversification criteria above will fall-back to the current 'Other bucket'.

Funds treatment under DRC should also be addressed since under the current text a JtD0 assumption should be used. This is clearly inappropriate if we think of a fund as a portfolio of some hundreds of instruments. Industry recommends the introduction of an LGD for funds that is sufficiently low (e.g. LGD = 5%<sup>44</sup>) to adequately represent the very high diversification in the portfolio. The risk weight (RW) should reflect the fact that scenarios in which multiple fund's components default (with limited impact on fund's NAV as discussed above) could be in general quite frequent.

***153.1) If no, please elaborate on your response to question 153.***

N/A

***154) What are your views in relation to the conditions and approaches under the Basel III SA-MR for the treatment of CIUs?***

***In particular, how do the approaches compare in terms of operational burden?***

**Please elaborate and provide relevant evidence to substantiate your views.**

A description of the most problematic aspects of each of the three SA approaches was provided in Q153 and could be summarized as follows

- Look-Through: extremely high computational and operational burden but adequate capitalization
- Mandate: medium operational burden but very inaccurate and conservative capitalization
- Other Sector: very low operational burden but unsustainable capital density (i.e. such to jeopardize the economic sustainability of the business)

## Relevant Evidence

<sup>44</sup> A 5% LGD can be obtained by applying IMA DRC on a Look-through representation of a representative Equity Fund and assessing the fund value erosion due to defaults at 99.9% over 1Y capital horizon. An LGD of 25% could also be considered when adopting the concentration requirements of 'CRR II Article 325i 3. (c) for funds, in order to increase the conservatism of the approach.



Using again the real-life Funds portfolio, the table below<sup>45</sup> compares the different approaches amongst each other and versus Basel 2.5 standard from three viewpoints:

- Operational burden: represented by the number of risk-factors to be maintained in terms of meta-data and the number of hypothetical portfolios to be set up interpreting (human operation) the mandate of the funds. Assumes e constituents per fund.
- Computational burden: represented by the number of scenarios on which relevant instruments need to reevaluate on to estimate either VaR or sensitivities [delta (1), gamma (2)]. The latter number can be seen as a lower bound in that a) vega is not considered (since it does not get looked-through) and b) the fact that the same risk-factor can be referenced by more fund derivatives is ignored, effectively increasing the number of revaluations needed.
- Resulting capital

	Basel 2.5	SA-LT	SA-Mandate	SA-70%
#Risk-Factors	30	35,000	30x5 = 150	30
#HypoPort	0	0	30	0
#Scenarios	500	3 x 35,000	3 x 150	3 x 30
RWA	100	234	2700	4100

### Industry Recommendation

To tackle the issues described above, in a way that would permit keeping the equity investments in CIU activity economical and to reduce the operational burden of the look-through approach, we believe that:

- the possibility to opt out of the look-through approach for index-instruments introduced under certain conditions by the CRR II Article 325i(3) of the delegated act, with a dedicated bucket, should be extended to debt and equity funds meeting similar conditions, as detailed in the response to Q 153.1

when available, the use of sensitivities provided by a third party and verified by an independent other party, as this is allowed for funds in the non-trading book and for insurance companies in the context of Solvency II

➤ **Note that, further evidence is required in order to assess the availability of NAV sensitivities provided by third parties.**

- if needed, the use of upper bound proxy sensitivities instead of sensitivities perfectly matching those defined by the Regulation (EU) No 575/2013 to ensure conservative level of capital requirements.

<sup>45</sup> Additional details upon request. The figures are indicative results based on a consensus of Industry member feedback provided to the FRTB Working Group.



Institutions should be allowed to calculate the own funds requirements for market risk on equity investment in funds by using a combination of the look-through approach and the 'single equity' approach for components that cannot be perfectly looked-through.

#### 4.4. Date of application of new own funds requirements for market risk

**155) Views are sought regarding the date of application of the new own funds requirements for market risk. Taking into account the time needed for the legislative process to implement the new own fund requirements for market risk in the EU and the time-consuming model approval process, which date would you consider appropriate for the application of the FRTB framework as a binding own fund requirements in the Union?**

To reflect appropriately the global nature of capital markets activities, it is fundamentally important the FRTB requirements are implemented simultaneously and harmoniously across the key jurisdictions globally to avoid significant undue technological and business burdens for banks.

Trading businesses of banks are fundamentally global, and fragmentation of trading books through inconsistent implementation would result in reduced capacity and frictions in the markets.

We note the constraints and specificities that the EU is facing on turning the market risk reporting framework into a new binding own funds requirements.

##### **Industry Recommendation:**

We recommend that any approach to FRTB implementation in the EU is focused on achieving the following objectives:

- A binding application of FRTB cannot be earlier than the envisaged start dates for the FRTB reporting requirements - expected in 2021 for SA and not before Q3 2023 at the earliest for IMA as mentioned in the introduction for this section of the consultation.
- To ensure that implementation is globally aligned, it will be important to monitor and coordinate with other key jurisdictions to avoid disproportionate operational obstacles for banks and regulators and level playing field issues.
- It will be important to set reasonable implementation period for banks once the legislative process is finalised, that takes into account the observations and findings of the reporting period
- Setting a reasonable approach for model approval process will also be necessary before the start date of the framework. For example, given IMA reporting will already require model approval, it will be crucial to avoid going through an additional full-fledged model approval process once capitalisation of FRTB becomes effective. In addition, given the time gap between reporting and capitalisation, EBA guidance on how reporting numbers would impact capital planning for banks would be warranted to ensure there is a consistent approach across firms in the EU.

## 4.5. Other provisions

**156) In your view, which other aspects, if any, should be considered in the context of revising the market risk framework?**

***Please specify and rank your answers from the most important to the least important aspect.***

### ***a) Impact of the Output Floor***

Quantitative analysis has shown that the impact of the revised Basel III framework for European banks is significant (+23.6\*% increase in T1 minimum required capital (MRC) compared to current T1 MRC according to the updated EBA analysis published in December 2019) with the output floor being the largest driver behind the overall increase. The analysis shows that the output floor contributes to 8.6% percentage points to the increase.

The calibration of the market risk framework particularly in relation to the output floor (OF) should be carefully considered.

For market risk, the standardized approach (SA) may become the binding constraint either through firm losing model approval or due to the output floor. The extent of the constraint imposed on banks by the OF has negative implications for the Basel Committee on Banking Supervision (BCBS) and EU regulators' objectives in their pledge to preserve the use of risk-sensitive internal models.

Additionally, banks will take a broad set of capital measures into account and the floor will be a determining factor in risk-return evaluations, capital allocation decisions with impact on business continuity. Overly conservative calibration of standardized approaches including in the FRTB framework will have negative consequences for products, markets and business areas, which may warrant further analysis.

Note that the overall impact of the output floor is further developed in section 6 of the consultation response.

The overly conservative calibration of many elements of the standardized approaches therefore have negative consequences for certain products, markets and business areas that warrant further analysis.

**Industry Recommendation:** Revise elements of the SA which are unintentionally punitive (see under "4.1 Converting the reporting requirement into an Own funds Requirement"), and avoid uplift in standardised outputs. The objective is for the output floor to be sensitive to risk in IMA, rather than outweighed by SA.

### ***b) Challenges and issues IBOR transition***

Industry would also like to highlight that the impending IBOR transition programs across various large economies including the EU may introduce additional market risk capital under the FRTB standards. The

transition to alternative reference rates will bring notable changes in banks' trading books, hedging apparatus and risk factor universe amongst others, which are not yet fully visible as banks look to estimate the impact of the final market risk requirements.

The implementation of the transition framework could be impeded by the prescriptive nature of model change assessments. Careful planning and management of resources will allow banks to mitigate some of the possible negative impacts but there are other areas where banks will be dependent on regulators to process large volumes of applications simultaneously within very tight timeframes.

An important consideration is whether changes made to bank risk models following implementation of the transition framework are considered to be model changes that require ex ante model approvals or whether ex-post approval could be sufficient. Specific areas of potential impact:

- Model change notification requirements including requirement to obtain pre-approval from regulators for material changes. (e.g. extended periods of review by regulators may force banks to keep transactions outside of the internal models perimeter)
- Model backtesting and stress calibration – potentially impacted by limited data time series
- Model limitation monitoring – banks' models for the new benchmarks may evolve in sophistication over time, increasing the complexity of the model limitation monitoring framework including efforts to implement compensating controls, such as through capital additions. This may also lead to the need for repeated model change submissions to regulators

#### **Industry Recommendation:**

In line with the Working Group on Sterling Risk Free Reference Rates (RFR WG)'s recent letter to the European Commission, the PRA and the BCBS highlighting these challenges and issues, Industry recommends a period of forbearance during which firms are permitted use current benchmarks as proxies and, where possible, backfill or extrapolate to help mitigate against unnecessary capital. This is especially true of IMA reporting requirements during the transition period, due to the impact on historical data series and NMRFs.

#### ***c) Importance of FRTB for CMU and financial markets***

The impact of FRTB needs to be considered in relation with other broad EU projects such as the Capital Markets Union.

Banks that conduct wholesale or market intermediation activities provide clients, such as governments, corporates (including SMEs) and other banks, with access to investors across the globe by enabling market-based finance and foreign exchange transactions.

FRTB will introduce a new approach for calculating how much capital banks must hold against their market intermediation activities, and its introduction may result in increases in the capital required for this type of activities.

European users of the market intermediation services provided by these international players are likely to find their access to markets reduced, or the costs of financial market products and services increased, if the impact of FRTB is too punitive.

This would clearly be against the CMU objectives of developing deep European capital markets to unlock alternative sources of capital or complement bank financing.

#### ***d) Domestic currencies***

As the Level 1 rules state under the IMA, interest rate risk in a bank's domestic currency is considered to belong to the most liquid (10 day) bucket. The standardised approach has similar favourable treatment. On the basis that domestic currency is the same as reporting currency, then in our view this approach will inadvertently penalise banks operating with a significant presence in several countries and (home) currencies and in doing so create a barrier for banks from other jurisdictions to have significant participation (in the case of Europe) in non-Euro European interest rate markets.

For example, a bank whose domestic currency is DKK would be able to put DKK interest rate risk in the 10 day liquidity horizon bucket under IMA, while a non-DKK domestic currency bank - even those with significant presences in the DKK market - would have to consider DKK risk in the 20 day bucket, even though the risk is the same. We believe the rules create a competitive distortion in parts of the EU market, that may directly lead to a reduction in liquidity in these markets.

#### **Industry Recommendation**

We recommend that changes are made to CRR III to permit the relevant national competent authority to classify a local currency as "domestic" for specific banks domiciled elsewhere. Criteria for this determination could include access to the local central bank as well as a large presence in the local market.

We note that in practice this could be solved via a clarification of the definition of the word "domestic" (in contrast to reporting currency) either in the final EBA RTS on liquidity horizons or alternatively directly in the level 1 text.

### **4.6. Implementation challenges and administrative burden**

***157) Which elements/revisions of the SA-MR and, respectively, IMA, if any, would you deem particularly challenging to be implemented?***

***Please elaborate and rank your answers from the most challenging to the least challenging revision.***

#### **IMA Implementation Challenges**

Further to the negative capital impact arising from the global output floor, the implementation complexity and increased operational costs induced by the revised standards is viewed by the Industry as a major disincentive for maintaining an IMA framework.

The revised IMA framework indeed requires the production and validation of an unparalleled number of risk metrics. Even though optimization can be sought via technical innovation or reassessment of target operating models, it is Industry consensus that the revised IMA cannot be run or maintained with current operational resources and computational capacity.

The implementation challenges differ across metrics, depending on specific modelling and computational complexity. As a general provision, the Industry considers that prescribing in CRR III a weekly frequency for all IMA metrics would provide a determinant relief on the model operation while it is not likely to alter the quarterly averages regulatory charges are based upon.

#### ***a. NMRF / ES /DRC charge***

A bank's exposure to non-modellable risk factors is assumed to be quite stable through time, as the bank does not have the capacity to take and unwind a position within a week, or hedge/de-hedge it at free will. Such a capacity would only be plausible in a high-liquidity environment and would contradict the fact that the risk is not modellable (or at least would not deserve to pass the modellability tests).

In addition, when a new exposure is taken on a NMRF, the small delay until capital recognition (i.e. 5 days at worse, in case of a weekly computation) will not cause a material distortion to the quarterly 12-weeks average.

On the other hand, although the stability of a bank's exposure to **MRF or default** is more difficult to qualify ex-ante, it is empirically arguable that a 60-day average wouldn't diverge much from a 12-weeks average if no intentional intra-week pattern is applied.

The proposal for ES and DRC metrics would be therefore to allow banks computing own funds requirements based on 12-weeks averages, provided that they can evidence to the satisfaction of supervisory authorities that the quarterly average exposure assuming weekly observations is fairly representative of the average exposure assuming daily observations, for any of the selected weekday (Mondays, Tuesdays, ... or Fridays). For the sake of simplicity this evidence could be supported by studies on the 1-day VaR figures used for backtesting purposes, on the full scope of position as a proxy for ES stability, and on the equity and credit position scope as a proxy for the DRC stability.

#### **Industry recommendation**

##### **NMRF:**

- Allow 'weekly' frequency for NMRF, with no monitoring requirement for the weekday selection.

**ES:**

- Extend the 'weekly' allowance/derogation (already existent for asset class ES, as per CRR II Article 325bb(4) ) to all ES metrics.
- Allow to leverage 1-day VaR figures to support evidence / monitoring requirements for the weekday selection.

**DRC:**

- Allow to leverage 1-day VaR figures restricted to the DRC scope (equity and credit) to support the weekday selection for DRC.

**b. Baskets & Funds**

Look-Through treatment of baskets and Funds in particular is extremely challenging for the proliferation of risk-factors it generates and consequently all the costs related to the

- identification of all needed meta-data,
- acquisition of time-series,
- handling and storage of huge scenario files.

This is true across all measures: IMCC, NMRF, DRC.

One-Off Costs: The hardware will need to be sized accordingly. Depending on the relative size of the funds/baskets for an institution it might imply a manifold increased in hardware required to process all the data. a manifold increased in hardware required to process all the data.

**c. NMRF Stress Calibration**

NMRF requires the capitalization of each risk-factor individually. Under the EBA methodology this will result in a search of the most impacting scenario over several scenarios (i.e. 13). Attempts to identify ex-ante the scenario that produces the largest loss are not implementable on an industrial scale since the Desk portfolio is not necessarily linear with respect to each specific risk-factor by definition.

It is however fair to assume the largest loss is typically associated to the largest shock. Such working assumption is however not allowed by the EBA approach.

One-Off Costs: This will make the SES methodology in EU more demanding from a computational standpoint than IMCC, leading to a doubling of the hardware required to process all the calculations.

**SA Implementation Challenges**

**d) Baskets & Funds**

Look-Through treatment of baskets and Funds in SA in particular is extremely challenging due to the proliferation of risk-factors they generate and consequently all the costs related to:

- I. the identification of all needed meta-data
- II. handling and storage of huge scenario files and
- III. massive increase in the number of revaluations needed for the calculation of all the sensitivities that this proliferation implies.

This is true both for SBA and DRC.

**Please provide relevant evidence on the expected one-off costs to substantiate your views.**

**158) Which elements/revisions of the SA-MR and, respectively, IMA, if any, would in your view cause additional administrative burden?**

***Please elaborate and provide relevant evidence on the expected recurring costs.***

The mechanism for the regular assessment of the IMA perimeter through the quarterly...

- Assessment of BT requirements for all the Desks
- Assessment of PLA requirements for all the Desks
- Assessment of the modellability requirements of the RF in the IMA eligible desks
- Consequent adjustments to the IMA perimeter and to the complementary SA perimeter for OFR calculation and OFR Forecasting

...will make the management of the Trading Book perimeter extremely complicated, potentially requiring an increase of the number of expert personnel to manage it.”

An automation of the processes will be necessary, but it will not be immediately implementable. A good understanding of the mechanics within the FRTB framework will be required, in order to automate the process.



## Appendix A: CTP

### 1) Decomposition of JTDs into single names for a given tranche and the relative drivers of JTDs

The following table shows JTDs for several single names and the total for the 0%-3% equity tranche of the iTraxx Europe Main index (Series 30), comprised of 125 equally-weighted investment grade European entities with an index reference notional of EUR 250MM. The JTDs assume a zero-recovery rate.

Issuer	JTD (in MM)	Cash Flow Effect (in MM)	MtM effect (in MM)
ACCOR	1.7	2.0	(0.3)
AEGON N.V.	1.7	2.0	(0.3)
AIRBUS SE	1.7	2.0	(0.3)
AKTIEBOLAGET ELECTROLUX	1.7	2.0	(0.3)
AKTIEBOLAGET VOLVO	1.7	2.0	(0.3)
AKZO NOBEL N.V.	1.7	2.0	(0.3)
...			
<b>Total</b>	<b>207.2</b>	250.0	(42.8)

The individual JTD for each issuer will differ depending on spread levels but, in the above example, will generally be between EUR 1.6MM and EUR 1.7MM (EUR 207MM / 125 issuers = EUR 1.7MM).

The calculation of decomposed JTD is prescribed by the rule (see MAR22.39):

*“Such decomposition is the sensitivity of the security’s value to the default of the underlying single name obligor. Decomposition with a valuation model is defined as follows: a single name equivalent constituent of a securitisation (e.g. tranching position) is the difference between the unconditional value of the securitisation and the conditional value of the securitisation assuming that the single name defaults, with zero recovery, where the value is determined by a valuation model.”*

Based on the above specifications, the JTD for each issuer is calculated assuming other issuers have not defaulted. And, for the equity tranche, the pay-out with zero recovery is EUR 2MM (EUR 250 / 125 issuers). The maximum amount the equity tranche can absorb in losses under the defaulting scenario is EUR 5.3MM, which exceeds each individual pay-out of EUR 2MM. This is the ‘cash flow effect’ and is different from the ‘MtM effect’ (see cash flow effect and MtM effect columns above). In the case of an equity tranche, the MtM effect lowers the total loss by roughly EUR 0.3MM to arrive at an actual JTD of EUR 1.7MM. The reason for this MtM effect is that the loss from the pay-out (i.e., EUR 2MM) is partially offset by the implied initial value of protection on the defaulted issuer (i.e., a pay-out of EUR 2MM for something that was initially priced at EUR 0.3MM).

### 2) Comparison between total gross decomposed JTDs across different tranches of the capital structure, gross JTD of an undecomposed tranche, and gross JTD of an untranching index

The following table shows individual JTDs, calculated for each single name assuming no other name defaults, across different tranches of the capital structure:<sup>46</sup>

Issuer	JTD in MM for the tranches					JTD in MM for the untranchéd
	0-3%	3-6%	6-12%	12-100%		
ACCOR	1.7	0.2	0.1	0.1	2.0	2.0
AEGON N.V.	1.7	0.2	0.1	0.1	2.0	2.0
AIRBUS SE	1.7	0.2	0.1	0.1	2.1	2.1
AKTIEBOLAGET ELECTROLUX	1.7	0.2	0.1	0.1	2.1	2.1
AKTIEBOLAGET VOLVO	1.7	0.2	0.1	0.1	2.1	2.1
AKZO NOBEL N.V.	1.7	0.2	0.1	0.1	2.1	2.1
...						
<b>Total</b>	<b>207.2</b>	<b>26.8</b>	<b>12.7</b>	<b>8.9</b>	<b>255.6</b>	<b>255.1</b>
<b>Notional</b>	<b>7.5</b>	<b>7.5</b>	<b>15.0</b>	<b>220.0</b>	<b>250.0</b>	<b>250.0</b>
<b>Tranche Market Value</b>	<b>5.3</b>	<b>7.3</b>	<b>15.2</b>	<b>227.6</b>	<b>255.4</b>	

As shown above, the total JTD across all individual names and tranches across the capital structure (EUR 255.6 MM) adds up to roughly the total JTD of the entire index (i.e., EUR 250MM) assuming no recovery.<sup>47</sup>

For tranches above the equity tranche, there is no cash flow impact in the single name default scenario, as the equity tranche has a sufficient buffer to cover losses arising from single issuer defaults. The MtM impact on the remaining tranches is driven by the lower capital buffer benefit that these tranches receive until they start absorbing losses.

The sum of single name JTDs is EUR 207MM while the market value of the tranche is only EUR 5.3MM. In this respect it is unclear how the requirement “...where in particular the sum of the decomposed single name amounts must be consistent with the undecomposed value of the securitization” should be interpreted given “a single name equivalent constituent is the difference between the unconditional value and the conditional value assuming that the single name defaults.” Clearly, the sum of the unadjusted single name JTDs of the equity tranche (i.e., EUR 207MM) is far larger than the maximum loss of EUR 5.3MM under the defaulting scenario.

If the requirement above is interpreted narrowly, meaning the sum of single name JTDs with only one name defaulting must be *equal* to the undecomposed JTD with enough names defaulting to fully exhaust the tranche, banks would have to scale down the sum of single name JTDs for the equity tranche to match its capacity for loss absorption (i.e., EUR 5.3MM), while scaling up other tranches to the corresponding undecomposed JTD. Such scaling would not be consistent with how banks manage and limit their single name exposures for risk management purposes, and it would also be inconsistent with how JTDs are calculated in the rest of the standardized framework where each underlying risk factor is shocked individually<sup>48</sup>. In addition, scaling down or up decomposed JTDs

<sup>46</sup> Consistent with the previous example, this represents JTDs of the iTraxx Europe Main index (Series 30) which comprises of 125 equally-weighted investment grade European entities with a reference notional of the entire index of EUR 250MM

<sup>47</sup> The industry would point out that outside CTP the gross JTD of untranchéd index would correctly reflect the prescribed recovery assumption as per section MAR22.12. Accordingly, the JTD would be roughly 25% lower than the EUR 255.1 in the table. Please see the section below on a discussion of why the zero-recovery assumption in the context of decomposed JTDs does not appear appropriate

<sup>48</sup> In particular, this is consistent with the approach specified for non-securitizations as per FAQ 1 to MAR22.14

would result in a reverse capitalization of the tranches where the senior tranche would receive a higher capital charge than the equity tranche, an outcome that is inconsistent with the relative risk of these positions (see next section for further analysis on this point). In this respect, it is important to allow banks to use a decomposition approach that appropriately reflects the risk inherent in these positions.

### 3) Comparison of the SSFA securitization approach and the CTP DRC decomposition approach

Once decomposed into single-name JTDs and netting is applied, the securitization risk weights cannot be applied as the decomposed single name JTDs are no longer associated with any particular tranche. Therefore, the industry recommends that non-securitization risk weights prescribed in MAR22.24 should apply.<sup>49</sup> The table below provides a comparison of capital requirements for different tranches assuming no decomposition and decomposition.<sup>50</sup>

Tranches	SSFA, p value = 0.5 with B4 corporate risk weights		Decomposition using non-sec risk weights as per MAR22.24	
	Undecomposed JTD	Capital Charge in MM	Decomposed JTD in MM	Capital Charge in MM
Equity	5.3	5.3	207.2	9.8**
Mezz1	7.3	6.8	26.8	1.3
Mezz2	15.2	3.6	12.7	0.6
Senior	227.7	3.6*	8.9	0.4
Total	255.4	19.3	255.6	12.0

\*Without the 1.6% floor the capital charge under SSFA for the senior tranche would be EUR 0.4MM

\*\* Consistent with MAR22.34 (3), we propose that the capital applied against an individual securitization position can be capped at the fair value (or maximum loss) of the transaction which is EUR 5.3MM in this case

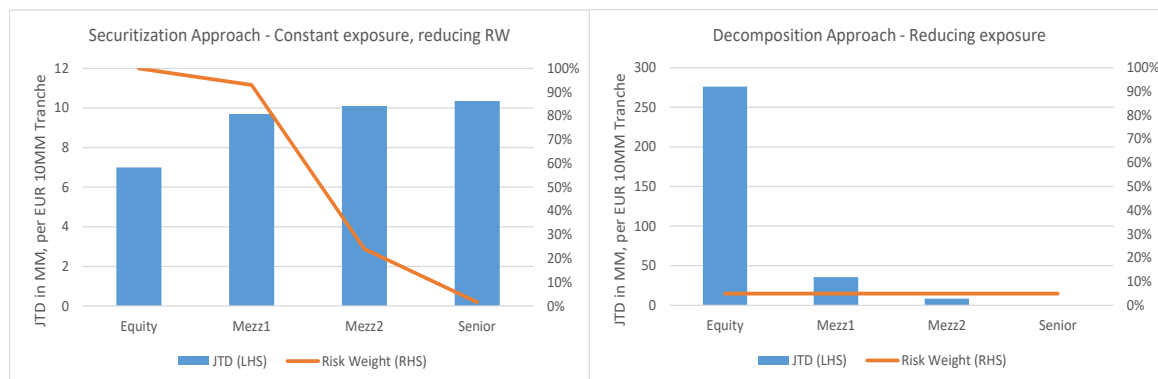
Two differences are particularly noteworthy. First, capital charges, in particular for the senior tranche, drop under the decomposition approach compared to the SSFA where a risk weight floor of 1.6% is imposed. However, it is important to note that the FRTB standardized approach incorporates several mitigating elements that ensure a conservative capital outcome for CTPs:

- The 0.1% residual risk add-on (RRAO) charge ensures that risk factors not captured by the standardized approach are capitalized. Given that the charge is based on notional, it has a particularly large impact on the senior tranches (i.e., senior tranches tend to be thicker than bottom-most tranches).
- The credit spread risk (CSR) risk weights for CTP within the sensitivities-based method (SBM) are substantially higher than those used for non-securitizations, which capturing risk associated with longer liquidity horizons and increased basis risk.

<sup>49</sup> The industry understands that section 939A of the Dodd-Frank Act prohibits the US agencies from issuing regulations that explicitly reference external credit ratings. However, similar to the simple CVA approach under section 132(e) under 12 CFR 217, credit rating reference could for example be converted into PD ranges

<sup>50</sup> Consistent with the previous example, this represents capital charges for the iTraxx Europe Main index (Series 30) which comprises of 125 equally-weighted investment grade European entities with a reference notional of the entire index of EUR 250MM

In the context of the senior tranches, it is worth highlighting the difference between the securitization approach and decomposition approach, illustrate in the following graph:<sup>51</sup>



The graph shows JTDs and corresponding risk weights under the securitization and decomposition approaches across different tranches of a securitization and for a given tranche notional (EUR 10MM). Under the securitization approach, the lower levels of capital attracted by the more senior tranches are achieved through decreasing risk weights, while keeping the exposure relatively constant.<sup>52</sup> In contrast, in the decomposition approach, the lower capital charge for senior tranches is driven by lower exposures, while maintaining constant risk weights. This further supports the point made earlier that scaling up the decomposed single-name JTDs to equal tranche JTD yields uneconomic outcomes, as the more senior tranches, with higher JTDs (see chart on the left), attract the same risk weight (see chart on the right) and thus, a higher capital charge, even though they are less risky.

Second, the capital charge based on SSFA for iTraxx Europe Main Index is roughly 60% higher than if a bank were to decompose the exposure into single-names and apply non-securitization risk weights (i.e., EUR 19.3MM vs EUR 12.0MM). There are several reasons for this:

- A p-value of 0.5 ensures that the capital charge that span across the full capital structure is 50% higher than if the bank were to enter the same exposure through an untranched index for which the total capital charge would be consistent with what is shown in the CTP DRC decomposition approach, above. Given that the capital charge for an equity tranche is capped at 100% and for the senior tranche is floored at 1.6% (see next point), setting the p-value at 0.5 results in capital charges of mezzanine tranches to be higher than they would be if the overall capitalization of the securitization were consistent with that of the underlying exposures.
- Without the 1.6% SSFA floor, the capital charge for the senior tranche (12%-100%) would be EUR 0.4MM (similar to the decomposition approach) and the total charge across the capital structure would be EUR 16.1MM instead of EUR 19.3MM.
- Another potential driver of differences in capitalization is the underlying risk weight assumption. In the case of iTraxx Europe Main index, the SSFA risk weight assigned to the

<sup>51</sup> As previous examples, this is based on the iTraxx Europe Main index (Series 30)

<sup>52</sup> Given that the JTD is based on MtM the exposures are not constant even though the underlying notional of EUR 10MM is identical across the tranches in this graph

underlying constituents, referred to as  $K_g$ , is 4.9% and is quite close to the average risk weight of the single name JTD exposures in the decomposition approach (4.7%). It, therefore, does not explain the difference observed. However, in the case of indices composed of lower rated entities, such as the iTraxx Europe Crossover index, the decomposition approach can result in higher capital charges as illustrated in the table below (i.e., EUR 61.2MM vs EUR 17.2MM<sup>53</sup>):

Tranches	SSFA, p value = 0.5 with B4 corporate risk weights		Decomposition using non-sec risk weights as per MAR22.24	
	Undecomposed JTD	Capital Charge in MM	Decomposed JTD in MM	Capital Charge in MM
Equity	6.1	6.1	148.4	34.0**
Mezz1	23.0	7.3	87.6	20.1
Mezz2	43.1	0.7	24.9	5.7
Senior	193.5	3.1*	5.9	1.4
Total	265.7	17.2	266.8	61.2

\*Without the 1.6% floor, the capital charge under SSFA for the senior tranche would be EUR 0MM

\*\* Consistent with MAR22.34 (3), we propose that the capital applied against an individual securitization position can be capped at the fair value (or maximum loss) of the transaction which is EUR 6.1MM in this case

In the case of the iTraxx Europe Crossover index, the average risk weight assigned to the underlying constituents under the SSFA is around 7.7%, whereas the average risk weight assigned to the single name JTD exposures in the decomposition approach is almost three times as high at 22.9%. It is worth noting that the total capital charge under the SSFA for the iTraxx Europe Crossover index is lower than the capital charge for the iTraxx Europe Main index (EUR 17.2MM vs EUR 19.3MM), which is not consistent with the underlying risk. The reason for this counterintuitive result is that the subordination of mezzanine and senior tranches is higher for the crossover index<sup>54</sup> compared to the main index, which results in lower risk weights for the mezzanine crossover tranches even though the risk weight of the underlying exposures is slightly higher (i.e., 7.7% for the crossover index as opposed to 4.9%). In contrast, the capital charge under the CTP DRC decomposition approach for the iTraxx Europe Crossover index is around five times as high as iTraxx Europe Main index, which is in line with the difference in the one-year default probabilities for the two indices.<sup>55</sup>

It is worth noting that under the SSFA the capital charge for the senior tranche of the crossover index is EUR 3.1MM higher than that of the mezzanine tranche of EUR 0.7MM, which, again, is a counterintuitive result driven by the SSFA risk weight floor of 1.6%. Moreover, the crossover example highlights the potentially very different risk weight assumptions for the underlying exposures (i.e., RWs based on banking book securitization framework and the non-securitization risk weights within

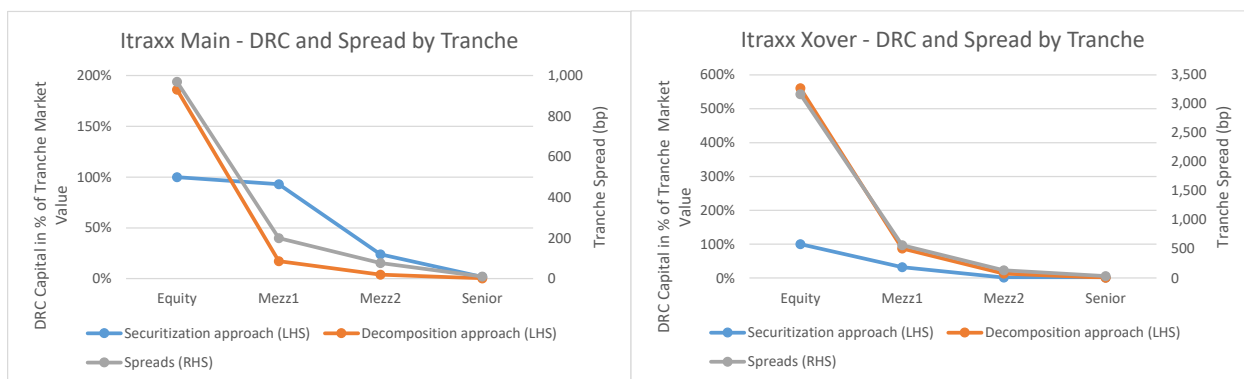
<sup>53</sup> This represents capital charges for the iTraxx Europe Crossover index (Series 30) which comprises of originally 75 equally-weighted European non-investment grade issuers with an original reference notional of the entire index of EUR 250MM

<sup>54</sup> Original attachment / detachment points for mezzanine tranches for the crossover index are 10% / 20% and 20% / 35% whereas for the main index they are 3% / 6% and 6% / 12%

<sup>55</sup> As of October 3, 2019, the one year CDS-implied default probability for the iTraxx Europe Main index Series 30 is 18bps whereas the default probability for the iTraxx Europe Crossover index Series 30 is around 91bps (around 5 times)

DRC). This potential inconsistency can be avoided through the decomposition approach as tranches, untranching indices, and single names would be subject to the same risk weights.

Overall, it is evident that decomposition allows for greater risk sensitivity in the calculation of the DRC, which is particularly important when it comes to netting across tranches, series, and single names of the same index family. The following graph illustrates this by comparing the capitalization under the SSFA securitization approach and the CTP DRC decomposition approach to spread levels of tranches as a reflection of relative risk.



The blue and the orange lines show the effective risk weight of the different tranches for the two approaches by calculating the ratio of DRC to the tranche MtM, which forms the basis for JTD under the securitization approach. The charts show that the effective risk weights across the different tranches track more closely to the markets' assessment of relative riskiness of the tranches reflected in spread levels. This further highlights that decomposition is crucial to improving risk sensitivity of CTP DRC.

As highlighted below in the context of risk weights, the calculation of the DRC for CTP should be consistent with that for non-securitization if the bank chooses to decompose securitization positions. Most importantly, this pertains to the risk weights as per above. Beyond that, however, this principle also applies to the appropriate assumption (see below) as well as the bucketing of the JTDs. In particular, the buckets should not any longer align with an index family, e.g. CDX North America IG but with the ones described in the non-securitization section of DRC, i.e. corporates, sovereigns and local governments / municipalities. The reason why this matters is that once the tranches are decomposed it becomes irrelevant which index the single name JTD was part of. For example, the risk profile of an underlying single name exposure is not different depending on whether it was part of the iTraxx Europe Crossover index at some point in time and subsequently part of the iTraxx Europe Main index<sup>56</sup>. The bucketing alignment with the non-securitization framework would further strengthen risk sensitivity and overall consistency of the framework.

#### 4) LGD assumption for calculating JTDs within CTP

<sup>56</sup> For example, ArcelorMittal was part of the iTraxx Europe Crossover index until series 29 and subsequently included in the iTraxx Europe Main index following rating upgrades in 2018



In the examples above, the JTDs have been calculated based on an LGD assumption of 100% as prescribed in MAR22.39. The underlying justification being that LGD is already incorporated in the default risk weight for securitizations and therefore the JTD should equal the market value to avoid any double count (see MAR22.27). In other words, the reason for not applying an LGD of less than 100% to the exposure value is not related to a more punitive loss assumption of the underlying instruments for securitizations but to the fact that the LGD is already reflected in the risk weight. For example, within the securitization risk weight calculation based on SSFA the LGD is meant to be embedded in the risk weight  $K_G$  assigned to the underlying exposures of the securitization. Similarly, within the securitization risk weight calculation based on the supervisory formula approach (SFA) the LGD is reflected through the underlying risk weight  $K_{IRB}$  and the exposure-weighted average loss given default (EWALGD). Given that, the industry agrees that the exposure against which the securitization risk weight is applied (SFA or SSFA) should not be adjusted to reflect a recovery value of more than 0% for the underlying exposures.

However, the argument for why the JTD should not be adjusted is not relevant in the context of the decomposed single name exposures. As explained above, once a tranche is decomposed, a non-securitization risk weight should be assigned. Unlike the securitization RWs, the non-securitization risk weights only reflect the probability of default of the underlying issuers, not the LGD. Consequently, JTDs for non-securitization exposures need to reflect prescribed LGD. Banks should then be allowed to calculate decomposed JTDs based on the prescribed LGD assumptions in section MAR22.12.

Such adjustment would result in a lower capital charge than the EUR 12MM for the iTraxx Europe Main index and the EUR 61.2MM for the iTraxx Europe Crossover index shown in the tables above. The industry would also point out that section MAR22.37 seems to suggest that the JTD for non-securitizations should be calculated based on a zero-recovery assumption. Based on the arguments made above, JTDs for non-securitization should also reflect LGDs prescribed in MAR22.12, as the risk weights listed in MAR22.24 do not incorporate LGD assumptions.



## 5. Credit valuation adjustment (CVA) risk

### Executive Summary

The Industry appreciates the opportunity to provide additional details on the impact of the revised credit valuation adjustment (CVA) risk framework in Europe. The Industry remains concerned by the implementation of the final Basel III reforms in Europe as demonstrated by the responses to the consultation questions below which highlight issues with the revised CVA framework, finalised by the Basel Committee on Banking Supervision (BCBS) in 2017.

We very much welcome the recent BCBS consultation<sup>57</sup>, which addresses some of the issues in the framework and aims to provide targeted changes to the CVA framework.

Our analysis has shown that the current BCBS framework does not appropriately reflect how CVA desks manage and account for risk and will result in high capital impacts for banks. CVA risk represents a significant driver in 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 are addressed appropriately to ensure that capital requirements are in line with real economic risk incurred by banks.

These results are in line with Industry and regulators' analysis and impact assessments. An Industry QIS analysis finalised<sup>58</sup> in June 2019 shows that the revisions under the Basel III framework have a significant impact on CVA RWA, resulting in an increase of 84% compared to current capital requirements at global level. In its recent December 2019 report<sup>59</sup>, the European Banking Authority's (EBA) results highlight that the impact of these revisions for European banks is significant (+558% on CVA RWA under the central scenario assuming the re-integration of the CRR exemptions and +140% under the alternative scenario assuming the current CRR exemption framework). The EBA report also shows that the largest driver behind the increase of total SA-CVA RWA is the Counterparty Credit Spread (CCS) CVA RWA component at 72% and the next largest contributors to SA-CVA RWA are Interest Rate CVA and FX CVA, at circa 12% and 4% of SA-CVA RWA respectively.

In light of the design and calibration issues in the global standard, it will be important to get resolution of these issues at the BCBS level to ensure a sound, harmonised and consistent CVA

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<sup>57</sup> <https://www.bis.org/bcbs/publ/d488.htm>

<sup>58</sup> This study has been estimated re-integrating EU exemptions both in the current and revised CVA calculations using data as of December 2018 for the 16 international active participating banks based in, Europe, Switzerland and the US. Please note that as part of the recently published BCBS consultation paper (CP), we will be providing updated numbers using assumptions and scenarios in the CP, including for instance, the adjustment to the multiplier mCVA from [1.25-1]. We will share these updated numbers once they are available.

<sup>59</sup> See link - [EBA Report – Basel III Reforms: Impact Study and Key Recommendations](#)

framework that addresses some of the lack of risk sensitivity of the framework and brings the calibration down to a reasonable level.

It is crucial that the revised framework meets its intended objectives to capture all CVA risks and better recognition of CVA hedges, align with Industry practices for accounting purposes and align with proposed revisions to the market risk framework.

We continue to believe the BCBS consultation will not call into question the readiness of regulators and the Industry to implement the required changes in line with the Basel III regulatory timeline. We would therefore encourage the EU to consider these developments in its upcoming transposition of the Basel CVA framework. In the European context therefore, a review of the existing CVA exemptions should only be performed once the Basel standard has been recalibrated and a thorough impact analysis has demonstrated the impact on end-users is significantly reduced.

The elements provided in response to this consultation highlight the issue and shortcomings of the framework, and we will continue to support the global and regional processes as the Basel Committee works to finalising its consultation.

The Industry continues to recommend that the revisions to the CVA framework include:

- Changes to hedge recognition to better capture the benefits of hedging the systemic risk of a typically diversified CVA portfolio;
- Recalibration of specific elements of the CVA framework to remove some excess conservatism still prevalent in the SA-CVA framework; and
- An adjustment of some framework parameters and scope that would induce more convergence between the regulatory view of CVA and Industry best practices on accounting CVA.

## 5.1. Revised CVA framework

***159) Views are sought on the cost and benefits of implementing the revised CVA framework in the EU.***

***In particular, how do the approaches provided by the final Basel III standards compare with the current approach of the CRR in terms of impacts on RWAs and operational burden?***

***Please provide relevant evidence to substantiate your views.***

The revisions to the CVA framework issued in December 2017 by the Basel Committee on Banking Supervision (BCBS) introduced some significant modifications to the existing framework.

Specifically, the Basel revised CVA framework removed the internal model approach, and introduced a standardised approach based on fair value sensitivities to market risk factors (SA-CVA) and a basic approach to calculating CVA (BA-CVA) derived from the existing standardised approach. In addition, a materiality threshold was established (less than or equal to €100bn) which allows banks to choose to set their CVA capital equal to 100% capital requirement for CCR.

We note and welcome the recent publication of the consultation launched by the Basel Committee on targeted changes to the CVA framework. We hope that the resulting final global framework will address the lack of sensitivity of the framework and its punitive calibration.

In light of the shortcoming in the global standard, and with the ongoing consultation, we would encourage the EU to consider these developments in its upcoming transposition of the BCBS CVA framework. We will continue to support efforts at global and regional level as the Basel Committee works to finalising its consultation.

The following sections detail issues that exist in the current CVA framework.

### **Impact of the revised CVA framework**

The Industry analysis on the revised CVA standard has shown that the new framework does not appropriately reflect how CVA desks manage and account for risk. The Industry believes the design and calibration issues prevalent in the CVA framework are important to address as part of the alignment of the CVA risk standard to the updated market risk requirements. Given the removal of the internal-model approach (IMA-CVA) from the revised framework, it is important to ensure that SA-CVA be adjusted appropriately to reflect and capture actual CVA risk and so that it does not generate unintended market distortions.

CVA risk represents a significant driver in 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.

An Industry QIS analysis finalised in June 2019 shows that the revisions under the Basel III framework have a significant impact on CVA RWA resulting in an increase of 84%<sup>60</sup> compared to current capital requirement at global level.

The European Banking Authority (EBA) report<sup>61</sup> published in December 2019 highlights a significant impact for European banks in the central scenario (+558% in CVA RWA assuming that EU CRR exemptions are re-integrated in the scope of calculation) and +140% in CVA RWA in the alternative scenario based on the current CRR exemptions framework and change of scope for SFTs ) with the largest driver behind the increase of total SA-CVA RWA being the Counterparty Credit Spread (CCS) CVA RWA component at 72%. The next largest contributors to SA-CVA RWA are Interest Rate CVA and FX CVA, at circa 12% and 4% of SA-CVA RWA respectively.

In addition, we note that both the recent BCBS Monitoring Report and the EBA updated impact analysis report published in December 2019 have confirmed that CVA is one of the main drivers behind the increase of Tier 1 minimum capital requirements (contributing to 3.9% to the overall increase in T1 MRC according to the EBA analysis).

Please note that as part of the recently published BCBS consultation paper (CP), we will be providing updated numbers using assumptions and scenarios in the CP, including for instance, the adjustment to the multiplier mCVA from [1.25-1]. We will share these updated numbers once they are available.

***160) Would in your view any type of transactions be particularly affected by the implementation of the revised CVA framework in the Union?***

- Yes

***160.1) Please provide relevant evidence to substantiate your views on question 160.***

To account for CVA risk, banks put in place hedges to target the exposure component of CVA variability. CVA desks use proxy hedges (single names and liquid CDS indices) to mitigate the systematic counterparty credit risk at the overall portfolio level.

However, as it currently stands, the revised CVA framework does not sufficiently consider how CVA desks account for and manage risk, leading to punitive capital requirements.

We take note and welcome the recent BCBS consultation paper d488 ('Credit Valuation Adjustment risk: targeted final revisions') which seeks to address design, calibration and risk-sensitivity issues

<sup>60</sup> This study has been estimated re-integrating EU exemptions both in the current and revised CVA calculations using data as of December 2018 for the 16 international active participating banks based in, Europe, Switzerland and the US.

<sup>61</sup> <https://eba.europa.eu/file/362841/download?token=050iTyEx>

in the framework, and look forward to respond to this consultation. The answer below provides some highlights to the issues in the current framework.

Proxy and index hedges, in particular, are poorly recognised. This leads to an overly conservative credit capital requirement that is not proportionate with the real risks incurred by banks.

This can typically impact transactions with non-financial counterparties, where indirect hedges (proxy for single name CDS or CDS index hedges) are the sole instruments available to hedge counterparty credit risk where there is no liquid CDS. Usually in the CVA book, credit risk comes from counterparty risk to illiquid names, and CVA desks hedge against the impact of credit spread movement in CVA through the following:

- Direct single name hedges - where the reference entity of the CDS is the same as the counterparty generating the exposure;
- Proxy single name hedges - where there is no name-specific CDS available and the CDS reference name is considered a suitable proxy; and
- Index CDS hedges - credit indices are used to hedge the systemic spread risk at the portfolio level.

Under SA-CVA index hedges must be decomposed and allocated across sector buckets, impacting on hedge efficiency and portfolio risk:

- Decomposition - index hedges are treated as a collection of single name hedges and allocated across sector buckets, and risk is additive across sector buckets.
- Hedge Efficiency - decomposing the index significantly reduces efficiency as hedge performance comes down to the way in which the individual components are bucketed.
- Portfolio Risk - Fundamentally index hedges are not applied at a sector level but at portfolio level; decomposing the index distorts the economic purpose of mitigating systemic risk.

Under SA-CVA, risk is additive across buckets so separating the proxy hedge can result in a higher capital charge for hedged positions compared to unhedged position. This can result in prudent CVA hedges increasing capital due to bucket misalignment.

A recent Industry study shows that there has been a deterioration of hedging efficiency in the recognition of indirect hedges for counterparty credit risk under the proposed new framework. The average reduction in capital requirements for counterparty credit spread risk considering the actual hedging strategy is 11.8% under the proposed SA-CVA approach. This compares to a reduction of 22.1% in the previous CVA framework (when considering hedged and unhedged capital requirements) and highlights that the regulatory objective to better recognise CVA hedges has not been achieved.

Correcting this mismatch is crucial to reflect the appropriate capitalisation of the risk captured, which is a key element of the Basel reform. Failure to address this mismatch may limit end-user

counterparties' access to risk management solutions, as banks might be required to reduce exposures for these transactions.

Other issues in the framework include the calibration and the lack of granularity and risk sensitivity of counterparty risk-weights for exposures to financial entities – which is also a key driver behind the significant uplift in capital requirements. A significant portion of the CVA capital requirement – 72% according to the European Banking Authority (EBA) in its December 2019 report) derives from the counterparty credit spread component.

For example, there are only two risk weights for counterparty credit exposures to financials. This bucket includes a wide range of financial counterparties which are pivotal to finance the real economy, such as:

- Highly regulated institutions with multiple financial business lines (commercial and investment banks, insurance companies);
- Unregulated and highly leveraged institutions (hedge funds, private equity); and
- Institutions with narrowly defined missions based on earning appropriate returns for investor stakeholders (pension funds, mutual funds, asset management accounts).

The lack of risk sensitivity of the framework, particularly for financials, is an issue in the revised CVA framework. The current standardised CVA approach (finalised in 2011) has a more granular approach to defining the risk weights for counterparty credit spreads. The lack of granularity in the risk weight for exposure in the revised CVA framework, in particular to financials, presents a problem and contributes to the significant uplift in capital requirements having a potential significant impact on end-users

In addition, the revised CVA framework does not account for the specific nature of covered bonds, which makes them significantly less risky than other debts of their issuer. This concern has already been raised in relation to the revisions to the minimum capital requirements for market risk and acknowledged by the Basel Committee through a risk-weight revision. A more risk sensitive framework for counterparties representing covered bonds should also be implemented in CVA risk, for instance via the introduction of a dedicated risk bucket which aligns CVA and FRTB risk-weights.

Finally, a large number of counterparties in this bucket do not have actively traded debt instruments or CDS. Financial names in credit trading books, in contrast, are concentrated among the larger, broad based institutions – banks and insurance companies. The dichotomy between CVA portfolios and credit trading books argues for enhanced bucketing granularity for CVA. The Industry believes that a 500bp risk weight is very punitive for a pension fund with a strict investment policy, very high-quality assets and negligible leverage. A similar argument can be made for asset managers more broadly, including investment companies/funds with investment guidelines that prohibit material leverage. Conversely, lightly or un-regulated funds with material leverage may justify a risk weight exceeding 500bp. The Industry also believes that the 500bp risk weight is unrealistically large for a counterparty representing covered bonds, and does not account for embedded credit enhancement features that make their credit-worthiness closer to sovereigns.



**161) One of the main objectives of the final Basel III standards was to enhance the risk-sensitivity of the CVA framework.**

**Are there in your view elements of the approaches of the revised CVA framework that do not achieve these objectives?**

- Yes

**161.1) If yes, which ones and what are the potential solutions to address them prudentially? Please provide relevant evidence to substantiate your views.**

One of the main areas of deficiency in the revised rules is the misalignment between sound risk management practices and regulatory capital mainly in the recognition of hedges. The recent BCBS Consultative Document d488 ('Credit Valuation Adjustment risk: targeted final revisions') aims to improve the recognitions of hedges with both the introduction of specific index buckets and a revised aggregating formula<sup>62</sup>. Industry analysis has shown that in some instances, capital requirements for hedged positions (less risky than non-hedged positions by definition) are close to or even greater than equivalent unhedged positions. Correcting this mismatch is crucial to reflect the appropriate capitalisation of the risk captured, which is a key element of the Basel reform. Failure to address this mismatch may limit end-users' access to risk management solutions, as banks may be required to reduce exposures for these transactions.

The limited risk sensitivity on counterparty credit spread risk weights in the revised framework is also an important issue to address, as a significant portion of the CVA capital requirement derives from the counterparty credit spread component<sup>63</sup>. For example, financial counterparties are captured in a single credit bucket, consistent with the trading book approach. Additional granularity is warranted in this case as the diversity and dispersion of financial counterparties in CVA is far greater than it is for traded products. CVA covers a much wider set of financial counterparties, including pension funds, mutual funds, insurance providers and other buy-side end-users that are pivotal to the real economy. In addition, compared to the existing standardised CVA framework, there is a relative change in risk weights for financials of 2 to 3 times in the revised CVA standard for well-rated investment grade financials (and consequently 2 to 3 times additional regulatory capital required for these positions). The BCBS intention to align CVA risk-weights with the finalised market risk standard for foreign exchange and interest rate instruments will not alone offset the increase in required capital, considering the contribution of the counterparty credit spread risk.

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<sup>62</sup> <https://www.bis.org/bcbs/publ/d488.pdf>

<sup>63</sup> XX% of the capital requirements of SA-CVA comes from the counterparty credit spread component (based on data from the June 2019 Industry addendum study). This component is specific to the FRTB-CVA framework and is not included in the FRTB-market risk framework



In addition, the risk sensitivity of the CVA framework is further reduced by the continued gap between regulatory and accounting CVA, primarily the result of the margin period of risk (MPOR) floor of 10 days and the LGD. The SA CVA capitalises a CVA distinct from the true accounting CVA, breaking the link between economic risk and own fund requirements. Closing this gap was one of the stated objectives of the revisions of the CVA framework and in this context an Industry survey<sup>64</sup> showed that a material percentage of banks (81%) use MPOR assumptions of 5 days and less for the calculation of accounting CVA. We note that in its consultation paper d488 ('Credit Valuation Adjustment risk: targeted final revisions'), the BCBS proposes to reduce the floor for the MPOR for clearing members' exposures to clients in the SA-CVA from ten to five days. More elements on the issue presented by the gap between regulatory and accounting CVA will be explored in section 5.4 of the consultation.

Amending the framework to align with the accounting treatment of CVA will go some way to realign the CVA framework with actual economic CVA risk. However, after calculating the sensitivities, the design of the framework introduces a number of conservative assumptions that by construction will mean that the capital requirement will overstate the CVA risk. Therefore, it is important that a review of CVA ensures that the framework appropriately reflects economic and financial risks. Since SA-CVA is a regulatory-prescribed standardised methodology with prescribed risk sensitivities, risk weights, aggregation and correlations it is unclear why an additional multiplier for model risk (mCVA) is required. We understand that in the past multipliers have been used by regulators to achieve a desired level of capital. Given the embedded conservatism in other areas and concerns on the calibration of the existing framework, we believe removing the multiplier from the revised framework should be considered. We also note that in its consultation document d488 ('Credit Valuation Adjustment risk: targeted final revisions'), the BCBS suggests a reduction in the value of the existing (mCVA) multiplier.

### **Industry Recommendation:**

The Industry recommends the following updates to be adopted for the CVA framework, which leverage concepts already existing within the market risk framework:

- Changes to hedge recognition to better capture the benefits of hedging the systemic risk of a typically diversified CVA portfolio;
- Recalibration of specific elements of the CVA framework to remove some excess conservatism still prevalent in the SA-CVA framework; and
- An adjustment of some framework parameters and scope that would induce more convergence between the regulatory view of CVA and Industry best practices on accounting CVA.

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<sup>64</sup> The survey was conducted in July 2019 (based on 16 participating G-SIBs and internationally active banks)

**161.1) If no, please elaborate on your response to question 161.**

N/A

**162) The final Basel III standards extend the scope of CVA risks subject to the framework.**

***In this context, what are your views on the capacity of institutions in the EU to manage and hedge all CVA risks? Are CVA hedges under the SA-CVA and BA-CVA appropriately recognised?***

- No

**162.1) If yes, please elaborate on your response to question 162.**

N/A

**162.2) If not, what are the potential solutions to better recognise them prudentially? Please provide relevant evidence to substantiate your views.**

Proxy and index hedges are poorly recognised in the revised CVA framework leading to an overly conservative credit capital requirement that is not proportionate with the real risks incurred by banks. As mentioned in response 161.1, we note that the Basel Committee is consulting the Industry on the option to include specific index buckets and using a potentially more risk-sensitive formula for aggregation.<sup>65</sup>

Under the SA-CVA approach proposed in the BCBS d424<sup>66</sup> framework (December 2017), index CDS are decomposed into a collection of single name instruments and allocated across buckets. However, treating an index CDS as a selection of single name hedges is inconsistent with the economic purpose of index hedges which is to mitigate systematic credit spread risk. Fundamentally, index hedges are not applied at a counterparty level but at a portfolio level – decomposing the index into its constituents distorts the economic purpose of the index hedge and significantly reduces its effectiveness.

CDS Index hedges are the sole instruments available to hedge counterparty credit risk without a liquid CDS, which would typically concern a large majority of counterparties. They allow for the

<sup>65</sup> <https://www.bis.org/bcbs/publ/d488.pdf>

<sup>66</sup> <https://www.bis.org/bcbs/publ/d424.pdf>

systematic portion of counterparty credit spread risk to be efficiently hedged and are thus widespread and central in hedging strategies across the Industry.

Under the SA-CVA framework as proposed in the BCBS d424 framework (December 20147), index CDS instruments are modelled as a collection of instruments efficiently hedging the idiosyncratic portion of counterparty credit spread risk, but lacking recognition of the systematic portion. This distortion between economic intent and regulatory recognition can even generate an increase in capital requirements when index constituents are not part of the institution's portfolio. Institutions with good risk-management practice, aiming to reduce the volatility of their CVA, should not be penalised from a capital perspective.

Indeed, banks are required to calculate delta sensitivities to counterparty credit spreads for illiquid and non-observable entities. The credit spread risk of these entities is then classified in such a way that no effective capital hedge can be obtained in the market. The decomposition of index CDS and economically related single name CDS (e.g. sharing credit quality, Industry and region) are ineffective at mitigating capital CVA. The treatment of hedges requires further improvements in order to:

- Align the economic CVA proxy hedging to capital CVA hedge relief including improving index hedge recognition;
- Improve proxy hedging recognition across illiquid and liquid counterparties; and
- Capture systematic correlation between same proxy buckets (this is to some extent recognised in the BA-CVA but not in the SA-CVA).

In addition, the design of the standardised approach – and use of risk weights - in the finalised FRTB framework and the CVA framework are generally consistent. Both approaches have risk weights for equity, FX, interest rates, reference credit and commodities. However, only the CVA framework has a series of risk weights for counterparty credit spreads. This is the most important part of the framework for CVA risk because, as mentioned above, 72%<sup>67</sup> of the capital requirement for CVA risk is derived from counterparty credit spreads. Since the counterparty credit spread risk weights are only found in the CVA framework, it would be possible to make revisions to counterparty risk weights without having implications for the design of the FRTB framework. Specifically, the Industry believes that further granularity and risk sensitivity should be introduced into the counterparty credit spread risk weights.

One of the problems with the counterparty credit spread risk weights in CVA is that there is limited risk sensitivity. For example, there are only two risk weights for counterparty credit exposures to financials while this bucket includes quite different counterparties (including pension funds and government-backed entities). The current Basel III standardized CVA approach (finalized in 2011) has a more granular approach to defining the risk weights for counterparty credit spreads. The lack of granularity in the risk weight for exposure, in particular to financials do present a problem and

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<sup>67</sup> Based on the EBA report published in December 2019: <https://eba.europa.eu/file/362841/download?token=050iTyEx>

contribute to the significant uplift in capital requirements having a potential heavy impact on end-users.

Another problem to highlight is the identification of non-credit CVA hedges. It is a common practice across various institutions to manage XVA (including CVA) risks on a net basis. Identifying the non-credit part of CVA hedges introduces limited economical meaning from banks' risk management perspective. Besides, having such an identification process would inevitably lead to tremendous technology implementation efforts and operational risks due to booking considerations.

Finally, CVA hedges are also not appropriately recognised in the framework due to the mismatch between accounting and regulatory CVA. When banks' definition of accounting and regulatory CVA differ, it creates a mismatch in exposure profile level and render the exposure hedges sub-optimal for prudential purposes since banks' will generally choose to hedge the accounting CVA rather than the regulatory CVA as defined in the prudential text.

### **Industry Recommendations**

The Industry has developed simple recommendations drawing on existing elements of the framework, aimed at improving the recognition of CVA hedges:

- Making the necessary changes to hedge recognition to better capture the benefits of hedging the systemic risk of a typically diversified CVA portfolio, with a) the option to assign indices to dedicated counterparty credit buckets alongside an appropriate correlation across buckets, and b) a proper recognition of proxy single name hedges when justified by sound market practices;
- Adding further granularity in the risk weights by increasing the number of credit quality steps and improve the risk sensitivity with differentiated risk weights. This would help better reflect credit spread levels, spread volatility or counterparty types. In this regard, introducing additional sub-sector buckets for 'financials' would better reflect their risk profile; and
- Reduce the gap between accounting and regulatory CVA.

Further recommendations on the gap between accounting and regulatory CVA and other calibration issues related to the multiplier are detailed in question 174.

### ***163) Would you see particular challenges to implement the Basel III standards on CVA risk by the internationally agreed deadline?***

- Yes

#### ***163.1) If yes, why? Please elaborate.***

Given the new elements brought forward with the revised CVA framework, banks will face operational challenges to implement. In light of the design and calibration issues in the global framework, the resolution of these issues at the BCBS level is important to ensure a sound, harmonised and consistent CVA framework.

In this context, we welcome the recent publication of the targeted adjustments to the CVA risk framework by the Basel Committee. This will be crucial to ensure the revised framework meets its intended objectives to capture all CVA risks and better recognition of CVA hedges, align with Industry practices for accounting purposes and align with proposed revisions to the market risk framework. We continue to believe such a consultation will not call into question the readiness of regulators and the Industry to implement the required changes in line the Basel III regulatory reform timeline.

It is also imperative that the Basel III implementation does not result in large increases in capital as per the commitment made by the Basel Committee and European regulators to “not significantly increase capital requirements”. Therefore, it will be important to monitor and evaluate the impact and unintended consequences over the course of its implementation at global and regional level and adjust where necessary.

Operational challenges with regard to the overall implementation timeline of the Basel III standards on CVA risk relate to:

- Calculation of regulatory CVA on additional population as compared to accounting CVA: implementing Basel III standards on such non-business-as-usual (BAU) population is expected to take massive efforts and additional time.
- Uncertainty on SA-CVA approval process - including this process within their implementation timeline is a major consideration for banks wishing to apply for this method. However since there is no track record of an approval process for a standardised approach such as SA-CVA, the Industry would welcome any information of this process (application form, timeframe, etc.)

***163.1) If no, please elaborate on your response to question 163.***

N/A

## **5.2. Exemptions under the CRR**

***164) How do institutions currently manage the CVA risks arising from the counterparties exempted from the current CVA framework under CRR?***

***Please provide relevant evidence to substantiate your views.***

The CVA risks for the exempted counterparties are managed similar to non-exempted counterparties, by hedging the economic risk that the bank is exposed to under its accounting CVA. As we have highlighted below, the accounting CVA is not necessarily the same as the one imposed by the regulatory CVA, creating a mismatch between the economic risk and the capital that is held against it.

The CVA exemptions were originally granted in Europe because of valid concerns that the original Basel CVA regime was not appropriately calibrated. In particular, the exemption relating to non-financial counterparties, sovereign and pension funds were agreed to limit the downside of the poor calibration of the framework on the real economy and pensioners. This exemption has served the EU corporate sector, pension and sovereign well in permitting financial risks to be transferred economically to the financial sector, while Basel has been reconsidering the methodology for the CVA capital charge.

The Industry was expecting that the new CVA framework would propose a reasonable and proportionate CVA risk charge which might be applied without exemptions, but the current calibration of the new framework is very punitive.

The European Banking Authority (EBA) report published in December 2019 shows that the impact of the revised CVA framework in the EU is +558% assuming the integration of the CRR exemptions and 140% assuming the EU maintains its current exemptions framework. This analysis confirms the revised framework would result in a significant increase compared to the current approach both in RWA and in regulatory capital.

In order to manage CVA risks, the following hedging strategy are used:

- For Market Risk:
  - o FX Spot and FX Options;
  - o IR futures, swaps and options as well as Inflation Swaps;
- For Credit risk:
  - o Macro Index Hedges and convexity reduction using options;
  - o CDS single names. The hedging through CDS single names has been reduced mainly because of liquidity issues, especially for non-standard maturities.

The impact on corporates, sovereign and pension funds is significant and impact hedging activities. The main concern for corporates is that they are not generally able to put up collateral or margin, or to clear derivatives directly, as they will be the primary sector penalised by the poor calibration. For pension funds the concern is different, they do collateralise their derivatives with high quality liquid level 1 (HQLA level 1) assets, however they are not able to collateralise in cash as required by clearing houses for variation margin. Pension funds need to be fully invested, or close to fully invested, and requiring them to hold more assets in cash would increase the financial solvency risk of pension funds.



**165) What would you consider to be the potential impacts on RWAs and in terms of operational burden stemming from removing the existing exemptions under the CRR would have?**

***Please provide relevant evidence to substantiate your views.***

As highlighted by the European Banking Authority (EBA) in its December report to the European Commission, assuming that the EU retain the exemptions and exclude fair-valued SFTs (alternative scenario), the average impact of the revised CVA framework is a +140% change in CVA RWA compared to the existing framework.

By contrast, the impact in the EBA's analysis under the central scenario (i.e. applying the revised CVA framework without exemptions) would lead to a +558% change in CVA RWA, with the largest banking institutions being the most impacted.

Given the calibration issues in the revised CVA framework, it will be important to address them given the significant impact on RWAs. In the revised framework, hedging of these exposures is very difficult, and proxy hedging is penalised by the reform. This means that the cost of CVA is likely to be transferred to the clients, and this might limit their ability of managing their risks.

**166) In your view, which clarifications, if any, should be provided regarding the definition of the current exemptions, should these exemptions be retained under the CRR?**

***Please provide relevant evidence to substantiate your views.***

When Basel III was transposed into European legislation via the initial CRR package, European legislators decided to exclude CVA capital charges on the counterparty risk arising from derivative transactions with "end-users", i.e. non-financial counterparties (NFC), sovereign and pension funds, which use derivatives to hedge against potential adverse moves in currencies, interest rates or other financial variables.

EU policymakers believed end users of derivatives should not have to incur higher costs to hedge risks because they were either unable to collateralise their derivatives transactions due to significant infrastructure costs or lack of access to liquid assets (corporate issues) or because they were able to collateralise using HQLA level 1 assets but not cash (pension fund issues). This was also recognised in the European Market Infrastructure Regulation (EMIR) that exempts corporates below a threshold from the clearing obligation for derivative contracts, and also exempts pension funds until a robust clearing solution is found to the cash variation margin issue.

Another reason why such exemptions were introduced was the acknowledgement by European legislators that the current Basel framework suffers a number of shortcomings among which is the misalignment between accounting CVA and regulatory CVA. The revised framework does not address them (except that it now covers all CVA risks and their hedges). It rather introduces additional shortcomings, notably with respect to proxy/index hedges that become ineffective under SA-CVA (see answers to previous questions). Note that this is particularly detrimental for European



Corporates in a context where the Corporate CDS market is far less developed in Europe than in other parts of the world, and where CVA exposures on corporate counterparties with non-traded CDS available are typically hedged using proxy/index hedges.

In relation to intra-group transactions which are exempted under CRR, it is important to note that the BCBS rules are designed and calibrated to apply at a consolidated level. On a consolidated basis, intragroup transactions are not considered. On a solo basis, exposures between intra-group entities established in the EU or equivalent jurisdictions should continue to be exempted from CVA risk. More generally intra-group exposures between a parent entity and a consolidated sub-entity should be exempted. In addition, intra-group exposures subject to strong collateral agreements should be excluded from the scope of CVA risk on the basis that the identification of default is immediate, and the resulting market risk can be re-hedged simultaneously with the default.

### **Industry Recommendation**

As the Industry has stated before, the application of the exemptions could be reviewed only when the Basel standard proved to be correctly amended. Now that the IMA approach has been removed, the Industry continues to believe that the misspecification of CVA risk capital could lead to an overall increase in costs derivatives for end users (corporates pension funds and sovereigns counterparties) and creates a disincentive for end users to use these instruments for hedging purposes.

This is corroborated by the European Banking Authority's (EBA) analysis published in December 2019 under the central scenario (i.e. applying the revised CVA framework without exemptions), which highlights that the revised CVA framework would lead to a 558% increase in CVA RWA – this does not take account of potential revisions to the Basel standard as a result of the ongoing consultation on the CVA framework published in November 2019. We hope that the ongoing Basel consultation addresses some of the lack of risk sensitivity and brings the calibration down to a reasonable level.

In the absence of such an outcome and unless a thorough analysis shows that the impact on end-users is not significant, the exemptions should be maintained. In order to make an informed decision, we suggest that once the review of the framework is completed at international level, the European Authorities perform an impact assessment in order to evaluate whether calibration of the framework has reached a reasonable level as outlined above, with a particular focus on the cost of derivatives for end users, which would permit lifting the exemptions.

### **5.3. Proportionality in the CVA framework**

***167) Views are sought on the costs and benefits of the simplified approach provided by the Basel III standards to calculate the own funds requirements for CVA risks.***

***In particular, what would be the impact in terms of RWAs and operational burden? Please provide relevant evidence to substantiate your views.***

N/A

**168) Would you consider a simple multiplier applied to the own funds requirements for counterparty credit risk to provide an appropriate proxy for determining the own funds requirement for CVA risks of institutions with smaller derivatives portfolios?**

- Don't know / no opinion / not relevant

**168.1) If yes, please elaborate on your response to question 168.**

N/A

**168.1) If not, what would be a better proxy to measure those risks? Please provide relevant evidence to substantiate your views.**

N/A

**169) Views are sought on the appropriateness of the EUR 100 billion threshold for allowing institutions to use the simplified approach. How would this threshold compare to the eligibility criteria for the use of the existing simplified approach to calculate the own funds requirements for CVA risks under Article 385 of the CRR?**

**How would the EUR 100 billion threshold compare to the eligibility criteria for the use of the simplified methods to calculate the exposure value for counterparty credit risk under Article 273a CRR?**

**Please provide relevant evidence to substantiate your views.**

N/A

## **5.4. Internal CVA under the SA-CVA**

**170) What are your views on the principle-based definition of internal CVA sensitivities under the SA-CVA? Would these principles be aligned with the accounting CVA?**

**Would these principles create undesirable effects or excessive operational burden if not aligned with these principles used for the accounting CVA?**

**What would be the potential solutions to address those misalignments? Please elaborate and provide relevant evidence to substantiate your views.**

Article 30 sets two major parameters of the CVA calculation to levels that often diverge from banks' practices for accounting CVA:

- **Loss Given Default (LGD):** The expected loss given default must be set to the LGD used for the determination of the probability of default. However, there may be many circumstances where the LGD for derivative exposures may differ from market LGD as observed in the CDS market. This has been shown historically where the recovery on a derivatives claim can be much different from the recovery determined in a CDS auction. The Basel framework only recognise one such instance, when the seniority of the derivative exposure differs from the seniority of unsecured bonds.
- **Margin Period of Risk (MPoR):** The margin period of risk for margined netting sets must be set to 9+N business days where N is the re-margining period. For a daily margined netting set, the MPoR used for regulatory CVA is 10 business days. Accounting CVA practices for MPoR are typically much less than this for daily margined netting sets.

***171) In your view, what considerations should be taken into account in the supervisory permission process set up to approve internal CVA under the SA-CVA?***

There are several considerations to be taken into account in the supervisory permission process. From a high level, the considerations include but are not limited to the following:

- Daily data feed
- Data quality check on CVA sensitivities and population
- Accuracy and completeness check on CVA sensitivities and population
- Documentation on CVA sensitivities

## 5.5. Fair-value SFTs under the CVA framework

***172) What are your views regarding the inclusion of fair-valued SFTs in the scope of the revised CVA framework in terms of impacts on RWA and operational burden?***

***Please provide relevant evidence to substantiate your views.***

Risks from the fair-valued SFT portfolios are not currently captured in existing books and records and hence does not impact institution's P&L. This population (fair-valued SFTs) should hence also be excluded from CVA capital calculations. Moreover, putting this population under BA-CVA capital calculation would be extremely conservative. This would also lead to negative impacts on the liquidity of repo markets.

In addition to fair-valued SFTs, the new requirements include other additional population for regulatory CVA calculation as compared to accounting CVA. Overall, such additional calculations can be massive at legal entity level and hence would introduce additional computational and operational efforts for the banks.

The Industry suggests keeping SFTs exempted from the calculation potentially improving the identification of those trades as specified by the UK Prudential Regulation Authority (PRA)<sup>68</sup>.

We note that in its consultation paper d488 ('Credit Valuation Adjustment risk: targeted final revisions'), the BCBS proposes to exclude from the scope of CVA capital requirements those SFTs where the CVA loss exposures are immaterial.

### **Industry recommendation**

Similar to SFTS, and in order to be consistent with the accounting treatment and in the spirit of the recent changes to the leverage ratio framework to set appropriate incentives for client clearing, CCP-facing and client-facing legs of all client-cleared trades should be exempted from the CVA calculation.

***173) Which portion of institutions' SFTs portfolios is fair-valued for accounting purposes and according to which accounting standards?***

***What are the features of those SFT transactions?***

***Would the introduction of those SFTs in the scope of the revised CVA framework particularly affect those activities?***

***Please elaborate and provide relevant evidence to substantiate your views.***

Within one institution, the same trade can be booked differently under local accounting or foreign accounting standards. Given this difference in accounting, it is almost impossible to achieve consistent CVA capital treatment for SFT portfolios across various legal entities within the same institution.

In addition, the risks originated from SFT portfolios may not be material from overall risk management perspective. The regulation does not allow partial compliance and hence for institutions to avoid being non-compliant, a great amount of computational work and operational effort is required.

### **Industry recommendation**

It is recommended to set up some level of flexibility in the regulation with consideration to the risk materiality of SFT portfolios.

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<sup>68</sup> <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2016/ss1213-update>

## 5.6. Other provisions

**174) In your view, which other aspects, if any, should be considered in the context of revising the CVA framework?**

***Please specify and rank your answers from the most important to the least important aspect.***

Considering the cumulative impact of new requirement impacting trading and market making activities in the Basel III package like market risk and CVA, the Industry also believes that a review of the Standardised-Approach for Counterparty Credit Risk (SA-CCR) is necessary. The aggregate impact of these changes could be detrimental to the liquidity of capital markets, which in turn may impede business growth and make it difficult for end users to hedge the risks that arise from their core businesses.

While SA-CCR is intended to address some of the long-standing criticisms of the outdated non-modelled exposure methods – the Current Exposure Method (CEM) and the Standardised Method (SM) approaches – it has several shortcomings in its design and calibration, which does not reflect the current regulatory and economic environment.

Our analysis show that implementation of the SA-CCR framework would lead to a 50% (€172 billion) in RWAs and consequently additional regulatory capital of €14 billion (for participating banks)<sup>69</sup>.

Though ideally SA-CCR should be addressed at global level through the Basel Committee, it is important to also consider it as part of the CRR 3 proposal - particularly given its key contribution to the output floor calculation.

Originally calibrated in 2014, the rule is outdated and does not reflect the current market environment, in particular the shift to clearing and margining and the larger portfolio diversification effect. Its calibration and lack of recognition of margining and netting which result in significantly overstated exposures. This could severely impact the availability and pricing of hedging products for end users.

This is especially important, considering SA-CCR will be used more broadly in the Basel III standards than was originally designed:

- Replace CEM in the leverage ratio and may affect the calibration of the leverage ratio as a non-risk-based backstop measure;

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<sup>69</sup> The study has analysed data submitted by 18 G-SIBs and internationally active banks based in Europe, the United States, Switzerland and Japan.  
Reference date: December 2017.

- In some regions, replace internal models in the large exposure framework risking, creating un-level playing fields across regions;
- Be used for the Central Counterparty (“CCP”) hypothetical capital calculation and in the calculation of exposures for the CVA risk capital requirements;
- Be used to calculate EADs used in the BA-CVA approach as a fallback to IMM; and
- Be part of the output floor for capital requirements. In this context, SA-CCR becomes relevant for all banks regardless if they are fully Internal Model Method (IMM) approved or if they have part of their portfolios under SA-CCR.

Our analysis shows that with respect to the Output Floor, the full portfolio RWAs calculated under SA-CCR and applying revised Standard Credit Risk Weights (RWs) would result in 1.78 times the full portfolio RWAs calculated under SA-CCR and IMM and applying Internal Credit RWs.

It could be noted that a capital uplift from the implementation of SA-CCR runs counter to the Committee's broad intentions “not to increase overall regulatory capital” with respect to the 2017 Basel III framework.

The full impact resulting from the implementation of SA-CCR remains untested by regulators. It is therefore imperative that the shortcomings of SA-CCR be remedied as well as a full impact study on its calibration and its aggregate impact performed before it is transposed into regional and national laws and implemented by supervisors.

The Industry would welcome the opportunity to support the global and regional regulatory community in undertaking the analysis to address the issues raised above and providing where needed targeted quantitative evidences. We note that in Europe, SA-CCR will be subject to a review in 2023 by the European Banking Authority (EBA), but we would urge that this should be reconsidered earlier in light of its broad impact, and considering the cumulative effect of the Basel III reforms on trading and wholesale market activities. EU policymakers should be mindful of the EU implementation timeframe of end June 2021 and potential impacts from an un-reviewed SA-CCR requirement coming into effect at this time.

An earlier EU review of SA-CCR will allow for the standard to better reflect current Industry practice, such as mandatory margining requirements or international developments such as adequately recognising Qualifying Master Netting Agreements (as set out in Basel FAQs and adopted by the US prudential regulators), prior to implementation.

If EU policymakers do not conduct a review of SA-CCR prior to its implementation, we urge European authorities to consider alternative measures that will offset the undue impact of SA-CCR until the review is complete.

These could include the recalibration of the alpha factor, allowing the netting of multiple CSAs under the same qualifying master agreement and amending the PFE multiplier formula to better recognise collateral received. This could significantly improve the alignment between actual levels of

exposures, risk and capital requirements resulting from SA-CCR, and result in a far more effective and truly risk-sensitive framework.

We note that in their final rules on SA-CCR<sup>70</sup>, the US Agencies have taken into consideration some of the shortcomings of the standard. In particular the agencies have introduced, amongst others:

- The removal of the alpha factor from the exposure amount formula for derivatives contracts with non-financial corporates;
- A better recognition of netting sets allowing banks to treat all settled-to-market (STM) contracts within the netting sets that are cleared transactions as subject to a variation margin agreement and receive the benefits of netting with cleared collateralised-to-market (CTM);
- An updated approach on index decomposition for commodities and equity indices - allowing for the latter firms to treat each component of the index as a separate single-name derivative contract recognising the hedging benefits provided by the component of an index;
- A more-risk sensitive for the supervisory factors for credit derivatives.

## 5.7. Implementation challenges and administrative burden

**175) Which elements of the revised CVA framework, respectively, IMA, if any, would you deem particularly challenging to be implemented?**

***Please elaborate and rank your answers from the most challenging to the least challenging revision.***

***Please provide relevant evidence on the expected one-off costs to substantiate your views.***

N/A

**176) Which elements of the revised CVA framework, if any, would in your view cause additional administrative burden?**

***Please elaborate and provide relevant evidence on the expected recurring costs.***

N/A

<sup>70</sup> <https://www.fdic.gov/news/board/2019/2019-11-19-notice-dis-a-fr.pdf>



## 6. Output Floor

### 6.1 Scope of Application

***177) What are your views on the relative costs and benefits of including in the calculation of the OF more own funds requirements than those explicitly mentioned in the Basel III standards? In particular, how would such broader material scope compare to the scope required by the Basel III standards in terms of impact on RWAs, risk-sensitivity, comparability, complexity and operational burden? Please provide relevant evidence to substantiate your views.***

As an industry, our members consider the Output Floor (OF) should be applied as a **parallel capital ratio limited to minimum capital requirements set through Pillar 1 and internationally agreed capital buffers** so that it is a genuine ‘backstop’ rather than the main constraint. This should be based on a calculation of (a) the output floor requirement applying RWA calculated as 72.5% of RWA using standardised approaches only (Basel III requirements only); and (b) the risk based requirement applying RWA calculated using approved internal models and standardised approaches as applicable (Based on all EU and nationally set requirements (e.g. Pillar 2 and SRB). The backstop would be activated (exceptionally) when (a) exceeds (b) and it would then be necessary to retain the highest risk weighted positions, i.e. the floored RWAs. In this respect it would deliver a capital amount which is equal to that which is required by Basel III.

However, we understand the EBA recommends the OF is applied to the full capital stack, i.e. calculated on the basis of all EU capital requirements including Pillar 2 and European specific capital buffers. If the Commission takes this proposal forward in CRR3 it would be a gold-plated European implementation of the floor, as the Basel text only requires the floor to be calculated based on Pillar 1 and international capital buffers. Doing so could also reduce comparability across banks, which runs counter to one of the stated purposes of the measure, as it would no longer be based on one common comparable set of metrics by which EU banks calculate the floor across the EU. This is especially relevant for the inclusion of Pillar 2, a bank specific framework which is decided by supervisors, and whose application ranges widely from country to country and even within countries, as highlighted in a Basel review from July 2019.<sup>71</sup> The EBA also suggests the calculation includes other non-internationally applied buffers specific to the EU including for O-SIIs and the Systemic Risk Buffer. Regarding the latter, this is applied by supervisors to address macro-economic imbalances, not unwarranted risk-weight variability which is the target of the floor.

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<sup>71</sup> <https://www.bis.org/bcbs/publ/d465.pdf> see pg. 1 and 2

***178) Would you deem further refinements or clarifications necessary concerning the material scope of the OF, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.***

The industry notes that in the EBA CfA report, they recommend that P2 and SRB should be revised down (recommendations OF3 and OF4). If the Commission decide to follow the approach proposed by the EBA, then we consider it essential that CRD includes provisions for supervisors that would avoid any double-counting stemming from P2 for internal models and the SRB. We note there is no publicised precedent for supervisors revisiting and revising P2 downward, and therefore consider it unlikely for this to happen without legal provisions to ensure it. In this respect, there should be a clear provision in the CRD for supervisors to review the SRB and that P2 should not cover or overlap with risks related to undue RW variability which are addressed through the OF requirement. Consequently, any reduction of P2 and the SRB should be done simultaneously alongside the implementation of the floor.

We also consider that the comments made by Andrea Enria on 12 November at the EC hearing should be taken into account by the Commission in relation to the implementation of the floor and the interaction with P2:

*“First, for a few banks, Pillar 2 might also cover model risks. These banks could rightfully argue that, thanks to the output floor, model risks would now be covered by the first pillar, meaning that Pillar 2 capital requirements could be reduced.*

*Allow me to be very clear on this point. Regulation does not allow us as supervisors to double-count risks. For pure model risks covered in Pillar 1, there will be no generic risk charge in Pillar 2. This means that we will eliminate any overlapping charges from Pillar 2 if the risks are covered by the new output floor or by other limitations to the use of internal models.*

*There is a second point regarding Pillar 2. Pillar 2 is defined as a measure to buffer risks that are not covered by Pillar 1. Assume that today, a bank needs to hold 200 basis points of risk-weighted assets as additional capital, which amounts to EUR 1 billion of actual capital. Now, if risk-weighted assets for that bank increase by 20% due to the new output floor, the 200 basis points might suddenly go from EUR 1 billion to EUR 1.2 billion of actual capital.*

*This increase wouldn't be justified, of course. It would be a purely arithmetic effect and would not reflect additional risks. I'm convinced that we should sterilise this purely arithmetic effect in our calculations.”*

Finally, in line with Andrea Enria's statement, we would also like to add that the review of P2 and SRB in the CRD should not only be limited to the implementation of the output floor. This

recalibration exercise should consider all sources of potential increases in the Pillar 1 requirements where there is potential for double counting under existing P2R.

## 6.2 Level of Application

***179) Views are sought on the relative costs and benefits of applying the OF at all levels of the banking group (i.e. individual, sub-consolidated and consolidated) or solely at the highest level of consolidation in the EU. In particular, how do the two approaches compare in terms of impact on RWAs, comparability, complexity and operational burden? Please provide relevant evidence to substantiate your views.***

Basel III calibrated the application of the output floor at the global consolidated group level, meaning that it is calculated at the aggregate RWA level, rather than at an entity-by-entity or risk-type by risk-type basis. Indeed, to date the formulation of this requirement and impact analysis of the impact of the floor has only ever been made on the consolidated basis, not entity level, apart from that undertaken by the EBA in its limited CfA exercise. The industry therefore considers the requirement for the level of application of the floor should be at the global consolidated group level in CRR3. Indeed, in the interests of international consistency, we believe this should be the approach of all global regulators such that it is not necessary to apply it at the level of each jurisdiction in which the bank has an entity.

In this respect, the industry strongly opposes recommendations of the EBA in relation to the level of application of the output floor at the solo bank entity level. This recommendation is based on limited analysis of the application to a sample of 15 EU banks' largest subsidiaries, which was not fully representative as acknowledged by the EBA itself. In particular, it failed to capture smaller banking entities across the EU, included subsidiaries that were mis-classified as universal banks when they only undertake a narrow subset of banking activities, and it did not consider the impact on third country banking subsidiaries operating within the EU that would fall into scope. In addition, the EBA's own analysis shows a number of shortcomings with its own findings, not least that its proposals could have adverse impacts on subsidiaries which are focused on mortgage lending (we also expect similar outcomes for other exposures e.g. off balance sheet exposures, including credit lines, to retail and corporate customers) and local universal banks. From the data they have made available, it also demonstrates that the impact of the floor on RWAs at an entity level is higher (13.34%) – and thus more binding – than it is for the consolidated position of the bank (8.5%). While we welcome the additional analysis they are undertaking, we are concerned by the methodology the analysis may take and whether this will account for the impact on third country subsidiaries operating in the EU.

If implemented at the entity level, there is a clear risk that the requirement could undermine business model neutrality. Banks currently may choose or be obliged to arrange their businesses in such a way that lower risk activities, such as residential property lending, may be held in one subsidiary whilst higher risk activities are in separate subsidiaries. However, an aggregate floor that is applied at the regulated legal entity level may result in the capital floor biting at an individual subsidiary level, when it is not an issue at the consolidated level. Consequently, this may force banks to change their business models, reducing diversity of how banks manage their risks. Should there be constraints on double leverage, the capitalisation of the subsidiaries driven by the capital floors may become the determining factor in the overall capitalisation of a banking group.

Indeed, we commend the speech of Andrea Enria which raises many of these central arguments for consolidated application. On 12 November he stated at the EC hearing:

*“...they should apply it at the highest level of consolidation. This 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. This cannot be in our interest.”*

**180) In your view, how would the two approaches affect the internal risk allocation across banking groups, in particular those with specific group structures or business models at subsidiary level? Please elaborate and provide relevant evidence.**

The industry considers that the capital framework should be business model neutral, avoid regulatory fragmentation, and focus on the purpose of the Output Floor which is to provide “a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approaches.”<sup>72</sup> In this respect, we support the assessment provided by Andrea Enria (SSM Chair) at the EC hearing on Basel III implementation on 12 November:

*“...it [application of the floor at solo level] would reduce banking groups’ flexibility when allocating capital internally and make market consolidation even less attractive. This is particularly unwelcome in Europe, where the universal bank model allows risks to be diversified at group level. If we were to add a risk-insensitive measure below group level, we would curb the benefits of diversification without adding anything to the sound management of risks.*

*But there is an even more important point. If the output floor were applied at the individual level, it would introduce a bias towards certain business models. Banking groups would have a clear incentive for regulatory arbitrage; they might start to book risky activities into subsidiaries with different*

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<sup>72</sup> [https://www.bis.org/bcbs/publ/d424\\_hlsummary.pdf](https://www.bis.org/bcbs/publ/d424_hlsummary.pdf) see pg.11

*business models just to mitigate the impact of the output floor. If these subsidiaries could not understand or control the risks booked to their businesses, there might be problems.”*

***181) What other solutions or safeguards could be envisaged as alternatives to your preferred approach? Please elaborate and provide relevant evidence.***

Pillar 2 requirements already exist at lower levels (with appropriate calibration to respect differences in business models), which are intended to capitalise risks not adequately captured under Pillar 1, including model risks. Therefore, these requirements already achieve a reduction in excessive variability in capital requirements at these levels.

We note that the introduction of a waiver subject to competent authority approval would not be a sensible mitigant, as this would likely result in an un-level playing field to the extent competent authorities apply this requirement differently.

### 6.3 Transitional Measures

***182) In your view, should both of the transitional measures provided by the Basel III standards be implemented in the EU, and if not why?***

The industry strongly supports the transitional measures provided for in the Basel III standards to a facilitate a smooth implementation. To ensure consistency across the EU and not undermine Basel's policy objective of enhanced comparability, the transitional cap on the incremental increase in a bank's total RWAs that results from the application of the floor should be mandatory (rather than subject to national discretion). We also recommend a review of the final impact once the measure is fully implemented. Where the international timeline for the implementation is extended beyond 2022, the 5-year transition should be maintained on the new implementation trajectory as banks will have set their capital and operational plans on the basis of this.

***183) Would you deem further refinements or clarifications necessary concerning the transitional measures, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.***

Basel indicates disclosure should be done at the aggregate level of RWAs. It is important disclosure requirements are set in a way which will not unintentionally lead to markets expectations pushing banks to implement the floor in advance of the Basel timeline, particularly given the impact of the dynamic aspects of the new Basel framework for credit risk are unknown – e.g. changes to the use of the IRB and the implementation of the EBA's IRB roadmap.

**184) In your view, what measures, if any, should be taken to ensure a smooth implementation of the OF? Please elaborate and provide relevant evidence.**

It is unknown what the final interaction will be between the different components as this has not yet been evaluated. For instance, one area which may be impacted by the increase in capital arising from the application of the Output floor is MREL, whereby the MREL requirements will also be mechanically increased, however this analysis was not incorporated into the EBA's CfA exercise. This interaction should be analysed and reviewed as a priority.

#### 6.4 Other provisions

**185) In your view, which other aspects, if any, should be considered in the context of implementing the OF? Please elaborate and rank your answers from the most important to the least important aspect.**

The Output Floor will be the most impactful measure for Europe included in the Basel III reforms - according to the BCBS Monitoring report (March 2019), the introduction of this measure will result in a strong regional increase for Europe in MRC of 21.3%, and overall represents 41.4% of the total impact of Basel III for EU Group 1 banks.<sup>73</sup> Essentially, nearly 80% of Group 1 European Banks will be bound by the Output floor or Leverage Ratio, increasing adverse incentives and inefficiencies for a major part of the industry. Furthermore, this measure, introduced to address unwarranted risk weight variability in banks' use of own models, represents a move away from risk sensitivity in the capital framework.

While the Basel Committee notes that the output floor is in effect a 'risk-based backstop'<sup>74</sup>, the data supplied in the BCBS Monitoring report (March 2019) demonstrates that the floor, not the risk-based capital nor the leverage ratio, will be the most binding constraint. The impact analysis to date therefore marks a further move away from a risk-sensitive framework for European banks at a time when other measures such as TRIM and the EBA's IRB repair work have been put in place to address unwarranted risk-weight variability. In addition, the EBA Call for Advice exercise on the impact of Basel III has not yet provided a full break down of the impact of the floor on types of risk, exposure classes or which business models would be excessively impacted by the introduction of the output floor as initially requested by the European Commission.<sup>75</sup> Nor has it explored whether and to what

<sup>73</sup> <sup>73</sup> "Group 1" banks are defined as internationally active banks that have Tier 1 capital of more than €3 billion and include all 29 institutions that have been designated as global systemically important banks (G-SIBs). <https://www.bis.org/bcbs/publ/d461.htm>

<sup>74</sup> Cf description p. 11 [https://www.bis.org/bcbs/publ/d424\\_hlsummary.pdf](https://www.bis.org/bcbs/publ/d424_hlsummary.pdf)

<sup>75</sup> EU Commission call for advice, Cf page 15: <https://eba.europa.eu/documents/10180/2207145/Call+for+advice+to+the+EBA+for+the+purposes+of+revising+th>



extent the capital allocation between business lines/exposure classes would be impacted, and to what extent differences in the treatment of provisions between the SA-CR and the IRBAs for credit risk could have an impact. Our members would like to request this breakdown, which should focus in particular on the impact of the floor on specific exposures such as mortgages and specialised lending, as well as implementation of other Basel rules such as SA-CCR.

Consequently, the European Commission should investigate and explain by June 2020 at the latest why the output floor is so binding for EU banks relative to other parts of the framework. This could be undertaken as part of the impact analysis the Commission itself is required to do prior to the publication of the CRR3 proposals. In light of this, we urge the Commission to also consider whether there are any global consistency implications in terms of outcomes. If any are identified, the EU should consider re-addressing these at the global level, failing which it should be addressed in the EU.

In terms of the interaction with other parts of the credit risk framework, it will be particularly important for legislators to consider the Basel revisions to the Credit Risk framework, where the impact on RWAs under the SA are most significant in the EU.<sup>76</sup> Changes to the credit risk framework will result in large RWA increases for Specialised Lending, SFT transactions, Real Estate, and Corporates, which will have a knock-on effect in calculating the Output Floor. EU implementation should also recognise national discretions and EU specificities built up in CRR in the SA (e.g. SME SF, Trade Finance) and Market Risk. Furthermore, the reduced scope of IRB to be applied to many exposure classes including financial institutions will have a significant impact. We therefore recommend regulators consider the industry position on credit risk to mitigate the consequences for the output floor.

Secondly, in addition to the impact of the SA to Credit risk, the Standardised Approach for Counterparty Credit Risk (SA-CCR) is considered to have significant shortcomings which may adversely affect derivatives markets. For instance, it will impact upon uncollateralized, directional portfolios which are generally typical of end-users of derivatives hedging financial risks and is generally not reflective of the true level of underlying economic risk. Not only will the higher capital requirements reduce the ability to service clients, potentially driving them to leave their risks unhedged or to pursue less-expensive protection providers outside of the regulated banking sector, but it will also feed into the calculation of the Output Floor.

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[e+own+fund+requirements+for+credit%2C%20operational+market+%26+credit+valuation+adjustment+risk+040518.pdf/fa15db69-5527-4fbe-a0e7-0d8ed46547fb](https://www.afme.eu/own+fund+requirements+for+credit%2C%20operational+market+%26+credit+valuation+adjustment+risk+040518.pdf/fa15db69-5527-4fbe-a0e7-0d8ed46547fb)

<sup>76</sup> Results of IIF, ISDA, GFMA cumulative impact assessment can be shared on a confidential basis to regulators



The aggregate impact resulting from the implementation of SA-CCR, including in the output floor, is still untested in the BCBS impact assessment published last March or the EBA Call for Advice. However, an industry impact assessment (ISDA SA-CCR QIS Analysis) based on BCBS RCAP Hypothetical Portfolios<sup>77</sup> highlights a SA-CCR EAD equivalent to 2.5 times IMM EAD and 2.3 times CEM EAD. Other Netting Sets, particularly when unmargined, can show significantly larger impacts<sup>78</sup>. In addition, a Quantitative Impact Study conducted in May 2018 involving 18 G-SIBs and internationally active banks and using data from real portfolios highlighted a SA-CCR EAD equivalent to 1.39 times CEM EAD and SA-CCR RWAs equal to 1.90 times the corresponding CEM RWAs. Overall, the Study found that the overall increase on the CCR RWAs would be equal to 94% if we compare real portfolios under CEM and IMM with the same portfolios applying SA-CCR and IMM and a hypothetical standalone output floor based solely on CCR RWAs. Therefore, the impact arising from SA-CCR is significant.

The finalised CRR2 includes a mandate in Article 514 for the EBA to report to the Commission on the impact and the calibration of SA-CCR by 28 June 2023. On the basis of this report, the Commission may submit a legislative proposal to amend SA-CCR. EU policymakers should be mindful of the EU implementation timeframe of end June 2021 and potential impacts from an un-reviewed SA-CCR requirement coming into effect at this time. We believe it is appropriate for the EBA to review SA-CCR prior to its implementation and ask that the review timetable is brought forward to allow this. This will allow for the standard to better reflect current industry practice, such as mandatory margining requirements or international developments such as adequately recognising Qualifying Master Netting Agreements (as set out in Basel FAQs and adopted by the US prudential regulators), prior to implementation.

If policymakers do not conduct a review of SA-CCR prior to its implementation, we urge European authorities to consider alternative measures that will offset the undue impact of SA-CCR until the review is complete. A simple solution would be to set the alpha factor to 1<sup>79</sup> for derivatives contracts with non-financial counterparties, which better represents analytical estimates of the correct calibration of alpha, as has been recognised by US Agencies in the final US SA-CCR rule<sup>80</sup>. The Commission should therefore do the same to address the overall punitive BCBS calibration of the SACC framework to ensure banks' ability to support clients' demand for derivative products for hedging at an acceptable cost is not jeopardized, while at the same time aligning with the US and creating a level playing field. Given the EU legislative process, we suggest that a 'fast tracked'

<sup>77</sup> <http://www.bis.org/bcbs/publ/d337.pdf> Results for Netting Set 16, unmargined, which encompasses all major asset classes.

<sup>78</sup> QIS results have highlighted in several instances a CCR capital charge equivalent to more than three times existing requirements. This is true when comparing SA-CCR to existing non-modelled approaches as well as internal model approaches.

<sup>79</sup> As applied to the replacement cost component of the exposure amount.

<sup>80</sup> Final rule on the Standardized Approach for Calculating the Exposure Amount of Derivative

approach may be the most efficient way of transposing such recalibration of SA-CCR into the EU before its date of application (June 2021).

Thirdly, the impact of the output floor on capital markets activities needs to be carefully considered particularly in relation to other broader EU projects such as the Capital Markets Union. Banks that conduct wholesale or market intermediation activities provide clients, such as governments, corporates (including SMEs) and other banks, with access to investors across the globe by enabling market-based finance and foreign exchange transactions. The new market risk framework will introduce a new approach for calculating how much capital banks must hold against their market intermediation activities, and its introduction may result in increases in the capital required for this type of activities. In relation to the floor, this needs to be considered especially as the standardized approach (SA) for market risk may become the binding constraint either through firm losing model approval or due to the output floor. The extent of the constraint imposed on banks by the OF may have negative implications on business continuity as the floor will be a determining factor in risk-return evaluations, capital allocation decisions. More analysis on market risk can be found in section 4 of the consultation response.

Finally, there are areas of the requirements for implementing the capital floor where further European-specific guidance is required;

- Deductions for securitisations RWAs at 1250% (Basel is silent);
- Provisioning rules (SA vs IRB different, interaction of the NPLs P1 backstop with treatment of defaulted exposures);
- The negative interaction with the application of the OF with the treatment of unrated corporates under the SA as elaborated on in our answers to questions 1 and 2;

The relevant CET1 ratio to be considered in the context of the AT1 trigger event outlined in CRR Article 54(1)(a)(i). (We support EBA's recommendation (OF5) that the trigger should refer to the floored regulatory ratios, i.e. the regulatory ratios computed on the basis of floored RWAs).

## 6.5 Implementation challenges and administrative burden:

***186) Which elements of the OF, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the expected one-off costs to substantiate your views.***

Implementation challenges / additional administrative burden will arise from the following:

- 1) Calculation of RWAs under the standardised approach across our entire portfolio: for banks applying advanced approaches, implementation of full standardised calculations will require significant data and infrastructure spend. This will not be a one-off cost, since there will also be ongoing costs of running two parallel systems/infrastructure to support RWA calculations using advanced and standardised approaches.
- 2) Capital management: the need to manage two RWA measures with different levels of risk sensitivity, available mitigation etc. will also require additional significant data and infrastructure spend.
- 3) Disclosures: the need to explain the disclosure of multiple variants of RWAs, and the challenge of identifying key areas of interest for investors. Additionally, banks significantly above or below the floor may end up disclosing large volumes of information that is not relevant to investors.
- 4) The EBA's recommendation (OF6) that legislation implementing the revised Basel III framework should clarify that the calculation of the standardised approach RWAs for the purposes of the output floor should take into account any higher risk weights set at the level of a Member State in accordance with the discretion provided under Article 124(2) of the CRR, could add complexity for cross-border banking groups and distort comparability.

***187) Which elements of the OF, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.***

N/A

## 7. Centralised supervisory reporting and Pillar 3

***188) Once EUCLID is fully implemented, would you support that the EBA, on the basis of the collected supervisory data from all institutions established in the Union, centrally discloses the information of all those institutions that are subject to disclosure requirements under CRR/D, thereby relieving institutions from mandatory disclosures?***

No. The associations note the possible benefits that centralised disclosure could deliver in theory (see answer to Question 189). We would not, however, be comfortable in principle with a substitution of the EBA for banks' in their relations with their investors and the market and we note some of the significant practical challenges that centralised distribution may entail (see answer to Question 190). More widely, we would question whether the proposal would lead to any decrease in administrative burden owing to these practical and operational concerns.

***189) If you support centralising disclosures at the EBA, please explain:***

***i) whether in your view stakeholders (investors, etc.) would have the benefit in accessing disclosures of all institutions in one internet place?***

In theory, a centralised data source for all disclosure requirements could support stakeholders in making better informed decisions by having easy access to large consistent data sets across institutions. This would be further enhanced by making the data available in an easy access format such as downloadable excel files.

***ii) whether in your view a single location policy should be applicable to all type of institutions: small non-complex, large and other institutions?***

A single location policy should work for both small and large institutions. To support smaller institutions, it may be useful to add a level of flexibility so that templates can be eliminated where they are not relevant. Filtering options on the data set could also improve usability such as; "large institution" vs "small and less complex institutions", parent institution geographic location, G-SIB vs non-G-SIB, etc.

***iii) how responsibilities for the disclosed information should be shared between institutions, competent authorities and the EBA?***

This should be aligned to the current FINREP/COREP processes. It would be important that institutions maintain ownership and responsibility for the data and that information is made public only following the approval of the institution concerned. Authorities could have a quality assurance

role to ensure the comparability of results across banks, but data should not be altered by competent authorities or the EBA and the role of the EBA should be limited to organising the process, setting definitions and publishing results.

***190) If you do not support centralising disclosures at the EBA, please explain why.***

In principle, the centralisation of disclosure could provide the benefits outlined above. There would, however, be very significant challenges to ensuring robust and manageable processes. For this to work practically and to relieve institutions of additional mandatory disclosures as intended the centralised disclosure would need to replace entirely the disclosure requirements under Pillar 3 for the specified templates. At a minimum it should include all elements of individual sections such as, the commentary and description requirements as well as the quantitative templates. Unless this is the case, institutions would have to manage an additional reporting process including the need to make sure that it is fully aligned and reconciled back to other Pillar 3 disclosures.

The ability for firms to make adjustments and deliver disclosures that are not COREP or FINREP derived would therefore be very important. In addition to qualitative information that is not included in the supervisory returns, adjustments might also be needed in other situations, for example when p&l is audited and taken to reserves.

Further technical uncertainties concern instances when the reporting date for Pillar 3, which should be aligned with that for the relevant public financial statements, differs from the reporting date for FINREP/COREP. This might not only create additional resourcing needs for an institution if FINREP/COREP data are used as sources for Pillar 3 but could also make it difficult for the EBA to centralise Pillar 3 reporting using existing FINREP/COREP data owing to timing differences. It is also not clear what the requirements might be for firms that are not required to report FINREP fully. In addition, it is not clear whether the proposals would apply only at a consolidated level or whether they would extend to entities which currently disclose on a local basis.

Other important considerations would involve whether the EBA would be able to disclose information under the timeline required by the market as it would seem that the regulator would need to wait for all contributions from all banks. In practice, it is likely that institutions would be prompted to disclose information by investors and other stakeholders as needed. It is likely also that the EBA would not be able to link the disclosure of sensitive information with appropriate commentary and context and all information would be disclosed at an equal level precluding prioritisation.

Finally, we would note that quantitative information is already provided through the EBA's transparency exercise and it is not clear whether it is intended that this would cease in the event of centralised Pillar 3 arrangements.



## 8. Sustainable Finance

***191) In your view, which further measures, if any, could be taken to incorporate ESG risks into prudential regulation without pre-empting ongoing work as set out above? Please elaborate and provide relevant evidence to substantiate your view.***

Industry welcomes the mandates given to the EBA in the context of CRR2 and will be closely engaging on the areas identified with the EBA to support the development of the reports and any subsequent policy recommendations. Industry remains aware that climate-related policy remains high on the agenda of the financial services industry and legislators alike. This could potentially lead to additional mandates and prudential considerations in the process of legislating for CRR3 and other areas of financial services legislation which are interlinked. One example of interlinked legislation is the development of the EU ‘Taxonomy’ Regulation which is intended to set out what can be considered an environmentally sustainable economic activity. Industry consider that the definition of common sustainability criteria is a significant positive step in an orderly transition towards a low-carbon and climate resilient economy, to which industry is fully committed. We think it would be premature to introduce changes in the CRR3 in addition to the CRR2 related ones and it is better to wait until the taxonomy is well established, which will look at existing data. Indeed, we would note that the taxonomy as developed by the technical expert group on sustainable finance is focused on purely green activities, and for the present would not be an appropriate basis for a future prudential regime, which should take into account how banks have committed to supporting their clients in transition.

Aside from this, we would like to take the opportunity to highlight some key messages about the CRR2 mandates and requirements.

**Disclosure:** we understand that as part of the EBA’s mandate on Pillar 3, EBA will develop uniform disclosure requirements that will be applicable as of June 2022. We note the EBA will not develop completely new disclosures but will build on the existing ones (such as, the recently published non-binding Guidelines on reporting climate-related information, which are based on TCFD), and will aim to take into consideration what data is actually available. This is welcome, however, we would also like to highlight the challenge in disclosure for banks: (i) banks need non-financial corporates to disclose about their activity in order to be in capacity to disclose information about their financings and (ii) there is a significant degree of dependency on issuers’ climate-related reporting, ESG data providers and ESG analysts. In this respect it may be necessary to make the disclosure of climate-related information by corporates mandatory and standardised, as well as consider some level of regulation of such data providers as information from different providers on the same companies currently lacks consistency. The EC should also closely consider the development of the market for ESG data analysis. Separately, we understand that the Commission may look at the issue of data availability, quality and analysis as part of its announced new Green deal. Above all with regard to

any further development of disclosure requirements, it is important to avoid any duplication and unnecessary operational burden. In the meantime, we stress that many financial institutions are already disclosing climate related information also by following the recommendations such as those of the TCFD.

**Stress-testing:** This has been a clear focus of the NGFS's work and will also be part of the EBA's CRR2 mandates to assess how stress testing and scenario analysis could reflect the impact of ESG risks. Indeed, some European national central banks have already taken action on this, for example, in April 2019 the Prudential Regulation Authority (PRA) issued a supervisory statement setting out specific governance, disclosure and ICAAP expectations in relation to climate risks and for firms to run 'scenario analysis'. Similarly in France, the ACPR is working on defining 3-4 types of macro-climate scenarios, in line with the next deliverables of the NGFS <sup>81</sup>(i) a handbook on climate and environment-related risk management for supervisory authorities and financial institutions; (ii) voluntary guidelines on scenario-based risk analysis (iii) best practices for incorporating sustainability criteria into Central Banks portfolio management (particularly with regard to climate-friendly investments). In light of this, we strongly urge regulators to reflect on best practices and experience of supervisors in this area to date and understand the links between climate change and the financial system (as noted by the NGFS). Given the numerous initiatives in this area it would be worth analysing how to best harmonise approaches among supervisors to ensure best practices.

**Infrastructure Supporting Factor (which includes environmental pre-conditions to apply it):**

In July 2019 the EBA recommended removing the infrastructure supporting factor in CRR3 in its CfA report. The recommendation (CR3) stems from the QIS analysis, where the compliance of institutions to this factor was deemed low (although only a very new measure at the time the analysis was undertaken). The analysis was also accompanied by a disclaimer noting small sample of banks for the study and that low compliance is potentially due to difficulties to assess criteria on existing portfolios. Furthermore, the infrastructure supporting factor only applies from 2021, and it will take time for banks to structure their transactions to meet the strict, comprehensive and cumulative criteria for this factor to be applied. Therefore, we are strongly opposed to the EBA recommendation CR3 in its CfA report, which is counterproductive and introduces uncertainty for banks wishing to undertake such transactions to support the development of European Infrastructure projects. Indeed, there seems to be room to explore better practicality of the Infrastructure Supporting Factor and maintaining this preferential treatment if it is relevant to promote green activities. CRR2 rightly provides for a Commission report on the impact of the supporting factor on lending to infrastructure project entities in 2023; this is when the measure should be assessed and potentially revisited.

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<sup>81</sup> NGFS 17 April 2019 Report

## 9. Fit and Proper

### 9.1. Key function holders

#### ***192) What would be the benefits and drawbacks of including the requirement for competent authorities to perform a fit and proper assessment of at least some key function holders in the CRD?***

The industry and its members are committed to deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. To achieve this, we support consistent standards across EU Member States as a means to provide a harmonised approach to supervision and clarity for market participants and assist in ensuring the sound and prudent management of institutions.

At the same time, Member States already retain the ability to extend fit and proper assessments to key function holders, above the requirements set out in the CRD, and we note that this ability has not been universally exercised. Equally, competent authorities may have determined that the assessments performed by institutions are sufficient and do not require additional oversight.

The divergence in corporate structures across jurisdictions and entities is also likely to be a key factor here, as it means that key function holder roles are not standardised. Furthermore, firms are subject to differing national corporate laws across the EU, which each impose individual requirements that are not compatible with a harmonised regime. As we discuss further in other questions below, review and harmonisation of these corporate law regimes should be undertaken before any changes to existing rules are considered.

As an illustration of existing corporate law challenges, we note that in France:

\* The French Commercial Code currently places most responsibility for the day-to-day functioning of an entity upon the CEO and his/her deputies, which would not be compatible with an increased focus on Key Function Holders in this way; and

\* Pursuant to Article L1232-1 of the Labour Code, a person may be fired for personal reasons (instead of economic reasons) only for actual and serious offences. Pursuant to the banking industry collective agreement, this means there might be only two grounds for termination:

- disciplinary termination, or

- dismissal for incompetence (which cannot be understood as not receiving the approval from a third party).

It would be therefore not possible to insert a condition precedent (the condition being the approval of the ECB/NCA) as a termination provision in the labour agreement for new appointee. As regards persons who are already in the institution, it is not possible to dismiss an employee on this basis.

We therefore suggest that it would not be appropriate at this stage to make the requirement mandatory, unless it is requested by competent authorities and appropriately resourced.

***193) In your view, would it be useful to identify key function holders in a descriptive manner, and/or to specify certain roles as belonging, by default, to the set of key function holders? Please consider the practical implications of each option and the need for clarity and consistent application across institutions and competent authorities. Please elaborate and provide evidence.***

As above, the industry does not believe that it should be a requirement for competent authorities to perform a fit and proper assessment of key function holders.

However, should this be put in place, due to the wide variety of corporate structures, the industry considers that specifying or identifying key function holders and their responsibilities in such a way as to apply across all firms would be challenging.

For example, although the UK implementation of its Senior Managers and Certification Regime (SMCR) has generally been welcomed by the industry in the UK, one complexity in implementation has been the description of certain mandatory management functions within firms, which has required extensive discussion with the industry and, in some cases, the ability to split or share defined roles between individuals, in order to adapt to different governance structures<sup>82</sup>. The SMCR has also addressed this challenge by identifying certain ‘Prescribed Responsibilities’ which must be held by a Senior Manager but have not been allocated to a specific job role.

Identifying or defining KFH as provided in the EBA guidelines dated 26 September 2017 is, as already said and mentioned in frame of the 2017 Consultation papers, too large and unprecise. This risks a

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<sup>82</sup> See for example, our comments on the Chief Operations Function in our response to the Prudential Regulation Authority (PRA) Consultation Paper 34/16, available at: <https://www.afme.eu/Portals/0/globalassets/downloads/consultation-responses/AFME-BBA-response-to-pra-cp34.16.pdf?ver=2019-09-11-143951-923>

lack of clarity and will put institutions in a situation of uncertainty. There may also be a risk of continuous extension of the number of persons to be considered as KFH.

Any descriptions of key function holders would need to take into account these complexities and be suitably adaptable to different corporate structures.

We therefore suggest that it would not be appropriate at this stage to make the requirement mandatory, unless it is requested by competent authorities and appropriately resourced.

***194) Were the CRD to specify a number of roles that would be considered, by their very nature, to be occupied by key function holders, which specific roles should, in your view, be included in this list?***

As above, the industry does not believe that it should be a requirement for competent authorities to perform a fit and proper assessment of key function holders.

However, should this be put in place, we do not suggest that the CRD specifies the roles to be occupied by key function holders. If maintained, the list of key function holders should be strictly limited, and we propose that this limitation is to the heads of key internal control functions (risk, compliance and audit), of the top parent company of consolidated CRD institutions which are classified as G-SIBs.

***195) Views are also sought as to whether the scope of key function holders subject to fit and proper assessment should be limited to those holding these positions at group level or whether it should also include key function holders at the level of each institution? Please elaborate and provide evidence.***

As above, the industry does not believe that it should be a requirement for competent authorities to perform a fit and proper assessment of key function holders.

However, should this be put in place, the industry considers that the scope of key function holders subject to fit and proper assessments should be limited to positions at group level of the top parent company of Global systemic entities as it the most relevant decision making level with significant impact on the global financial system.

As an example, in France, pursuant to the decree dated 3rd November 2014 on internal control functions which transposed the CRD 4 Directive, heads of internal control functions have direct access to the board of directors and it is possible for subsidiaries to delegate the functions to the group heads for internal control functions - they are therefore considered to be integrated in the subsidiaries.

***196) Should the key function holders be subject to fit and proper assessments by competent authorities, on what criteria could this assessment be performed?***

As above, the industry does not believe that it should be a requirement for competent authorities to perform a fit and proper assessment of key function holders.

However, should this be put in place, the fit and proper assessment should be conducted according to the criteria set out in the Joint EBA/ESMA Guidelines, subject to the disapplication of those criteria which pertain to Board directors rather than employees of the firm (such as independence of mind). Every assessment should be based on very simple, clearly defined criteria that ensure a level playing field, efficient harmonisation and allow both European authorities and banks to establish a true Single European Market.

**9.2.1. Supervisory procedure**

**9.2.1.1. Ex ante and ex post approval and ex post notification**

***197) Please explain what you consider to be the advantages and disadvantages of competent authorities conducting ex ante and ex post approval, respectively, of suitability of members of the management body.***

While the industry considers that there are significant advantages to an ex-ante assessment, where this can be performed in a reasonable timeframe to avoid long hiring delays, we are concerned that there are significant barriers to such a harmonised approach, largely due to existing national corporate and labour laws. We outline some examples of these below and suggest that this lack of standardisation should be addressed before a harmonised ex-ante assessment approach can be considered.

For example:

- The individual responsibility doesn't seem to be compatible with the traditional Italian corporate governance system, where the Board of Directors is composed of a substantial majority (almost totally) of non-executive directors. Considering that the latter must not be delegated specific powers, an accountability regime according to which each director has specific functions could be compatible only with reference to executive members (this cluster in Italy is usually limited to the CEO, while the other members are non-executive).

- In France, the ex-ante approach is not consistent with existing legislative framework (see e.g. art. R. 612-29-3, French monetary and financial code and Article L. 225-24 al. 3 of the French commercial



code). The considered change may entail a corporate law system much more complex with a regime for financial institutions that would be different from the one applied to other kinds of commercial firms.

Until such time as the national legal barriers to firms' compliance with a harmonised ex-ante assessment regime are addressed, we believe that there should remain flexibility for competent authorities to make part or all of the assessment ex-post. In this respect, we supported the text in the 2012 EBA 'Guidelines on the assessment of the suitability of members of the management body and key function holders', which provided that while the assessment should take place before the appointment, it could take place afterwards and must be completed within six weeks of the appointment.

Where an ex-ante assessment is undertaken, we suggest that the process can be streamlined in three ways. First, firms are required to gather all the required information and perform their own assessment before making a submission to their competent authority. If a clear common template for this assessment could be produced, firms would be working to a single standard and could ensure that they provided at the start of the assessment all the documents that might be required.

Second, the competent authority must allocate sufficient time and resources to make its own assessment, to reduce the risk of a lengthy process for senior appointments.

Third, we suggest that the period of time set for competent authority assessments is reasonable. For example, we note that the Dutch AFM currently assesses approvals within 6-13 weeks<sup>83</sup>. This allows firms to estimate how long a role will remain unfilled. We also request that the assessment period is paused whenever a request for additional materials is made to a requesting firm, and not started again until that material has been provided.

***198) If, in your jurisdiction, institutions are required to request approval for the appointment of members of the management body only after they take up their position, please explain what, if anything, would make it difficult for you to adapt to an ex ante system.***

We refer to our response to Q197 and suggest that the lack of standardisation in European corporate law should be addressed before harmonisation of the approval process is considered.

***199) One issue that has been raised in the past in relation to ex ante assessment is avoiding vacant positions on the board. Please explain, based on your experience, to what extent this can be overcome (if it is an issue in the first place) giving examples and making reference where***

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<sup>83</sup> <https://www.afm.nl/en/professionals/onderwerpen/toetsing-proces>



***appropriate to succession planning and procedures in place for identifying skills/experience that could be particularly difficult to replace.***

The industry proposes that it should be possible to grant temporary permissions in order to avoid vacant positions on the board.

***200) Which specific positions within the board and/or senior management of institutions do you believe should be considered as part of an ex ante assessment, given the responsibilities they hold and the risks they may pose? Please provide evidence and/or examples to support your views.***

N/A

#### 9.2.1.2. Processing of applications for fit and proper approval

***201) Considering a scenario in which at least some fit and proper assessments were to be conducted by competent authorities ex ante, what would be, for you, the costs and benefits of a deadline for the assessment of proposed board members being set in the CRD? What would you consider a reasonable period of time for the assessment?***

We refer to our comments above to the effect that the lack of standardisation in European corporate law should be addressed before harmonisation of the approval process is considered. This is particularly key given that many firms are under obligations relating to the approval of Board Directors at shareholder meetings, which impose timeframes upon the approval process, different per Member State.

However, where an ex-ante assessment is to be undertaken, it is important that the process is clearly set out for firms in order that they are able to plan their hiring schedules. We suggest that the process can be streamlined in three ways:

First, firms are required to gather all the required information and perform their own assessment before making a submission to their competent authority. If a clear common template for this assessment could be produced, firms would be working to a single standard and could ensure that they provided at the start of the assessment all the documents that might be required.

Second, the competent authority must allocate sufficient time and resources to make its own assessment, to reduce the risk of a lengthy process for senior appointments.

Third, we suggest that the period of time set for competent authority assessments is reasonable and clearly defined. For example, we note that the Dutch AFM currently assesses approvals within 6-13 weeks<sup>84</sup>. This allows firms to estimate how long a role will remain unfilled. We also request that the assessment period is paused whenever a request for additional materials is made to a requesting firm, and not started again until that material has been provided.

Finally, we note that, if an effort is not undertaken to harmonise corporate law structures across Member States, ex-ante assessments will need to take place in accordance with timelines for existing corporate requirements. In France, for instance, this may require the assessment to be completed by a certain date in order that the Board can agree the resolutions to be published 3 months before an annual general assembly, which will place significant constraints on both firms and competent authorities. A refusal shortly before the yearly General Meeting or a delay in approval process would require the re-scheduling of a General meeting, which could unintentionally give a negative signal to the market. Similarly, if the number of board directors were to fall below the minimum required by the by-laws, Article L. 225-24 al. 3 of the French commercial code requires a firm to appoint new directors within a 3-month period following the vacancy.

***202) Do you currently use, or have you envisaged, other timelines for approval, e.g. whereby institutions only have a limited time to provide the additional information requested, or where the length of the assessment period depends on the specific type of position? If so, please explain the rationale for these timelines.***

N/A

***203) If competent authorities had a fixed time period for giving their approval to proposed new board appointments, would you nonetheless consider it preferable for a decision to be issued in cases where the competent authority decides to approve a candidate? Could you instead envisage a system of “tacit approval” (i.e. whereby, if no decision has been issued by the deadline, the institution can consider the candidate approved)?***

We could in principle envisage a system of tacit approval. However, besides the gains in terms of effectiveness, we suggest that a system of tacit approval may present challenges for firms operating on a cross-border basis. For instance, there are likely to be situations where a firm is required to prove (e.g. to a parent entity in a third country) that approval has been granted. We believe that a tacit approval system would therefore need to ensure smooth cross-border operations of banks with respect to the approval of candidates.

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<sup>84</sup> <https://www.afm.nl/en/professionals/onderwerpen/toetsing-proces>

### 9.2.2. Proportionality

***204) Should the scope and format of fit and proper assessments be adapted to take into account the principle of proportionality, including in relation to any new provisions such as those discussed in Sections 9.2.1.1. and 9.2.1.2.? Please elaborate on your reply and provide examples.***

The industry believes that while proportionality is relevant, the EBA Guidelines on Internal Governance and the ECB Guidelines on Fit and Proper Assessments already provide a comprehensive list of proportionality criteria. However, we also believe that the size of an entity should not be the main factor in determining proportionality, as this is not the key determinant of risk.

***205) What specific criteria would you consider appropriate as a basis for allowing some degree of proportionality in the fit and proper assessment, including in relation to any new provisions such as those discussed in Sections 9.2.1.1 and 9.2.1.2? Views are also sought on the possibility of granting competent authorities the right to apply supervisory judgement to enlarge the scope of their assessment based on the risk profile of the institution/role.***

As noted in our response to Q204, the industry believes that the EBA Guidelines on Internal Governance and the ECB Guidelines on Fit and Proper Assessments already provide a comprehensive list of proportionality criteria. However, we also believe that the size of an entity should not be the main factor in determining proportionality, as this is not the key determinant of risk.

We also note that granting additional powers to competent authorities may conflict with corporate law in certain jurisdictions.

***206) What specific risks do you see in allowing some degree of proportionality in the application of any new provisions, such as those discussed in Sections 9.2.1.1. and 9.2.1.2., on the timing of the approval of board members by competent authorities and of key function holders?***

As noted in our response to Q204 and Q205, the industry believes that the EBA Guidelines on Internal Governance and the ECB Guidelines on Fit and Proper Assessments already provide a comprehensive list of proportionality criteria. However, we also believe that the size of an entity should not be the main factor in determining proportionality, as this is not the key determinant of risk.

We also note that granting additional powers to competent authorities may conflict with corporate law in certain jurisdictions.

### 9.2.3. Roles on the management body, individual and collective suitability

***207) What would be the benefits and drawbacks of designing an accountability regime whereby the management body of each institution would be required to draw up a statement of responsibilities of each of its members clearly identifying the activities for which they are responsible, beyond the sole responsibilities linked to their membership of specialised committees (e.g. risk committee, remuneration committee)?***

The industry notes that well-designed accountability regimes serve to strengthen corporate governance as well as individual and collective responsibility for key decisions. However, (in addition to our comments about the need to standardise corporate law before any changes to accountability rules would be possible) there are a number of challenges which must be taken into account when considering the imposition of a new accountability regime, which include:

- The lack of harmonisation across EU member States in relation to corporate and labour laws, which should be addressed in order to enable greater standardisation of accountability requirements. For example:

- \* The individual responsibility doesn't seem to be compatible with the traditional Italian corporate governance system, where the Board of Directors is composed of a substantial majority (almost totally) of non-executive directors. Considering that the latter must not be delegated specific powers, an accountability regime according to which each director has specific functions could be compatible only with reference to executive members (in Italy this is usually limited to the CEO, while the other members are non-executive).

- \* In France, the Board is a collective body implying decisions are the result of deliberations. Each Director has the duty to develop his or her thinking, to express his or her questions and opinions clearly and to share them with his or her Board colleagues. These discussions lead the Board to take joint decisions. Once made, these decisions become, those of the board. From a legal standpoint, each member is therefore responsible for it and therefore assumes its collegial responsibility. The Board is responsible in its entirety. Introducing rules on individual responsibility would put at stake the principles set by French law on the collective responsibility of the Board.

- Examination of the scope of the regime in relation to corporate structures. Many firms operate on a global basis, making it difficult to fully delineate responsibility for business lines within individual entities or jurisdictions. In addition, roles and responsibilities differ between structures, meaning that each firm may have a different set of roles making up their management body;

- How any such regime can continue to support collective decision-making while clarifying individual roles and responsibilities; and

- In large firms, changes in structure and individuals within the management body are relatively frequent. Any such requirement should take into account the resources required to continually update responsibility maps and statements of responsibility, and the submission process for such updates to competent authorities.

***208) How might the collective functioning of the board be affected by the introduction of a system where each individual has a defined set of responsibilities? Please consider the possible effects on both individual conduct and the board as a whole (e.g. the impact on the collective responsibility of the board, or on the quality of its discussions).***

As outlined in our response to Q207, the design of any accountability regime would need to ensure that collective decision making was not impacted by the articulation of individual roles and responsibilities. This could be done by ensuring that the roles and responsibilities of particular committees were well defined within a firm's structure (supported by the EBA's existing 'Guidelines on internal governance under Directive 2013/36/EU') and that the procedures and decisions of these committee are well documented.

However, since some of the challenges relating to collective decision making pertain to local corporate law in Member States, we strongly suggest that this lack of harmonisation is addressed as a critical enabler for any new accountability regime.

***209) What would be the benefits and drawbacks of designing a similar accountability regime for key function holders (e.g. information on key function holders, their responsibilities, details of the firm's governance and structure)?***

As outlined in our response to Q207, the design of any accountability regime would need to take into account the individual structures of firms and be suitably flexible to adapt to differing roles and responsibilities between entities.

***210) Would the assessment of individuals proposed for positions on the board or as key function holders be more accurate and/or reliable if the responsibilities the individual would be taking on were clearly defined, including in relation to any new provisions, such as those discussed in Sections 9.2.1.1 and 9.2.1.2?***

The responsibilities vary depending on the definition of KFH. It could be possible only as regards heads of internal control functions, and only at the top parent company level.

#### 9.2.4. Cultural factors influencing conduct

***211) Do you consider that corporate culture could and should be taken into consideration as part of the fit and proper assessment? If yes, please explain how this could be most effectively achieved.***

The industry believes that good corporate culture and values, which have become subject to significantly increased focus within the industry, are integral to the management of any firm. Moreover, we would like to add that the hiring strategy and succession plans are specific to each institution and can constitute competitive advantage and a better adaptation to the specific situation of the institution. However, it is unclear exactly how the European Commission envisages the integration by competent authorities of cultural factors into the Fit and Proper assessment. Such integration would have to include a broadening of the Fit and Proper criteria to take into account a wider range of factors, which are also generally more subjective and difficult to define. We believe that the challenges of addressing corporate culture by means of regulation have been acknowledged by a number of regulators in their creation of separate initiatives focused on this area<sup>85</sup>.

***212) What do you consider would be the benefits of, and/or difficulties encountered in, including the ability to create and promote the organisation's desired culture as part of the "fit and proper" assessment of members of the management body?***

As noted in our response to Q211, discussion of cultural factors is highly subjective. It is therefore not clear how members of a management body of a firm could be assessed in terms of the organisation's desired culture.

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<sup>85</sup> See, for example, the AFM <https://www.afm.nl/en/professionals/onderwerpen/gedrag-cultuur> and the FCA <https://www.fca.org.uk/firms/culture-and-governance>

## Annex – Financial innovation and Regulation for consideration in CRR

### Introduction and Background

Digitalisation is impacting the provision of financial services in significant and innovative ways and in some cases is leading to a blurring of the boundaries between sectors.

It is important from the perspectives of financial stability and growth that regulation is applied in a consistent and clear form across different types of firms that are undertaking the same activities and posing similar risks. At present innovation within banking groups is restricted as prudential requirements are applied to the entity undertaking the activity while this would not be the case for comparable activities in stand-alone entities.

For instance, in the EU payment services providers are regulated by the Payment Services Directive ('PSD') framework. However, when those payment services are provided by a bank and regardless of the risks that the service might pose to the core banking business, prudential banking regulation also applies, in particular through the capital requirements directive and regulation framework (CRD/CRR). The asymmetry in regulating bank and non-bank payment providers has very significant consequences for innovation and systemic risk and it creates barriers to banks' innovation and customer service.

It is important also that policymakers and supervisors adequately consider the systemic risks associated with "big techs", including risks posed by bank disintermediation and its consequences for lending and the provision of financing for the wider economy.

### Possible Alternatives

There appear options that might be considered to eliminate competitive disadvantages while also seeking to ensure financial stability. We would not consider, however, that the application of prudential requirements to all types of entities would be proportionate nor would their application to firms that are not conducting maturity transformation or undertaking banking type business properly or accurately target or mitigate the actual risks that exist.

Instead, we consider that more targeted and feasible options could include:

#### 1. Deconsolidation of banks' digital businesses



One option banks might have to alleviate the supervisory burden on their digital ventures is to seek their deconsolidation, which effectively involves them placing the relevant entities on an ‘arms lengths basis’ not only from a financial perspective but also in terms of governance. Although this would represent an effective way to ring-fence the core banking business of the group from the risks posed by those ventures, this solution is likely to be suboptimal both for the bank and the supervisor. First, because it means the bank relinquishing control over its venture and its innovation, thus losing the ability to contribute to its strategy and operations. Second, this situation would limit supervisors’ ability to oversee the operations of those ventures.

An alternative option over time, might involve redefining the ‘financial institution’ and ‘ancillary services undertakings’ concepts under the CRD text so that the scope of consolidations captures better the risks posed by different undertakings within a banking group.

## 2. Activity and risk based regulatory framework

A proportionate, activity and risk based regulatory and supervisory framework that gradually increases regulatory and supervisory requirements as a firms’ services expand, could create a conducive and enabling environment for new market entrants while also ensuring a level playing field for established banks.

To create an effective activity- and risk-based framework the following considerations would need to be taken into account:

- a) Banking groups should be subject to an activity-based approach where needed with the application of prudential standards to relevant risks only. For instance, PSD 2 operational capital requirements would apply to payments business, and prudential requirements in relation to new products, outsourcing and remuneration arrangements should apply only to the extent relevant to the nature and risks of the activity in question.

An activity-based framework would therefore apply regulatory or supervisory requirements in a proportionate way and would involve for instance: The application of requirements that apply to specific activities, but not the automatic application of prudential standards to such activities where they are undertaken by entities that form part of a banking group but do not add risks to the group other than the potential loss of the investment in that subsidiary.

For example, a subsidiary that is providing information services to customers may attract a charge for operational risk but should not be subject to the wider capital and liquidity requirements that are needed and relevant for deposit taking and lending activities.

The introduction of such a framework might involve regulatory change as currently, the concept of proportionality under CRD V is intended to differentiate the complexity, business model and size of different credit institutions, but might not be suited to enable the application of activity- and risk- based proportionality to digital activities within a banking group's scope of consolidation. There we call on regulators and supervisors to consider whether new criteria need to be defined for this purpose.

- b) In addition to work on the detail of such a framework, structural changes in regulation and supervision might also be needed. In particular, the supervision of banking, payments and e-money institutions and way licences are granted differ across Europe.

The supervisory regime for larger banks operates at an EU level with the European Central Bank as single supervisor, while payments and e-money institutions are licensed and supervised nationally. The nationally licensed and supervised institutions can offer their services in other Member States through the EU passporting system. This creates a risk of supervisory fragmentation or even supervisory competition, which increases as technology companies concentrating on specific services outsource non-core parts of their business to third parties. This growing trend has led to the emergence of a complex network of interconnected financial institutions offering services across Europe while supervision is focused mainly at national levels.

Work might need to be undertaken, therefore, to harmonise not only the regulatory framework, but also the supervision of payments and e-money institutions at an EU level.