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# CRR3 - Output Floor

February 2022

### Executive Summary

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

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

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

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

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

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

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

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

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

### Level of Consolidation

We support the Commission’s approach to apply at the group consolidated level and would note this reflects the way in which it was analysed and calibrated by the Basel committee and has also received the support of the SSM, as noted by their Chairperson, Andrea Enria: *“This [consolidated application] would be simpler because each banking group would only have to calculate the output floor once. It would also be in line with our goal of supporting a truly European banking market. If the output floor were to be applied at the individual level, the European banking market would fragment further.”*[*1*](#_bookmark0)We therefore think applying it in this way will ensure it is a truly business model-neutral measure and allow banks to diversify their risks and avoid regulatory fragmentation. We also recognise that a redistribution mechanism is important to allay the concerns of host Member States.

### Calculation of the Output Floor

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

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

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

1 [https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp191112\_1~01be3b89b0.en.html,](https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp191112_1%7E01be3b89b0.en.html)

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

### Transitional Arrangements for Unrated Corporates

Industry welcomes the proposed Article 465 which provides a transitional treatment lasting until 2032 for how to calculate exposures to unrated corporates under a “hybrid approach”.[2](#_bookmark1) This will mitigate the impact of the Output Floor on lending to corporates by encouraging banks to maintain lending to this vital sector of the economy, as they adjust to implementing the floor in full (by 2030). However, corporate exposures could be potentially negatively impacted as the transitional arrangements end in 2032 leading to a contraction in lending if there is not a wider availability of corporate ratings.

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

**Unratedness of Corporates (an explainer)**

It’s estimated around 75%[3](#_bookmark2) of corporates[4](#_bookmark3) in the EU are unrated. While the BCBS has conceded that unrated corporates are not higher-risk assets in the absence of other parameters to determine their creditworthiness, they nonetheless receive a 100% risk weight (RW), aside from in the case of SMEs[5](#_bookmark4) , under the External Credit Ratings Approach (ECRA).

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

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

3 EBA Basel III [credit risk advice](https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2886865/d383ee58-8665-4f8b-99d3-058984c2711e/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20Credit%20Risk.pdf?retry=1) Table 8: Exposure class corporates (excluding SMEs): exposure amounts by rated/unrated

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

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

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

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

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

The issue of lack of ratings is not only limited to banks which use models, but also extends to banks that apply the Standardised Approach, especially with regard to investment grade corporates, which all banks are able to identify. Consequently, we propose commensurate treatment of unrated corporates should be extended to banks using the Standardised Approach where it can be demonstrated that the corporate is investment grade. For instance, this could be achieved by allowing institutions to make use of the internally estimated Probability of Default (PDs) for those exposures for the purposes of either the economic capital calculation or the accounting expected credit loss calculation.[6](#_bookmark5) These metrics (PDs) follow existing EU regulations, are decoupled from the capital metrics, and are used by all institutions regardless of the approach they use and allow them to identify investment grade unrated corporates with the same level of guarantee as regulatory PDs:

* **PDs used for Provisions (under IFRS9):** They are calculated by all entities using common principles and rules which homogenize this measure across entities: the “EBA Guidelines on Credit institutions’ credit risk management practices and accounting for expected credit losses (2017)”[7](#_bookmark6). The reliability of these PDs is illustrated by the EBA Guidelines themselves, by giving then priority over ratings provided by credit rating agencies
* **PDs used for Economic Capital:** PDs used as risk parameters for Economic Capital are an alternative mechanism to identify investment grade unrated corporates provided that they meet minimum governance and robustness requirements. Such is the case of PDs used for Economic Capital that follow

6 Consistent with the ‘EU Guidelines for the estimation of risk parameters for the IRB approach’ or the ‘EU Guidelines for the credit institutions' credit risk management practices and accounting for expected credit losses’, respectively

7 EBA Guidelines on Credit institutions’ credit risk management practices and accounting for expected credit losses (published in 2017) ([Link](https://www.eba.europa.eu/eba-publishes-final-guidelines-on-credit-institutions-credit-risk-management-practices-and-accounting-for-expected-credit-losses))

the “EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (2017)”[8](#_bookmark7).

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

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

### Transitional arrangements for low-risk mortgages

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

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

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

8 EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (published in 2017) [(Link](https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2033363/6b062012-45d6-4655-af04-801d26493ed0/Guidelines%20on%20PD%20and%20LGD%20estimation%20%28EBA-GL-2017-16%29.pdf?retry=1))

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

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

SA-CCR is a new approach which replaced the Current Exposure Method (CEM) and the Standardized Method (SM), for the calculation of Counterparty Credit Risk (CCR)[9](#_bookmark8) as applied to derivatives transactions, as part of the Regulation (EU) 2019/876 (“CRR2”).[10](#_bookmark9)

While more risk-sensitive, SA-CCR, in its current design and calibration, will lead to disproportionate increases in capital requirements for banks[11](#_bookmark10) and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) which often use long dated non-cleared (typically unmargined) derivatives to hedge risk, and benefit less from the improvements made through the introduction of SA-CCR in capturing portfolio netting benefits.

Since June 2021, SA-CCR is used in many areas across the prudential framework, such as for calculating capital requirements for CVA risk, for Large Exposures framework[12](#_bookmark11) and for the Leverage Ratio. It affects all banks and users of derivatives, and the impact is not restricted to those that apply standardized methodologies only. In CRR3, this impact will become even more pronounced as SA-CCR will also contribute towards the calculation of the newly introduced Output Floor.

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

We are supportive, therefore, of the Commission’s proposals[13](#_bookmark12) to reduce the impact on the output floor RWA, per CRR Article 465(4), by resetting the alpha factor to 1 for a transitional period until 31 December 2029,

9 Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

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

11 According to ISDA-GFMA estimates, the exposure calculated under SA-CCR will be significantly higher than under both IMM (1.9 – 2.5 times higher) and CEM (2-4 times higher). This is before considering the impact of the Output floor. (See: [Link](https://www.isda.org/a/hTiDE/isda-sa-ccr-briefing-paper-final1.pdf))

12 <https://www.bis.org/fsi/fsisummaries/largeexpos.pdf>

13 [[https://ec.europa.eu/info/publications/211027-banking-package\_en](https://eur02.safelinks.protection.outlook.com/?url=https%3A%2F%2Furldefense.proofpoint.com%2Fv2%2Furl%3Fu%3Dhttps-3A__ec.europa.eu_info_publications_211027-2Dbanking-2Dpackage-5Fen%26d%3DDwQGaQ%26c%3DeuGZstcaTDllvimEN8b7jXrwqOf-v5A_CdpgnVfiiMM%26r%3DN3qb883yVypBXk_rGqOVxA%26m%3D8MoHtC2FeKDguy-HB5XMQ7YILL3CKRDk3CLU3HHtCIw%26s%3DElRDmeV4ZCtJOlH7RjcWxIiAiLqnsZIlHfPrNIvXWg0%26e%3D&data=04%7C01%7C%7C03b986da5aa646d730e308d9e59991b8%7Cd1039c55923b41d4ac3363147f66ea3d%7C0%7C0%7C637793270031903644%7CUnknown%7CTWFpbGZsb3d8eyJWIjoiMC4wLjAwMDAiLCJQIjoiV2luMzIiLCJBTiI6Ik1haWwiLCJXVCI6Mn0%3D%7C3000&sdata=DAUmFp%2FnI1UdZh0hf1kA8n53TC7OXFKAGijlhTypQ3U%3D&reserved=0)

with the potential for this to be permanent, having taken into account the EBA report mandated by CRR2 and due by June 2023.[14](#_bookmark13)

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

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

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

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

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

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

### Securitisation Review

Whilst the prudential treatment of securitisations does not feature in the CRR3 proposals, the CRR already includes a mandate for a review of the securitisation framework per Article 519a. The review was originally due by 1 January 2022, but the European Commission revised this deadline to 1 September 2022 in its call for advice to the Joint Committee (JC) of the ESAs[15](#_bookmark14). We believe this review is essential and international regulatory developments, such as the introduction of the Output Floor will have a significant impact on prudential requirements for securitisations that require consideration. Industry will provide detailed feedback to the JC of the ESAs for consideration, including a recalibration of the p-factor, and we believe it imperative that policy makers consider this work stream in tandem with the ongoing CRR3 proposals to ensure coherence and appropriate calibration of the prudential framework as a whole.

15 Call for advice – See [(link](https://www.eba.europa.eu/sites/default/documents/files/document_library/About%20Us/Missions%20and%20tasks/Call%20for%20Advice/2021/CfA%20to%20JC%20for%20securitisation%20in%20prudential%20framework%20review/1022481/CfA_Review%20Framework%20_JC%20ESAs_Final.pdf))

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