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Finance for Europe

Association for Financial Markets in Europe

Output Floor

Pre- CRR3 position paper

July 2019

In December 2017, the Basel Committee completed the Basel III capital standards, including a new component known as the "Output Floor". Under this measure, banks' total assets weighted for risk using their own models cannot be less than 72.5% of the amount calculated under standardised approach.

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.[1] 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.

Banks constrained by different parts of the framework[1], by region

Group 1 banks, in per cent — Table C.73

	Europe		Americas		Rest of the world	
	Current	Final	Current	Final	Current	Final
Risk-based capital	41.4	20.7	37.5	62.5	71.9	46.9
Output floors	0.0	41.4	37.5	6.3	9.4	34.4
Leverage ratio	58.6	37.9	25.0	31.3	18.8	18.8

[1] Europe includes 29 banks, the Americas include 16 banks and the rest of the world includes 32 banks.

Source: Basel Committee on Banking Supervision.

While the Basel Committee notes that the output floor is in effect a 'risk-based backstop'[2], the above table 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 on 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.[3] Nor has it explored whether and to what 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. AFME members would welcome this breakdown, which should focus in particular on the impact of

[1] 1 "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

[2] Cf description p. 11 https://www.bis.org/bcbs/publ/d424_hlsummary.pdf

[3] 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+the+own+fund+requirements+for+credit%2C%20operational+market+%26+credit+valuation+adjustment+risk+040518.pdf/fa15db69-5527-4fbe-a0e7-0d8ed46547fb

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, they should 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 addition to undertaking the further analysis of the impact, it will be essential that the output floor 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 approach builds in enough risk sensitivity** so that lending to the real economy is not adversely impacted.

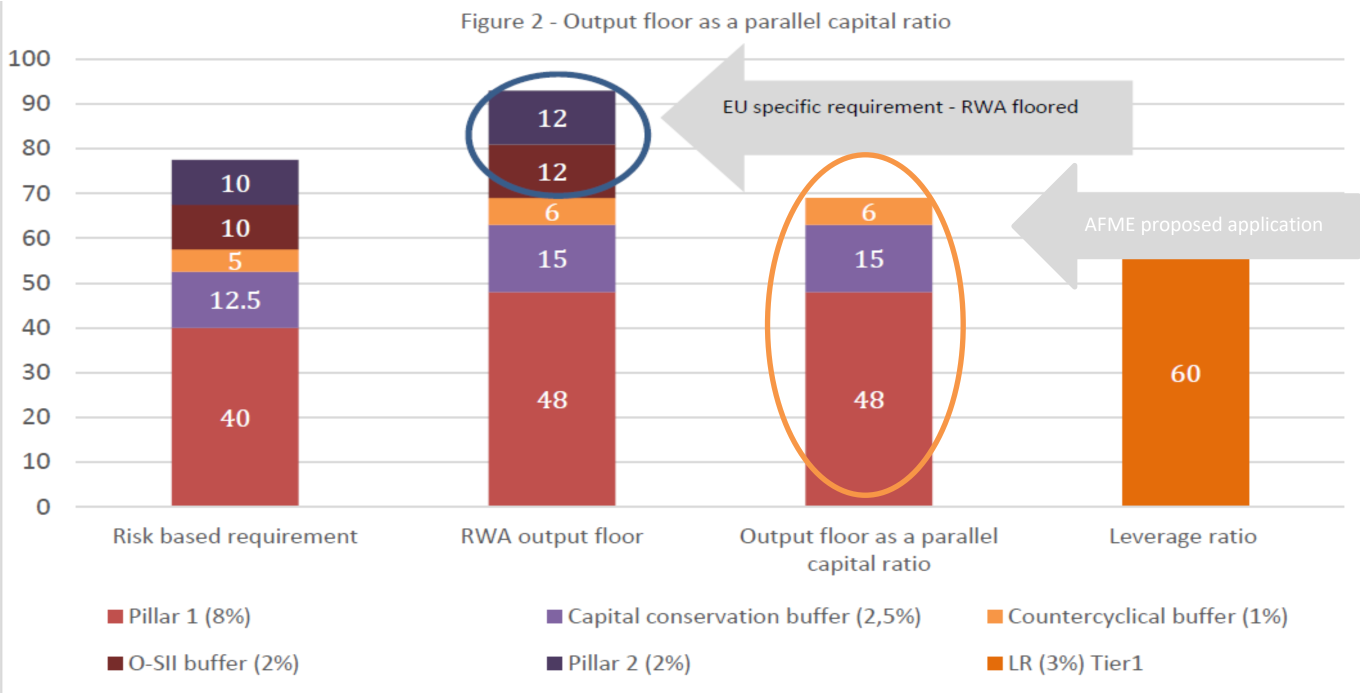
Recommendations the implementation of the Output floor

Level of application of the floor: Basel III calibrated the application of floor at the global consolidated group level meaning that it is calculated at the aggregate RWA level, rather than on 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. AFME therefore urges EU regulators to reflect on the requirement for the level of application of the floor 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 therefore not necessary to apply at the level of each jurisdiction in which the bank has an entity.

In this respect, AFME 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. In particular, it failed to capture smaller banking entities across the EU as well as third country banking subsidiaries. In addition, the EBA's own analysis shows a number of shortcomings with its own findings, not least that its proposals could have adverse impact on subsidiaries which are focused on mortgage lending 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%).

We consider this concerning because 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.

Methodology for calculating the floor: It is unclear how the Output floor will interact with capital buffers and the Pillar 2 framework, particularly given these are set by national competent authorities and often country or institution specific. This could make it challenging to have one common comparable set of metrics by which EU banks calculate the floor across the EU. In our view, the output floor should therefore be 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 as the chart below demonstrates:



As an industry, AFME members support the third option/bar in Figure 2 where the output floor is a parallel capital ratio, however we understand the EBA supports the second option/bar to the European Commission in its CfA analysis, which would require banks to calculate the floor on the basis of the full capital stack including Pillar 2 and European specific capital buffers. If the Commission takes this proposal forward in CRR3 it would be a gold-plating of European implementation of the output floor, as the Basel text only requires the floor to be calculated on the basis of 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 of the floor. This is because the Pillar 2 framework is a bank specific measure which is decided by supervisors and its application ranges widely from country to country and even within countries, as highlighted in a Basel review from July 2019.[4] 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.

In addition to the above considerations, there are areas of the requirements for implementing the capital floor where further European-specific guidance is required e.g. deductions for securitisations RWAs at

[4] https://www.bis.org/bcbs/publ/d465.pdf see pg. 1 and 2

1250% (Basel is silent) and provisioning rules (SA vs. IRB different, interaction of the NPLs P1 backstop with treatment of defaulted exposures).

It is also 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.

Finally, 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 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.

A more risk-sensitive Standardised Approach in the EU: Increases to Credit Risk RWAs under the SA are most significant in the EU.[5] Changes to the credit risk framework will result in large RWA increases for Specialised Lending, SFT transactions 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.

In addition to the impact of the SA to Credit risk, both the Counterparty Credit Risk and SA-CCR framework are 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 un-hedged 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.

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[6] 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[7].

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

[5] Results of IIF, ISDA, GFMA cumulative impact assessment can be shared on a confidential basis to regulators
[6] http://www.bis.org/bcbs/publ/d337.pdf Results for Netting Set 16, unmargined, which encompasses all major asset classes.
[7] 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.

reflect current industry practice, such as mandatory margining requirements or international developments such as adequately recognising Qualifying Master Netting Agreements (as se 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 temporarily set the alpha factor to 1[8], which better represents analytical estimates of the correct calibration of alpha[9]. Alternatively, consideration could be given to the benefit of a scalar applied to SA-CCR in the output floor. At the same time, we encourage EU policymakers to pursue recalibration of SA-CCR at Basel and to consider how best to incorporate potential changes from recalibration conducted at international level. Given the EU legislative process, we suggest that a 'fast tracked' or delegated act may be the most efficient ways of transposing international recalibration of SA-CCR into the EU.

Conclusion:

The Output floor is one of the most impactful aspects of the revised Basel framework, and it is not yet fully understood what the holistic impact will be from the banking system to business models, nor the wider macro impact for bank clients that may derive from this. As policy makers and legislators begin to implement the floor we urge more analysis to be undertaken of the level of application and calculation requirement of the floor alongside the risk-sensitivity of the standardised approach. This should be augmented during the transitional implementation with regular review and recalibration as necessary to ensure appropriate implementation in Europe in order to avoid undue or adverse impact.

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[8] As applied to the replacement cost component of the exposure amount.

[9] See AFME SA-CCR position paper, which sets out issues with the design and calibration of SA-CCR and includes analytical analysis of the correct calibration of SA-CCR that represents current market conditions.