Consultation Response

European Commission Consultation on the possible impact of the CRR and CRD IV on bank financing of the economy

7 October 2015

AFME and ISDA (the Associations) welcome the opportunity to comment on the **European Commission's Consultation on the possible impact of the CRR and CRD IV on bank financing of the economy.**

An executive summary of our response can be found below.

The executive summary is followed by our detailed comments on the issues raised in the consultation paper, structured as follows: the first section briefly describes the key prudential elements of the financial reform programme and is followed by an overview of the full range of factors industry considers need taken into account when reviewing the prudential framework. Section III discusses the crucial role risk sensitivity plays in an appropriate prudential framework and Section IV looks at the difficulties banks have in making strategic capital management decisions in an uncertain regulatory environment. This is followed by a description of the economic contributions of banks beyond direct lending. Section VI examines the impact of regulation on bank lending and market functions, providing evidence and examples where possible. Areas of the current framework where the Commission should focus immediate attention are set out in Section VII and Section VIII recaps our concerns with, and possible economic impacts of, future workstreams being discussed at international level.

A table cross referencing the individual questions raised in the consultation with the relevant areas of our response can be found in the Appendix to the response.

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. For more information please visit the AFME website www.afme.eu.

About ISDA

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Executive Summary

AFME & ISDA Response to the European Commission Consultation on the possible impact of the CRR and CRD IV on bank financing of the economy

The European Commission's financial reform programme has made the EU financial services sector fundamentally more resilient, reducing the likelihood of bank failure and containing its effects should this occur - but it is essential that the right balance be found so that the financial sector is not prevented from carrying out its basic economic functions and supporting future economic growth. The present consultation is therefore a welcome step in trying to assess the impacts of the CRDIV/CRR on the economy and determine where that balance should sit.

There is a multiplicity of actual and prospective regulatory change within the banking sector all of which influence banks' strategic decision-making, the products and services they offer and the price of those products and services, and which need to be taken into account in assessing this balance. This is as true of the role banks play in providing access to and supporting the functioning of financial markets, as it is of their role in providing traditional intermediary services.

Given its focus on bank capital requirements, this review is partial and fails to take into account the important impacts of, and interlinkages between, the other measures that are part of the CRDIV/CRR, notably liquidity and leverage requirements. Moreover, its scope does not extend to the BRRD, a new prudential framework that goes hand in hand with the CRDIV, providing authorities with a proactive toolkit, including capital measures, to manage recovery and resolution. Resolution tools enable authorities to minimise financial instability by ensuring the continuity of a bank's critical functions and restoration of viable parts of the bank. The recently launched cumulative impact assessment exercise, part of the Commission's CMU Action Plan, will thus be helpful in understanding the broader implications of the EU prudential regulation within the overall financial reform package.

Beyond the EU's reform programme itself, there are several workstreams underway at international level likely to further increase capital requirements and significantly reduce the level of risk sensitivity of the prudential framework. It is crucial for the Commission to consider how these developments may impact European growth, as a lack of risk sensitivity leads to the inappropriate pricing of risk, creating a misallocation of capital across the economy, less diversification across firms' portfolios, and potentially an increase in risk to the financial system as a whole.

When examining the prudential framework and the impact it has on the economy, the Commission's analysis and review must therefore be forward looking and comprehensive.

Over the past years, banks have responded to regulatory reform by taking multiple restructuring actions, both of their organisations and product offering. We are concerned that regulatory changes driving these responses may represent an over-correction, beyond what could be considered as "necessary deleveraging". Indeed, the decrease in lending to corporates and the structural and comparably small share of market-based financing in Europe are signs that choice for banking customers has been reducing and will continue to do so.

While there may not yet be an apparent impact on prices to customers, the extensive cost cutting and activity reduction undertaken by banks over the past years means that banks may have been able to shield their core customers from much of the impact of regulation. However, this can only be a finite exercise, particularly given persistent low returns of the industry. Lower returns are not an issue *per se*, however banking profitability and sustainable returns play an important role in contributing to financial stability as retained earnings are the main source of capital resources to meet higher capital requirements. Moreover, as once economic growth returns to the Single Market and monetary policy normalises, regulation that overly constrains banks' balance sheets means that the industry may very well not be a position to support this growth.

There is also evidence that many banks have exited or reduced market-making activities, implying that banks need to be more selective in offering their balance sheet capacity and end-users ultimately face a less diversified capital markets offering. Additionally, an increasing focus is being placed on the impacts of regulation on primary and secondary market liquidity and there are concerns that market liquidity could be further affected as monetary policy tightens. With the development of the CMU in the EU being one of the key priorities for EU policymakers, AFME and ISDA consider it is essential that the Commission examines how the prudential framework affects market liquidity and acts to preserve this important market function.

Having completed its reform agenda, the Commission now has a once-in-a-generation opportunity to reflect on the best approach to prudential regulation within the context of its objectives to support growth and develop European capital markets. Ideally, this should also be accompanied by the definition of a yardstick against which the success and impacts of the new prudential regulatory framework can be measured. In our view, this must involve finding the appropriate trade-off between the benefits of financial stability and a banking sector that is able to take controlled risks to provide credit to the economy. This balance could be jeopardised by unnecessary regulatory layering.

AFME & ISDA Response to the European Commission Consultation on the possible impact of the CRR and CRD IV on bank financing of the economy

Section I. The EU's far-reaching programme of financial reform has been effective in improving the financial system

The reinforced prudential framework, recovery and resolution tools and the new supervisory and resolution frameworks are an integral and effective package to ensure financial stability

The EU's unprecedented programme of financial reform, of which the Capital Requirements Directive and Regulation (CRDIV/CRR) is a cornerstone, has fundamentally reshaped the European financial services sector and its supervisory environment. The sector is significantly more resilient than it was before the crisis. Both the firms and markets comprising the sector, as well as the users of services provided by the sector, benefit from this enhanced resilience.

In particular, the CRDIV/CRR has greatly reduced the likelihood that banks will fail by making them less leveraged and more liquid. Comparing like with like, the CRDIV/CRR will require banks to hold ten times more equity capital than before the crisis[1]. The quantity and quality of capital in the system have already improved, with the largest EU banks' average core tier 1 capital ratio having doubled between 2007 and 2013[2]. The new liquidity and leverage requirements, also part of CRDIV/CRR, have already lead to Europe's largest institutions tripling their holdings of cash and halving their leverage compared to 2007[3].

If banks do get into difficulty, groundbreaking measures to ensure that taxpayers no longer foot the bill, and that the effects on the real economy are contained, have been introduced under the Bank Recovery and Resolution Directive (BRRD). These include statutory tools such as bail-in so designed to ensure that shareholders and certain creditors bear losses. Together with Total Loss Absorbing Capacity (TLAC) requirements, coordinated at international level by the Financial Stability Board and that apply specifically to the most systemically important banks, the combination of the CRDIV/CRR and the BRRD measures mean that no European bank can be considered as being "too big to fail" any longer.

The EU's supervisory architecture, including the establishment of macroprudential authorities, has also been fundamentally transformed and strengthened. Moreover, a Banking Union for Eurozone countries has been created to break the negative sovereign-bank feedback loop from which several weaker European economies have suffered. Banking Union will also promote market integration with the creation of the single supervisory and resolution mechanisms for Eurozone banks[4]. With the SSM and other EU competent authorities working together under the auspices of the EBA, harmonised supervision within the EU should fast become a reality and cross border supervisory collaboration should be facilitated in general..

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1 Paul Tucker, "Regulatory reform, stability and central banking", Hutchins Centre on Fiscal & monetary Policy at Brookings, January 2014. The annex to the consultation refers in fact to an increase that could be as great as 13 times the pre-crisis requirements.

2 Increase in average core tier 1 capital ratio of EU G-SIBs from 2007 to 2013.Source: SNL

3 Source: SNL

4 With the possibility for non-Eurozone Member States to opt into the Banking Union

Stress testing initiatives also ensure that banks maintain sufficient capital to meet minimum regulatory requirements even after suffering losses estimated as arising from severe, but plausible, adverse economic scenarios.

With the SSM and other EU competent authorities working together under the auspices of the EBA, harmonised supervision within the EU should fast become a reality and cross border supervisory collaboration should be facilitated in general. Stress testing initiatives also ensure that banks maintain sufficient capital to meet minimum regulatory requirements even after suffering losses estimated as arising from severe, but plausible, adverse economic scenarios.

Zero-risk is neither desirable, nor attainable, but the goal of avoiding a similar, prolonged crisis and its associated spill over effects has, to the extent possible, been achieved

Taken together, these and the many other measures part of the regulatory reform programme have greatly increased the stability, transparency and integration of European financial markets. The risk of future financial crises occurring and leading to severe, prolonged economic crises has been substantially and effectively reduced. The wide social and economic benefits that this entails are well acknowledged. However, policy makers have to be aware that there comes a point when ever increasing measures to protect the system begin to prevent banks from carrying out economically valuable functions.

Section II. Reflection is now needed on the right prudential framework for supporting economic growth

Assessment must be comprehensive given the interlinkages between the various measures of financial reform

While the reform programme has already led to fundamental improvements in the financial system, it is essential that reform, particularly when so extensive, does not prevent the financial sector from carrying out its basic economic functions and supporting growth of the real economy in a sustainable way. A thorough assessment of the net cumulative impact of the changes involved is therefore necessary and must include in-depth, quantitative analysis of the impacts of reform on the industry's ability to support real economy participants and help the EU economy return to sustainable and sustained levels of growth. The present review is a welcome step towards understanding the effects of the CRDIV/CRR on the European economy, but is nevertheless still a partial exercise.

The consultation focuses only on capital requirements. Leverage and liquidity requirements, in spite of not all yet being adopted formally, have already become binding constraints for many institutions through market pressure, the requirements of national competent authorities and internal planning processes. Similarly, the supervisory stress test overlay on all of these requirements adds another driver of change in capital and liability structures, as do MREL[5] and TLAC requirements. Indeed, the CRDIV/CRR and BRRD go hand in hand and should be assessed as a package. In addition to this, macroprudential tools also have a significant impact on banks' ability to lend to the real economy. Lastly, and perhaps most importantly, given the (sometimes competing) interactions between the various metrics, it is essential that they all be factored into any analysis of the effects of regulation on lending in order to have a complete picture.

In this regard, the Associations and their members welcome the call for evidence issued by the Commission on 30 September 2015 regarding the cumulative impact of the EU regulatory framework for financial services[6]. We also urge the Commission to support the Basel Committee on Banking Supervision's (BCBS) commitment to consider the interaction of the different components of the new regulatory architecture[7] and hope that the recently published call for evidence will serve the same purpose at European level.

It is questionable whether forthcoming BCBS proposals are the right measures at the right time

Moreover, while EU financial reform has lead to significant change and is generally regarded in policy making circles as being complete, there are still several workstreams underway at international level that go beyond the reform agenda and are likely to result in further, fundamental change to the capital framework These include the Fundamental Review of the Trading Book (FRTB), a new framework for Interest Rate Risk in the Banking Book (IRRBB), the introduction of non-risk sensitive restrictions on the Internal Ratings Based (IRB) approach as well as capital floor proposals and revised standardised approaches for the main risk categories. We note that each of these appears likely to increase capital further and to reduce the level of risk sensitivity of the overall framework.

Policy makers must now gauge to what extent these additional changes are warranted, bearing in mind the significant progress that has already been made to secure financial stability, and consider whether these forthcoming measures will have dampening effects on real economy financing and, as a consequence, on growth. While it is of course necessary to take stock of the effects of financial reform already implemented within the EU, it is particularly important at this point in time for the EU to take a stance on whether the BCBS proposals listed above should be pursued[8].

This being said, if the EU concludes that certain of the pending BCBS reforms should not be pursued, it should take that conclusion back to the relevant global forum and actively seek to preserve a global level playing field to the greatest extent possible, with respect to both the rules themselves and the timing of their implementation. Material divergences from global standards create regulatory arbitrage opportunities and can potentially result in the misallocation of capital, to the detriment of long-term

[5] Minimum requirement for own funds and eligible liabilities
[6] Call for Evidence: EU regulatory framework for financial services
[7] See BCBS 2015/6 work programme and in particular the section on interaction, coherence and overall calibration
[8] Section VIII of our response provides more information on industry's views of the major proposals currently under discussion by the BCBS, as well as descriptions of the possible impacts of these proposals.

economic growth. Further, they invite other jurisdictions to also vary the global standards to which they have committed and thus can weaken the global institutions tasked with ensuring global financial stability.

The EU must be more involved in shaping the international regulatory agenda in order to achieve a global framework that caters to its own policy needs.

In this context, it is essential for the EU to have a strong, united voice within international discussions to be able to shape their development, or to make a case for removal from the regulatory agenda as appropriate. To be effective, these views must also be expressed during the early stages of standard development.

In this context, the Associations strongly support efforts of the Commission to achieve coordination amongst the various European participants of the Basel Committee. Indeed, any future EU proposals for financial services legislation must be fit for purpose within the European environment, while being consistent with international measures. Take for example the BCBS G-SIB scoring methodology, which was duly implemented in Europe in line with the global agreement. We believe however that EU representatives should have done more to promote the legitimacy and benefits of the Single Market by insisting that intra-EU exposures be scoped out of the cross border exposure measure.

Completing technical implementation

Moreover, before any additional major, level 1-type measures such as those being discussed by the BCBS are introduced into EU legislation, we think it is necessary to first complete the technical and detailed specification of the elements of reform that have already been adopted. We attach particular importance to the development of level 2 measures. This is because a single set of rules for the European financial sector is very much necessary for industry to reap the benefits of the Single Market, together with increased transparency and comparability across firms and sectors for investors. It is also needed for the positive impacts of regulatory reform to be fully felt to the benefit of society as a whole and for any unintended consequences to come to light.

Level 2 and 3 can also drive changes to the pricing and availability of banking services and must be considered carefully

While reiterating our support for the EBA and its mission to ensure consistent prudential regulation and supervision across the EU, we do wish to point out that we have encountered certain issues with the Lamfalussy process. Overall, the level 2 instruments (RTSs, ITSs) and level 3 instruments (Guidelines, Q&A, etc.) at the EBA's disposal have worked well in developing and promoting the Single Rulebook. Nevertheless, experience of the process has now shown that there are areas where level 3 instruments are being used to deal with issues that are clearly matters of policy (and not implementation or technical application of the CRR) and/or that may have significant impacts such that they imply substantive policy change. As a result, these would require a thorough cost/benefit assessment. In practice, level 3 instruments are extremely impactful because, unless firms receive an indication otherwise from their competent authorities, these instruments have to be complied with, and often with immediate effect. They are therefore far from being "soft" instruments. Examples include the EBA's Shadow Banking Guidelines, where the EBA is effectively taking a stance on an issue that should be dealt with by the co-legislators, and recent Q&A guidance on the application of Potential Future Exposure (PFE) add-ons for written options under the Mark-to-Market Method[9] that is inconsistent with the level 1 text and represents a significant change in policy.

European supervisory harmonisation must be a priority

Beyond this, we think it is important to stress that the Single Rulebook will only be truly effective in reaching its goals if it is implemented by supervisors that share common practices when applying these same rules. While we appreciate that efforts are ongoing to achieve this through the EBA and as a consequence of the creation of the SSM within the Eurozone[10], in practice diverging supervisory approaches within the EU remain and more must be done at the political level to drive supervisory harmonisation.

In this vein, we would also encourage the Commission to look not only at the impact of Pillar 1 requirements on banks' financing of the economy, but also at how Pillar 2 capital requirements are applied by national supervisors, and their interactions with a myriad of capital buffers. Pillar 2 requirements play a central role in determining the level and composition of capital targeted by firms, as well as the point at which heightened supervisory attention is applied. Given that application of Pillar 2 both at a national and firm-specific level is not particularly transparent, we are unable to gauge whether or not supervisors are applying capital add-ons in a risk-sensitive and uniform manner. In particular, given the important introduction of the new supervisor for major Eurozone banks, we believe that the SSM should publish its approach to Pillar 2 to provide greater transparency and to allow market participants to assess the potential level and nature of add-ons.

While we agree with the necessity of Pillar 2 risk assessments, we are concerned that the capital requirements may not be applied proportionately and uniformly across jurisdictions. While we believe that both the EBA's supervisory convergence work (including its SREP guidelines), as well as the continued evolution of the SSM will help to minimise divergences in Pillar 2 supervisory practices, a greater commitment to the spirit of harmonisation on the part of national supervisors is required. This must also be accompanied by a shift in the EBA's focus away from rule-making and towards the supervisory consistency aspect of its mandate. Indeed, the EBA's role in driving consistency in the application of the EU banking regulatory framework, and removing unwarranted national discretions and options, is paramount. The treatment of intra-group exposures, which are currently only exempt from the large exposure framework at the discretion of supervisory authorities, is a good example of an area of where the EBA should support a consistent approach in favour of exercise of the discretion so that entities operating in the EU can truly benefit from the advantages of the Single Market.

[9] Ref EBA Q&A 2013_666

[10] Together with the creation of the SRM and SRB, where the SRB will have "supervisory-like" powers, e.g. to set MREL, direct the removal of barriers to resolution, etc.

Defining the appropriate prudential framework

In summary, the prudential and supervisory framework for banks in the EU has made great strides thanks to the regulatory reform programme. It consists however of layers of multiple requirements, all of which influence the ability of banks to support the real economy. Many additional measures are on the horizon, but it is not clear whether they are necessary. Some of these measures could actually constrain the ability of the EU and markets to deliver the Capital Markets Union. In our view, the Commission now has a once-in-a-generation opportunity to reflect on the best approach to prudential regulation within the context of its objectives to support growth and develop European capital markets. Ideally, this should also be accompanied by the definition of a yardstick against which the success and impacts of the new prudential regulatory framework can be measured. In other words, the Commission needs to reflect on whether the current prudential framework has achieved the right balance between enabling appropriate capital allocation to the real economy and financial stability.

Section III. A risk sensitive capital framework is required to support appropriate capital allocation

In order to ensure a regulatory system that enables banks to measure risk accurately and that results in capital allocation t benefiting the economy at large, AFME and ISDA consider that risk sensitivity must remain a decisive feature of the capital framework. The role of risk management techniques, including expert judgement, also needs to be better recognised to avoid a lack of diversification within the banking sector. International proposals currently under development, in addition to leverage ratio requirements, could significantly hamper this and negatively influence the price and availability of banking services.

Without risk sensitivity, the capital framework will not represent a firm's true risk levels and may incentivise misguided origination. The less risk sensitive the framework is, the more opportunities for regulatory arbitrage are created, incentivising firms to seek higher risk assets as a means of boosting expected returns. A lack of risk sensitivity is also likely lead to the inappropriate pricing of risk, creating a misallocation of capital across the economy, less lending in low-risk asset classes, less diversification across firms' portfolios and a potentially an increase in risk to the financial system as a whole.

Risk sensitivity: a virtuous circle supporting economic growth

A risk sensitive and appropriately calibrated framework however creates the right incentives for firms to increasingly invest in improved data collection, together with a better understanding of risk drivers and the construction of models with superior predictive power. Models are in turn increasingly embedded in the business and used extensively to improve lending policies and risk-adjusted pricing. Indeed, through use test requirements, firms are required to demonstrate that models are integrated into their internal decision making, management and governance processes. A virtuous circle is thus created when regulatory capital requirements are based on risk sensitive measures.

Reducing variability and increasing comparability of risk sensitive capital outcomes

It is for the above reasons that Basel II was introduced in Europe through the CRD to encourage banks to move from simple, standardised, relatively risk insensitive approaches for determining regulatory capital to internal models based approaches that better aligned capital with underlying risks.

Since then, internal models have come under criticism for being unduly optimistic and not being able to prevent the crisis. Given that the bulk of failings contributing to the crisis were identified in the areas of market, liquidity and funding risk rather than capital modelling and have since been remedied through the introduction of Basel 3 via the CRDIV, such criticisms in our view are largely unjustified. Moreover, models are not synonymous to free choice for banks - they are subject to extremely rigorous validation processes and on-going scrutiny by supervisors. Lastly, While RWA levels may indeed have fallen over past years, rather than being a result of banks "gaming the system", the reduction can be attributed to a combination of deleveraging, improvements in portfolio quality and the accumulation of high quality liquid assets[11].

More recently, concerns have centred on the wide range of modelled outcomes, leading to various studies on RWA variance. For example, in 2013 the BCBS undertook a review of banks' risk weighted assets for credit risk in the banking book[12]. It found that "much of the variation (up to three quarters) is explained by the underlying differences in the risk composition of banks' assets, reflecting differences in risk preferences as intended under the risk-based capital framework. The remaining variation is driven by diversity in both bank and supervisory practices." Another BCBS exercise[13] looking at market risk showed that "a sizeable portion of variation is due to supervisory decisions [...]." The EBA's 2014 benchmarking exercise of low default portfolios[14] shows similar results to the BCBS credit risk study – 75% of the variance in RWAs can be explained by differences in banks' portfolios. In short, these studies prove so far that most of the variance is a function of differences in asset composition, rather than in differences in how identical assets are modelled.

Given their different businesses and risk management practices, some variation in risk weighted assets between banks is appropriate and to be expected, as it reflects differences in their risk levels and will be reflected in banks' pricing. This being said, the remaining variation needs be addressed, to the extent possible, to improve the consistency of the framework. This depends on its uniform implementation, both by legislators and supervisors in their requirements they may make of firms, and by banks in their modelling choices. However, all else being equal, removing risk sensitivity from the framework will not in itself tackle model variance across banks.

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[11] i.e. in anticipation of the Liquidity Coverage Ratio; see IIF RWA Task Force, Risk Sensitivity: The Important Role of Internal Models, September 2014 for a more detailed description of the reasons behind changes in RWA levels.

[12] BCBS, Analysis of risk-weighted assets for credit risk in the banking book, July 2013. The EBA has also undertaken extensive analysis of risk weighted asset variability for European banks.

[13] BCBS, Regulatory consistency assessment programme (RCAP) - Analysis of risk-weighted assets for market risk, January 2013

[14] EBA Results from the 2014 low default portfolio (LDP) exercise, July 2015

Through collaboration between supervisors and industry, significant progress is being made in this area. For example, the European Banking Authority is making great strides to achieve a Single Rule Book and a Single Supervisory Handbook in the EU[15]. The EBA has also recently published a Discussion Paper setting out a programme of initiatives designed to improve the comparability of IRB outcomes[16]. The areas where banks' risk modelling practices diverge have been identified and industry has made extensive recommendations to adopt common approaches, effectively harmonising modelling choices[17].

Additionally, industry continues to engage with supervisors on multifaceted, technical modelling issues. These discussions show that the recognition of a particular business's characteristics, risk management processes and recovery strategies, is entirely compatible with the implementation of comparable methodological frameworks between banks[18]. Benchmarking exercises[19] have become an integral supervisory tool and can be used to demonstrate how the variance in risk weights has evolved as a result of these ongoing efforts. In the same vein, Pillar 3 disclosures have recently been reviewed and, in an effort to further improve transparency and enhance market discipline, industry is in the process of developing indicators to provide a simple, standard disclosure of model performance.

Lastly, it is also important to note that the purpose of the leverage ratio is to serve as a binding backstop to risk based capital requirements. The leverage ratio precisely aims to facilitate cross-firm comparability and ensure that levels of capital in the system remain above a certain threshold. Moreover, Pillar 2 requirements address the potential of risks not being fully reflected under Pillar 1 calculations and this is further strengthened by the stress testing requirements implemented in many jurisdictions, including in the EU. As a consequence, any further measures that would be taken would result in a less risk sensitive framework and be unnecessarily duplicative.

A conceptual shift in the capital framework

In spite of the clear benefits of a risk sensitive capital framework and the progress made in achieving its consistent implementation and appropriate disclosure, we are currently witnessing a wave of regulatory initiatives at BCBS level that reflects a very different conceptual approach towards capital requirements.

These include the development of new advanced frameworks for securitisations, trading book exposures and credit valuation adjustments which limit modelling freedom and are insufficiently risk sensitive. Additionally, BCBS work underway to supposedly make existing standardised approaches for credit, market and operation risk more risk sensitive is in fact moving in the opposite direction[20].

Beyond this general direction of travel towards less risk sensitive approaches, there are further BCBS proposals in the pipelines that will explicitly limit the role of internal models.

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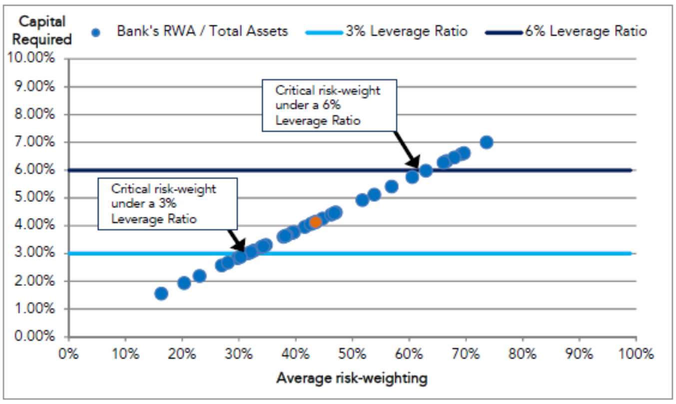
[15] See for instance the EBA's Guidelines on the Supervisory Review and Evaluation Process and its development of a common methodology for the approval and assessment of IRB models
[16] EBA's Discussion Paper on the Future of the IRB Approach
[17] See AFME's Downturn LGD Discussion Paper as an example
[18] IIF RWA Task Force final report, including approximately 100 recommendations for harmonisation of modelling approaches
[19] See the EBA's benchmarking package.
[20] See Section VIII for more information on the removal of risk sensitivity from these risk frameworks

For instance, the proposed introduction of a capital floor based on the new standardised approaches, whether calculated at an aggregate or risk-category level, will significantly reduce and distort the incentive for banks to develop and maintain sophisticated risk measurement and management models. This trade-off should not be taken lightly. While banks always manage themselves on a variety of bases, including strategic objectives, internal limits and investor demands, undue regulatory constraints such as capital floors have the potential to overtake these other important considerations.

Moreover, the introduction of further, granular exposure or parameter level modelling constraints[21] across the various risk frameworks and above those that currently exist, is likely to lead to the misrepresentation of risk and inappropriate capital allocation decisions within a bank, without actually avoiding modelling risk. The result will be a mispricing of risk and the misallocation of economic resources to the economy. Moreover, models will be less useful for internal risk management purposes and the virtuous circle described above becomes less effective.

It is also important to bear in the mind that the introduction of TLAC also amplifies the effects of the backstop leverage ratio. Moreover, the implementation of TLAC and MREL will reinforce the trend towards longer term funding created via the requirements of the NSFR and reduce banks' maturity transformation capacity. This is simply one example of many areas where regulatory layering is amplifying the impacts of the regulatory reform programme that could result in a limitation of banks' economic role.

Risk sensitivity must be retained to ensure appropriate allocation of capital to the economy



The Binding Constraint for Outliers or All? – Leverage Ratio at various calibrations vs the risk weighted framework Source: IIF analysis of 39 banks (the 30 G-SIBs plus the D-SIBs of Australia and Canada)[22]

It is when considered in combination that the fundamental change to the underlying philosophy of the capital framework being developed by the BCBS is clearly visible. A non-risk sensitive leverage ratio[23] together with revisions which dilute the risk sensitivity of capital framework may very well call into doubt the extent of investment the industry will be able to make in improving risk measurement. The

[21] For example LGD floors for so-called low default portfolios

[22] Risk and Capital: the Essential Nexus, IIF September 2015

[23] Currently calibrated at 3%, however, this is under review at BCBS level and may result in a higher calibration outcome, rendering it the binding ratio for many more banks.

cost will be a less accurate appreciation of risk and non-risk sensitive, regulatory driven capital allocation and pricing. Risks will also be pushed into the unregulated sector and the end result will be a more risky financial system overall. In general, the misallocation of capital to the economy hinders rather than promotes growth and it is therefore essential for the European Commission to consider these issues as a matter of urgency.

Section IV. The impacts of regulatory uncertainty on strategic capital management

The multiplicity of prudential measures that banks have to deal with, including capital, liquidity, leverage and bail-in requirements, both existing and forthcoming, makes it increasingly difficult for banks to manage their capital allocation and price products appropriately. Moreover, these requirements sometimes pull in different directions and when the requirements are considered at the level of individual business lines these capital management difficulties are further exacerbated because they can lead to potentially conflicting objectives within a firm. A recent paper by the EBA considering the potential implications of regulatory measures on banks' business models[24] highlights the challenges banks have in managing a historically high number of regulatory measures, which can have contradictory impacts in terms of managing capital. The paper also notes that these challenges do impact decisions on business models, and hence the availability of certain products and services provided by banks.

To the extent which banks are able to identify the binding capital constraints on different areas of their business, this will be reflected in capital allocation within the firm. All else equal, higher capital allocations against an unaltered stock of assets will result in upward pressure on the price of banking services to end-users, as banks seek to achieve target rates of return. Where capital allocations are driven by risk-insensitive requirements (i.e. lines of business where leverage requirements or risk floors are the binding constraint), the price faced by end-users will be higher than would be the case where capital allocation reflects a truly risk-based model.

Moreover, given the numerous components banks have to manage, they may try to provide certainty to investors over the level and composition of capital by seeking to maintain headroom over buffers. This makes buffers and time-varying capital requirements less functional. Time variant buffers generally make capital planning and pricing decisions more difficult andthe regulatory uncertainty firms face with respect to forthcoming proposals of the BCBS exacerbates the situation further. In this environment, policy makers must appreciate how difficult it is for firms to be able to take the business decisions necessary to ensure that they can support the real economy.

Another important source of regulatory uncertainty for banks relates to third country equivalence where a more predictable and timely process, providing a coherent approach to equivalence determination across the different pieces of EU financial services legislation would very much facilitate

[24] EBA Report, "Overview of the potential implications of regulatory measures for banks' business models", 9 February 2015

the operational environment[25]. This process would also need to take into account the different regulatory environments, approaches and regulatory topics in non-EU jurisdictions, eschewing an overly granular approach and providing for flexibility on the basis of agreed principles.

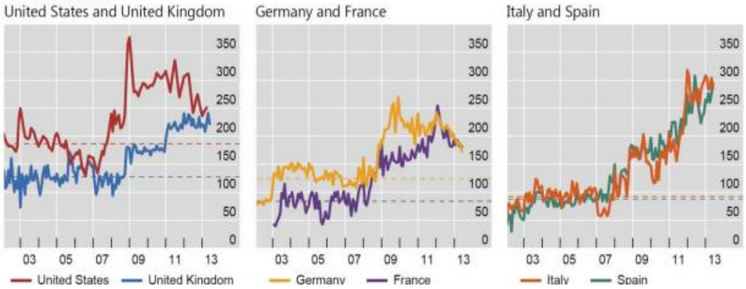
Why Modigliani-Miller does not hold

The annex to the consultation paper points to a counterargument to the notion of higher capital requirements having an adverse impact on banks' pricing (and thus impacting end-users). The paper cites the Modigliani-Miller (MM) theory that banks' cost of debt funding will decline as creditors demand lower compensation for taking on exposure to banks which are demonstrably less levered; overall, banks' all-in cost of funding, and hence their pricing of new assets, will not alter.

In reality however, this mechanism is precluded by many factors. For instance, MM theory only holds if aggregate demand and supply are unchanged, which we do not believe to be the case. Another such factor reflects industry best-practice regarding how business units are charged for funding by treasury functions. Specifically, Funds Transfer Pricing models[26] require new lending to be priced with reference to a *blended* cost of funding, which reflects a bank's entire liability structure and hence, *inter alia,* how a (growing) proportion of banks' funding is drawn from retail deposits.

These retail deposits are insensitive to changes in the riskiness of a bank, owing to the protection afforded to them by deposit insurance. Consequently, banks' overall cost of funding is less sensitive to changes in leverage, resulting in increased capital requirements driving pricing on new lending upwards. This can be seen for instance in the annex to the consultation document where Chart 4.13 (below), based on BIS data, shows the rising spread between lending to non-financial corporates and overnight rates over the period 2008-2013[27], despite this coinciding with the significant increase in the quantum and quality of capital held by banks already described.

Chart 4.13: Spreads between rates on loans to non-financial corporates and the overnight interbank rate



[25] The pragmatic, flexible outcomes-based approach taken recently in APAC CCP rules assessment would be a good example of EU best practice and contrasts with other assessments which have exacerbated investor and legal uncertainty. Remaining CCP equivalence decisions should follow this type of process to the extent possible.

[26] Funds Transfer Pricing (FTP) models are part of the process of setting retail and commercial interest rates and is a mechanism designed to account for the cost of funds faced by banks as well as the associated liquidity, interest rate and currency risks associated with lending and taking deposits. FTP is an internal process typically carried out by the bank's treasury function, acting as a central risk management hub for all business lines (such as the retail and commercial banking arms).

[27] Chart 4.13 in the annex of the consultation document (source BIS (2013)).

Moreover, a study by the ECB of 54 large international banks has shown that while there is some "MM effect" (i.e. increase in capital associated with a lower required return on equity), this effect is indeed only partial: the ECB's estimates are only 41% to 78% of what would otherwise be predicted under a full MM effect[28].

Section V. The role of banks beyond direct lending

The current consultation and its accompanying annex focus on the impact of the CRR's capital rules on banks' direct financing activities of households and non financial corporations. The annex notes that "At the end of 2014, loans made by euro area MFIs to [euro area] households and non-financial corporations made up only 30.4% of their aggregate balance sheet. The relationship between changes in the size of banks' balance sheets and the provision of loans to the economy is therefore not evident. Balance sheet reductions can be achieved without reducing real economy lending, for example through reductions in intra-financial system exposures and by cutting lengthy intermediation chains".

Direct support of the real economy

It is however essential to understand that the remaining part of banks' balance sheets also serves the real economy. In addition to granting other "real economy loans" (e.g. mortgage lending, etc.), banks provide crucial risk management and hedging services directly to corporates. Banks also help the real economy to access financial markets, matching issuers with investors and providing underwriting services so that governments and non-financial companies can access finance in other ways than through bank loans (i.e. through capital markets).

Indirect support though the provision of essential services...

Beyond these direct means, banks also serve the real economy indirectly[29]. For instance, banks with wholesale activities help other financial institutions, such as banks with a focus on retail and corporate lending, to manage their risks and access funding and liquidity sources.

... of which market liquidity is essential

They also make markets, buying and selling various financial instruments to provide market liquidity. This type of activity is not high risk and is necessary as it enables trading in and pricing of financial

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[28] ECB Financial Stability Review December 2011, "Common Equity Capital, Banks' Riskiness and Required Return on Equity"

[29] The Bank of England's Q1 2015 Quarterly Bulletin provides a good overview of the services that non-retail banks provide directly and indirectly to the real economy.

instruments and their associated risks. For instance, market liquidity is crucial to real economy participants such as institutional investors who manage individuals' savings and pensions, or for those who provide insurance products. Importantly, market liquidity is also crucial from a financial stability point of view. It is necessary for banks' ability to withstand shocks to have well functioning and liquid markets so that they can sell assets or raise capital (at appropriate prices) during a crisis. Moreover, market liquidity is also crucial to the success of the Commission's CMU project.

The role of derivatives in facilitating the flow of funds

Bank loans, as with the issuance of debt, carry interest rate and foreign exchange (if the funds are in a different currency) risks, and banks will be reluctant to direct funds to businesses unless they can be certain those risks can be contained. Moreover, in order to attract funds, companies will likely have to ensure that they maintain balance sheet stability by managing their financing and commercial risks, such as earnings uncertainty on foreign revenues.

This is why derivatives play a crucial role in the facilitation of the flow of funds. Derivatives are risk management tools that reduce uncertainty, allow market participants to effectively recycle risk. Derivatives enable corporates, irrespective of the funding source – banks or capital markets – to efficiently manage risk in their financing activities by allowing companies to tap new investor bases or access cheaper funding, and also allow infrastructure companies to eliminate the mismatch between inflation-linked revenues and fixed rate obligations on borrowings. Derivatives are also central to businesses that need to hedge risks associated with their day-to-day operations, such as eliminating exchange risk on foreign currency earnings, and thus ensuring stability in financial performance paving the way for greater access to funding.

Derivatives are vital to fostering economic growth. They allow banks to manage loan portfolios more efficiently, as well as play an important role in the facilitation of opening up other channels of financing via capital markets while acting as market intermediaries and managing securities inventories more efficiently.

All these functions are essential to creating the CMU

When reflecting on the right prudential framework for the EU, in addition to considering impacts on direct bank financing of the economy, it is therefore essential to consider the consequences of the CRR on banking activities in their entirety, including on the market functions described above. This must also be thought of in the context of other regulations governing derivatives. For example, the Commission's EMIR review is an opportunity to propose solutions to those areas of the framework that have worked counter to safer derivatives markets and financial stability[30]. In conclusion, if the CRR requires firms to reassess the cost of supporting the functioning of and access to capital markets, particularly as a consequence of the prudential framework becoming increasingly risk insensitive, Europe may encounter impediments to creating the CMU.

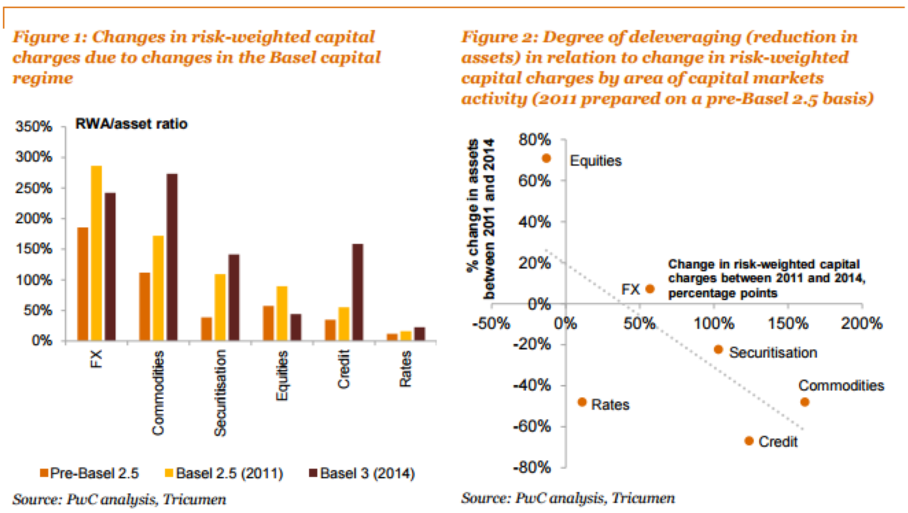
[30] For example, removing the frontloading requirement and giving ESMA the ability to suspend or terminate the clearing obligation as a matter of urgency.

Section VI. Impacts on lending and banks' market functions

Regulation has impacted capital market activities

Many banks have already exited or reduced market making activities affected by significant increases in capital and liquidity requirements. European banks in particular are reported to have withdrawn from these markets due to regulatory pressure[31]. Beyond just European banks, the 10 most important global players providing such services have seen their "investment banking" revenues as a percentage of their total earnings decrease significantly compared to pre-crisis levels, indicating that this retrenchment is a general phenomenon. According to an August 2015 PwC study[32], collectively, this means that banks are more selective in offering their balance sheet capacity, there are fewer banking participants in capital markets activities and end-users ultimately face a less diversified capital markets offering.

PwC's analysis[33] of the evolution of global banks' balance sheets suggests that business lines that are either low-risk, but impacted by the non-risk-based leverage capital ratio (such as sovereign and investment-grade bonds), or business lines that have experienced a relative increase in capital intensity, are the ones more likely to experience higher levels of deleveraging (see figure below).



Source: PwC Global Financial Markets Liquidity Study, August 2015

[31] Financial Times, 'Landscape shifts as titans retreat', 26 August 2015 - for the 6 banks for which comparable pre and post crisis data is available (Q2 2007 vs Q2 2015), investment banking revenues have declined by more than 17%.
[32] PWC, Global Financial Markets Liquidity Study, August 2015
[33] idem

Regulation has affected market liquidity, and this could be exacerbated as monetary policy tightens and if further structural reform is introduced

Regulatory reform is also likely to contribute, along with other factors, to a reduction in liquidity in the markets that are most affected by capital, leverage and liquidity requirements, such as commodities, securitisation and credit.

Indeed, PwC has found evidence of specific areas where market liquidity has declined and highlights that more significant declines may be masked by the current low interest rate environment and other factors such as strong asset valuations. Indeed, there is a very real risk that market liquidity could decline further as central banks withdraw from expansionary monetary policies.

The study finds in particular that:

- The ease of executing some trades has already decreased
- There are signs of declining depth in capital markets, characterised by falling transaction sizes.
- Some price impact measures also show that smaller trading volumes are moving market pricing by larger amounts.
- Ratios of trading to the size of markets for both corporate and sovereign bonds are on the decline.

Central bankers around the world are increasingly looking at the impact of regulation on market liquidity[34]. Importantly, this also includes the effects on the liquidity of secondary markets which are central to encouraging issuance activity by enabling investors to sell their investments quickly and at low costs when needed[35].

With the development of the Capital Markets Union in the EU currently being one of the key priorities for EU policymakers, AFME and ISDA consider it is essential that the Commission acts to preserve and enhance market liquidity. Investors require efficient and liquid markets – reduced market liquidity hampers their ability to change investment strategy according to their view of risks and makes it is less likely that they will decide to invest in the first place, making it more difficult to mobilise available capital. AFME's response to the European Commission's Green Paper on the CMU provides more detail on the need to carefully calibrate or review markets (e.g. MiFiD) and prudential regulation (e.g. liquidity requirements (NSFR), forthcoming proposals for trading capital requirements (FRTB))[36].

[34] For instance, BoE Governor Carney has observed that 'the combination of higher capital held against trading books, the new leverage ratio, and the proposed Volcker [and other] restrictions on proprietary trading have already combined to reduce dealer inventories across a range of securities. With dealers less willing to deploy capital against large market moves, volatility has increased and liquidity fallen in the face of shocks such as the potential shift in US monetary policy...' October 2013 - speech by Mark Carney, Governor of the Bank of England. The agenda of the BoE's upcoming Open Forum 2015 is also an indication of the growing importance that central bankers are attaching to trying to understand the impacts of regulation on market resilience and liquidity, particularly in the context of extraordinary monetary policies.

[35] This has been explicitly recognised by the European Commission in their Green Paper on Long Term Financing of the Economy. For information on the role of secondary markets, see also AFME Briefing note: The Role of Secondary Markets and Market Making in the Long-Term Financing of the European Economy.

[36] See AFME's response to the EC's Green Paper on the CMU, in particular questions 6, 8, 21 and 23 provide suggestions on how to promote efficient and liquid secondary markets.

Examples of reduction in market liquidity – an unintended consequence of regulation

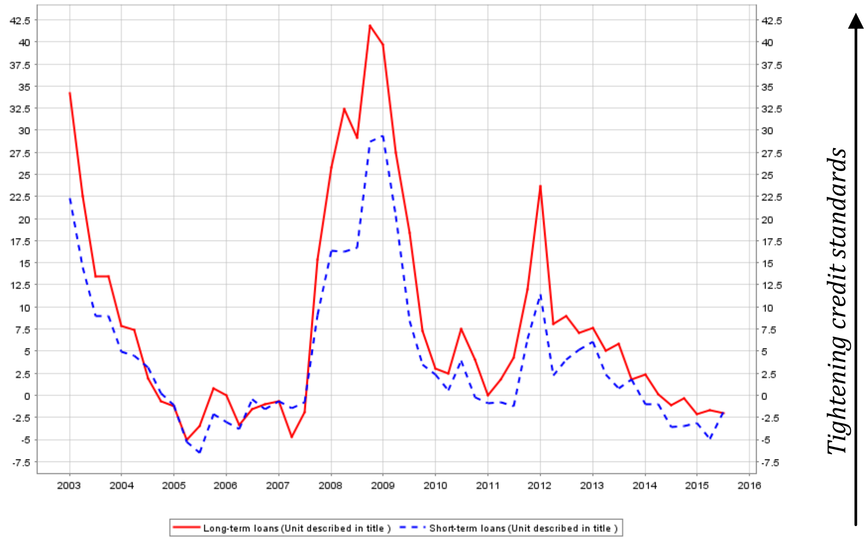
- 45% collapse in capital market liquidity since 2006 (Redburn, October 2014)
- Regulatory reforms have also reduced the role of banks as providers of liquidity at times of stress (IMF Report, October 2014)
- Further liquidity deterioration is expected, as regulation shrinks banks' capacity another 10-15% over the next two years (Morgan Stanley & Oliver Wyman, March 2015)
- SLR, higher buffers on CET1 and NSFR may have a material impact on the repo market and, by extension, trading revenues. It could generate adverse consequences for market liquidity in US Treasuries, agency debt and MBS, which comprise the bulk of US repo collateral (BAML, April 2015)
- Structural changes on the back of prudential regulations are the root cause of the reduced liquidity. (Credit Suisse Fixed Income Research, May 2015)
- These findings support the claim that the market-making capacity of dealers has fallen in recent years, reducing secondary market liquidity [for corporate bonds]. (BoE staff, Capital Markets Division, August 2015)
- Current levels of market liquidity are being sustained by benign cyclical conditions - and some structural developments may be eroding its resilience. (IMF Global Financial Stability Report, October 2015)

Moreover, the Commission's Bank Structural Reform proposals may also interfere with the provision of client-facing activities such as market making and risk transformation services. To the extent that the proposals will result in the separation of certain trading activities from other commercial operations or inhibit client hedging, the adoption of the structural reform proposals could lead to a consequent withdrawal of capital market capacity that is likely to increase concentration and reduce competition as well as the availability of products. Again, this will impact on end-users, creating issues that are particularly acute for smaller corporates trying to diversify funding sources and hedge business risks. Moreover, the restrictions on trading planned are also largely duplicative with the BCBS's proposed FRTB standards.

Regulatory impacts on direct lending – financial reform has a price

Understanding the reasons behind the decrease in direct lending to euro area non-financial corporates (more than €550 billion from end 2008 to end 2014 according to the consultation annex) is of course a complex issue and difficult to disentangle. For instance, to what extent is a decrease in demand (due to unfavourable economic conditions and/or cash rich firms) or a reduction in supply (due to regulatory induced deleveraging and/or other factors such as the deteriorating credit quality of borrowers) responsible for the decline in lending to corporates?

The following chart shows how the supply of direct credit to businesses in the Eurozone has evolved after past years. It is noticeable that only over the past year and a half or so has the balance of responses to the ECB's bank lending survey[37] started to show that credit standards have entered into a phase of net easing; and respondents to the survey do not expect net easing to continue into Q3 2015. Not surprisingly, the situation is also generally worse for the supply of longer term loans than short term loans, as long term investment funding has become much more expensive for banks to provide.



Eurozone Bank Lending Survey; Loan Supply (weighted diffusion index – shows net percentages of banks reporting tightening credit standards)

The ECB Access to Finance Surveys[38] show relatively weak demand for credit amongst non-financial corporates, and that SMEs are more concerned with finding customers than accessing finance. However, when credit demand does return together with economic growth, banks may very well not be a position to support this growth. As alternatives such as market financing or crowd or peer to peer funding will require time to develop to their full potential, capital constraints can very well prevent banks from supporting this key economic sector in the future, even if such effects have not yet been fully felt (we provide more detail on reasons for this below). Hence, consideration of the costs and benefits of the CRDIV/CRR and regulatory reform in general must also be forward looking.

As noted earlier, financial reform has already been effective. Banks have strengthened their balance sheets through a combination of deleveraging and increasing capital. However balance sheet strengthening has a price. Across 24 banks surveyed by PwC[39]., total assets fell by 12% between 2008 and 2013. PwC estimates that market capacity (measured as total assets that can be supported by a given amount of Tier 1 capital) has decreased by 1/5 across all banks in their sample and by 1/3 across investment banks between 2009 and 2013.

[37] Euro area bank lending survey, ECB
[38] Survey on the access to finance of SMEs (SAFE), ECB
[39] PwC 'Impact of bank structural reforms in Europe', November 2014

The table below shows the multitude of actions banks have taken in response to reform, both in terms of restructuring their organisations and product offerings. The extent of these changes clearly indicates that we could very well be facing an over correction, beyond what could be considered as “necessary deleveraging”, with real economy financing, including activities enabling market based financing and services that indirectly support economic agents, being affected.

	Organisational restructuring	**RWA, capital & leverage**	**Proprietary trading**	**Non-core activities**	**Investment in risk management**	**Product / asset exits**	**Jurisdictional / regional exits**	**Change in target clients**	**Cost reduction initiatives**
ABN AMRO	✓	✓			+	✓	✓	+	✓
Banque Populaire	+	✓	✓	✓	✓	✓			✓
Barclays	✓	✓	+	✓	+	✓	✓		✓
BBVA	✓	✓	✓	+	✓	✓	✓		+
BNP Paribas	✓	✓	✓	+	+	✓	✓		✓
Citi	✓	✓	✓	✓	✓	✓	✓	✓	✓
Commerzbank	✓	✓	✓	✓	✓	✓	+		✓
Crédit Agricole	✓	✓	✓	+		✓	✓	✓	✓
Credit Suisse	✓	✓	✓	✓	✓	✓	+	✓	✓
Danske Bank	✓	✓		✓	✓	✓	✓		✓
Deutsche Bank	✓	✓	✓	✓	✓	✓	+	+	✓
HSBC	✓	✓	✓	✓	✓	✓	✓		✓
ING	✓	✓	✓	✓	✓	✓	✓	✓	✓
Intesa Sanpaolo	✓	✓		✓	+	✓	✓		✓
Lloyds	✓	✓	✓	✓	✓	+	✓		✓
Morgan Stanley	+	✓	✓	+	✓	✓	✓	+	✓
Nordea	✓	✓		+	✓	+	✓		✓
Rabobank	✓	+		+	+	✓	✓		✓
RBS	✓	✓	✓	✓	+	✓	✓	✓	✓
Santander	+	✓	+	✓	✓	+	+	✓	✓
Société Générale	✓	✓	+	✓	✓	✓	✓	+	✓
Standard Chartered	✓	✓	+	+	✓	+	+		✓
UBS	✓	✓	✓	✓	✓	✓	+	✓	✓
Unicredit	+	✓	✓	✓	✓	✓	✓	✓	✓

(✓ = Significant change observed; + = Some change observed; [Blank] = No evidence of change found)

Structural, operational and financial changes within banks. Source: Impact of bank structural reforms in Europe, PwC

There is other evidence that increases in regulatory capital can lead to a reduction in credit supply to the real economy over and above the adverse impact on pricing, described above. Recent research by the Bank of England[40] for instance found that capital requirements do affect lending, albeit in different ways across products[41]. Looking at UK banks over the period 1990 to 2011, the authors of this study found that "in the year following an increase, banks tend to cut lending to commercial real estate, to other corporates[42] and household secured lending."

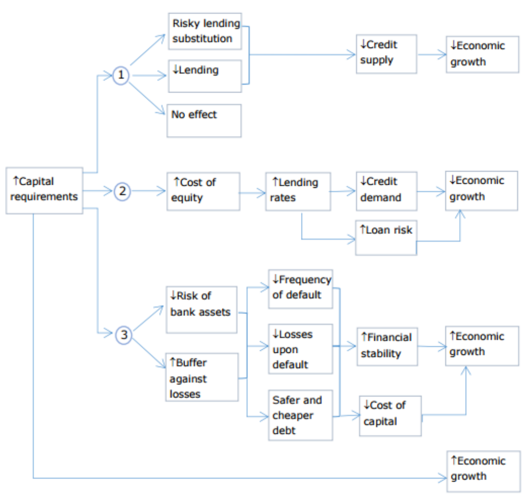
While this particular study shows that lending does recover, it is of course partial, limited to one specific jurisdiction, and does not take CRR requirements or indeed other regulatory developments into account given the data time span.

A more recent paper by De Nederlandsche Bank (DNB) provides a review of the literature on the effect of bank capital requirements on economic growth[43]. While recognising the challenges in disentangling credit supply and credit demand effects, the paper concludes that "most empirical evidence suggests that increase in capital requirements by one percentage point force banks to cut their total lending in the short run by 1.2-4.5% or reduce credit growth by 1.2-4.6 percentage points".

The paper also sets out the transmission paths through which increases in capital may affect economic growth. It notes that, to date, there have not been many attempts to study the interaction of these possible effects and the overall net impact of capital increases. Given that the transmission mechanisms are multiple and indirect (see figure below), it is clear that more work needs to carried out in this area.

The current consultation may therefore contribute to debate but it is also not sufficient. The Commission's recently announced call for evidence on the cumulative impacts of financial reform is thus welcome and its importance must not be underestimated.

Figure 1. Direct and indirect effects of capital requirements on economic growth



Source: DNB Working Paper Effect of bank capital on economic growth: a survey, March 2015

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[40] Bank of England Working Paper No 486, January 2014

[41] The authors also note that this research provides a contribution to the debate as to whether the Modigliani-Miller propositions hold in practice, indicating that the debt/capital structure of banks is not neutral for credit supply. See also Banking reform and macroprudential regulation: implications for banks' capital structure and credit conditions, Speech by Paul Tucker, June 2013

[42] "Other corporates" in this context refers to all non-commercial real estate firms

[43] DNB Working Paper, Natalya Martynova Effect of bank capital on economic growth: a survey, March 2015

The impacts of reform on direct lending may not have been fully felt yet; extreme care should be taken when drawing conclusion on the basis of past data

The decrease in lending to corporates, the structural and comparably small share of market-based financing in Europe and the increasing pressure on market liquidity are all signs that choice for banking customers has been reducing and will continue to do so. Again, this needs to be considered in the context of an extremely begin interest rate environment and additional, major reforms from the BCBS being in the pipeline.

While there may not yet be an apparent impact on customer price, the extensive cost cutting and activity reduction undertaken by banks over the past years means that banks may to some extent have been able to shield their core customers from the impact of regulation. However, this can only be a finite exercise, particularly given persistent low returns of the industry. Lower returns are not an issue *per se*, however banking profitability plays an important role in contributing to financial stability as retained earnings (as opposed to external capital issuance) are the main source of capital increases. The drag of low profitability is also a risk recognised by the ESRB in its latest Annual Report[44].

PwC[45] also notes that "European banks have outperformed their US peers with regards to asset reduction", indicating that deleveraging in Europe has progressed significantly and may be near to reaching a plateau. From this point onwards, the effects on supply are likely to be felt far more acutely, and again this may well be exacerbated by adding in other reforms down the line.

We therefore encourage the Commission to revisit and finesse the conclusions it has drawn in the annex to the consultation paper in relation to the transmission of costs of the reform to the real economy.

Section VII. Suggested targeted changes that should be made to current regulation

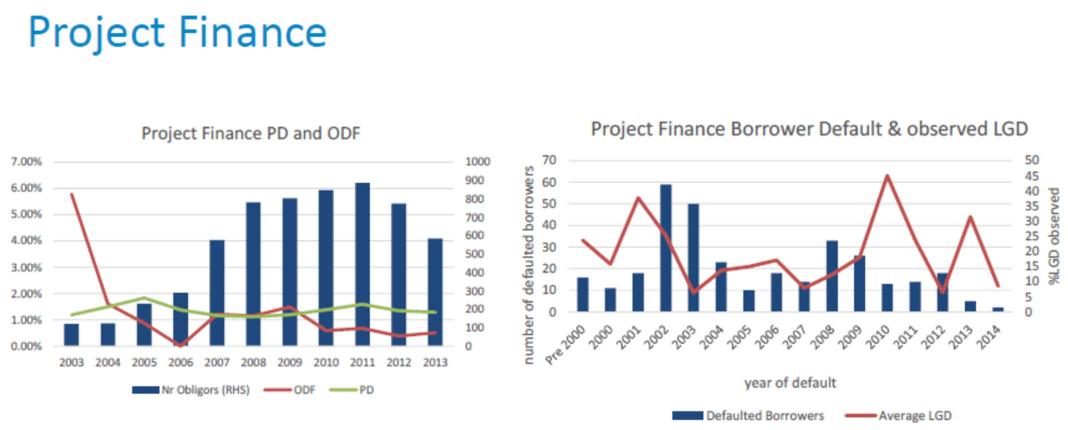
The following section briefly sets out targeted changes that we believe the Commission should consider in relation to the current CRDIV/CRR as a matter of priority as these changes will help in achieve Commission objectives in supporting economic growth.

Specialised Lending Exposures

The capital treatment of specialised lending needs to be revisited. Given their secured nature, many specialised lending products, such as project, object and commodity finance, are low risk in nature, and are precisely the types of financing tools that can be extremely useful in supporting productive investment and infrastructure financing. However, some jurisdictions currently impose the use of a

[44] ESRB 2014 Annual Report, 20 July 2015
[45] PwC BSR study

comparatively risk insensitive slotting approach to determining capital requirements[46]. Through the mechanisms described above, this drives increases in pricing, such that some banks have elected to withdraw from certain markets (e.g. from infrastructure lending). At a time when infrastructure lending within the EU is seen as a core component of delivering sustainable growth in the real economy – as reflected in initiatives such as the Juncker plan – risk insensitive approaches such as slotting preclude banks from being part of the solution alongside official sector efforts.



Source: Global Credit Data

This situation should be corrected so that the capital treatment of specialised lending throughout the EU is consistently implemented and in line with its risk profile.

Importantly, the EU should also pay particular attention to the development of BCBS proposals that will have a significant impact on the regulatory capital treatment of these exposures too. Section VIII below[47] provides more information on how these future BCBS proposals would result in a capital treatment of specialised lending exposures, including infrastructure financing, which would not be in line with their underlying risk profile.

Treatment of Derivatives under the Leverage Ratio Calculation

For the purposes of calculating derivatives exposures in the denominator of the leverage ratio, segregated margin received from clients is not allowed to offset the potential future exposure (PFE) associated with such off-balance sheet exposures – the policy rationale being that such margin can increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself. However, we believe that margin that is segregated may not be leveraged by a bank to fund its operations, and that such segregated margin solely functions as a risk mitigant in reducing exposures with respect to a bank's cleared derivatives exposures. Failure to recognise the exposure-

[46] The slotting approach is less risk sensitive that the IRB Approaches
[47] See section on "*Numerous Basel workstreams leading to a reduction in risk sensitivity of the overall prudential framework*"

reducing effect of such margin acts as a significant disincentive to central clearing, as margin will substantially increase a clearing firm's total leverage exposure, leading to an increase in the amount of capital required to support client clearing activities, which will:

- Lead to more clearing firms exiting the business thus concentrating risk among a smaller set of providers;
- Negatively impact the liquidity of cleared swaps, as higher clearing costs will force participants to limit their use of derivatives;
- Result in a reduction of clearing member capacity to clear for end-users thus forcing some participants to abandon use of derivatives; and
- Increase counterparty risk for clearing members as many will be disincentivised from collecting excess margin.

Therefore, we believe that the final leverage ratio should be amended to recognise the exposure-reducing effect of segregated margin.

Limits to shadow banking exposures

While we appreciate the CRR requires the EBA to consider the introduction of individual or aggregate limits to so-called shadow banking exposures, we are firmly of the view that such limits are unnecessary at this point in time and may even prove to be counterproductive.

Large exposure limits are already an integral part of the CRR. Additionally, a significant number of regulatory measures have already been taken to directly limit the interconnectedness between banks and shadow banks, derivatives reform has also reduced contagion risks in this area, the punitive treatment of SFTs under the leverage ratio has (unduly) constrained banks' ability to fund certain shadow banks and macro-prudential risks related to other (i.e. non-bank) areas of the financial sector have been or are being addressed through other regulatory reforms (e.g. MMFs, AIFMs, etc.).

Moreover, since the CRR was initially legislated, the policy objectives of legislators have evolved and the risks to the EU economy have changed. Political, regulatory and central bank initiatives are now underway to develop a framework of market based finance that can deliver economic growth in Europe. However, the introduction of limits in the CRR could potentially hamper the promotion and development of the CMU and ultimately undermine the provision of funds to the real economy. Again, banks should be able to be part of this solution, recognising that risks are controlled through other aspects of the regulatory framework.

We are particularly concerned with the EBA's proposals for aggregate limits and their suggested fallback approach. Firms have traditionally managed their exposures to other areas of the financial sector through portfolio sub-components, with these exposures not considered as being sufficiently correlated as to require a single portfolio restriction. The EBA's fallback approach however supposes that all shadow banking exposures are correlated, yet its proposed calibration has not been supported by any data collection or impact assessment. Given the all-encompassing definition of shadow banking that is being proposed, along with the extremely high hurdle rate to qualify for the Principal Approach, banks will often have no choice but to adopt this crude fallback approach. This means in practice that firms will have to reduce their exposure levels and as a result the Guidelines could have a significant effect on the provision of credit to the real economy.

In conclusion, it is our view the proposed requirements surrounding aggregate limits are not based on a clear understanding of risks or impact. Moreover their nature of these proposed Guidelines is more akin to level 1 policy making than secondary legislation. We strongly believe that they should not be introduced

Reviving the securitisation market - recent proposals are a welcome start

Under the CRR, securitisation has not been treated on a level playing field with other forms of fixed income or other investments. The differential treatment in regulations affecting capital, liquidity, transparency and disclosure and derivatives, when compared with both covered bonds and direct investment in "whole loan" pools, are well known. These have no logical or intellectual justification, and while it can be argued that the risks of these different forms of investment may not be completely equivalent, the differential as it exists today is wholly disproportionate to any difference in risk inherent to the different instruments.

The seven years or so that have passed since the onset of the financial crisis have provided strong evidence of how well most European securitisations have performed, such that securitisation is now part of the solution, not part of the problem. The Commission has said that "The development of a high-quality securitisation market constitutes a building block of the Capital Markets Union and contributes to the Commission's priority objective to support a return to sustainable growth and job creation" and "Securitisation is a crucial element of well-functioning financial markets. Soundly structured, securitisation can be an important channel for diversifying funding sources and allocating risk more efficiently within the EU financial system."

The Associations therefore very much welcomes the recently published CMU Action plan which includes a legislative package on securitisation comprising a Securitisation Regulation to set common rules for securitisation and a Capital Requirements Regulation (CRR) revision introducing STS into the capital rules as well as to implement the updated Basel framework for exposures to securitisations. There is much to welcome in the Commissions' proposals, in particular the proposed adjustment to the Basel hierarchy enabling banks to use the Standard Approach where the External Ratings Based Approach produces a result "not commensurate to the credit risk", and other improvements to regulatory capital treatment.

The Commission's proposals deliver a strong start to the legislative process, but of course they can only be part of the answer to reviving European securitisation. Prudential treatment of European securitisation should be considered in the context of its strong performance before, through and since the crisis

Section VIII. Overview of the Associations key concerns on BCBS/FSB standards that have not yet been implemented into EU legislation

This section provides a brief overview of various BCBS and FSB workstreams currently underway (or close to finalisation) that could result in an increase in capital requirements and significantly reduce the level of risk sensitivity of the prudential framework. Most of these represent fundamental changes to the existing framework and may also be unnecessarily duplicative with measures in the regulatory reform programme. As a result, they could significantly affect the pricing and availability of bank finance and services and should be taken into account by the Commission.

Net Stable Funding Ratio (NSFR) – issues still open following BCBS October 2014 publication

<u>Derivatives:</u>

The treatment of derivatives under the BCBS NSFR framework, currently being considered for implementation within the EU, needs to be reconsidered. The aggregate increase in funding requirements for banks will result in huge additional funding requirements well above the actual funding required, which will result in billions being levied on end-users, including SMEs thus impacting the wider economy. These additional costs run counter to the aim of facilitation of resilient bank financing. We believe there are three areas that need further consideration:

Recognition of margin received by banks:

- Under the BCBS framework derivatives assets and liabilities are calculated after counterparty netting and deduction of variation margin. However, the rules introduce an asymmetry between posted and received collateral. This creates RSF volatility, ignores the funding value of high quality liquid assets (HQLAs), and can potentially have a negative impact for asset liquidity. We believe that all rehypothecable cash and HQLAs (where such collateral meets regulatory margin standards) should be recognised.

20% RSF for derivatives liabilities:

- The framework requires that a 20% RSF be applied on total payable (post netting) gross of variation margin posted. This requirement does not incentivise managing derivatives volatility and does not appropriately capture funding risk. What is more, the requirement was not included in any NSFR consultative document, and the industry is uncertain as to how the methodology was developed and whether its impact is understood. We believe that the 20% factor should only be applied as a floor.

Initial margin (IM) recognition:

- Under the BCBS framework, IM posted receives an 85% RSF, however, no recognition is afforded to rehypothecable IM received. But rehypothecable IM received can be used to meet IM posting requirements. We believe that rehypothecable IM received should be allowed to offset IM posted before the 85% RSF factor is applied.

Linked transactions (paragraph 45):

- It is important that a well defined, principles based approach is taken to the identification of linked transactions to avoid unnecessary and heavy impacts on market making and risk management activity.
- Several types of transactions, involving for example client financed market risk hedges, short term derivative hedges and client and firm short trade facilitation can result in interdependent assets and liabilities and should therefore qualify in principle for exemption from the NSFR under paragraph 45.

Repos / Reverse repos:

- The asymmetric treatment of repos/reverse repos < 6 months with non-financial counterparties has been improved with the RSF brought back from 50% to 15% (match book on other assets) to 10 % (match book on LCR Level 1 assets). As the scope incldes non-banks (particularly insurers and asset managers which hold securities) this will deter banks from entering into reverse repos with them limiting the banks responsiveness to meet buy orders.
- The remaining asymmetry will be detrimental for the market making of securities. As the long term funding available for banks is scarce and costly, banks will have no other choice than dramatically downsize their very low profit market making activities and to require higher bid/ ask spreads
- Repo / reverse repo asymmetry should be removed for market making activities.

Total Loss Absorbing Capacity (TLAC)

- The FSB's TLAC requirements for G-SIBs will be finalised through the November 2015 G20 GHOS. *Ceteris paribus*, they will require firms to hold an increased quantum of capital, sub-debt and / or senior unsecured debt, which are all long term instruments. The objective of these requirements is to ensure that losses can be absorbed at the point of resolution and that the firm can be recapitalised.
- While industry is supportive of TLAC as being key to ensuring that firms can fail safely, calibration for individual firms, in addition to the form of internal funding arrangements which ensure material subsidiaries have their own TLAC in place, remains unknown. As with other requirements, firms have however been looking to anticipate this calibration, which implies prospective changes in the cost of internal funding established through the funds transfer pricing process (see Section IV above). *De facto*, all assets will now have a capital requirement, plus a further TLAC (and/or MREL) requirement attached, with the latter defined in terms of longer-term liabilities. How the cost of this longer-term funding will be reflected in the price of new products needs to be fully worked through and, as a result, the end-users of banking services may not yet be experiencing the full cost of this regulatory change.

- As pointed out in Section III above, the reinforcing nature of TLAC and NSFR will further changing banks' liability structures and has the potential to create an even greater impact in terms of the costs of longer term borrowing required to finance long term infrastructure projects and investments in the EU
- Rather than being expressed as a multiple of leverage ratio, TLAC (as well as MREL) amounts should be defined as a percentage of the leverage ratio denominator, calibrated to ensure an individual firm has a liability structure to allow for loss absorption and recapitalisation. This would also leave flexibility change the leverage ratio or TLAC requirement independently from each other.

Numerous Basel workstreams are leading to a reduction in risk sensitivity of the overall prudential framework:

- The BCBS is considering introducing modelling constraints under the IRB approach for credit risk. While detailed proposals are not yet available, risk sensitivity will likely be significantly reduced through the introduction of parameter level and/or exposure level floors, with possible changes to the credit risk mitigation framework also under consideration.
- Calibration of the new securitisation framework48 does not reflect global historical loss experience and its various approaches are not appropriately calibrated to encourage firms to move from the simplest to the most advanced approach. Firms in some jurisdictions are also prohibited from using the external rating based approach under this framework, leaving certain banks with little option but to adopt the least risk sensitive approach.
- Modelling freedom under the Internal Models Approach (IMA) approach of the new framework for the trading book, once finalised, is likely to be considerably limited and certain risk factors subject to undue regulatory restrictions.
- Depending on the outcome of BCBS review of the credit valuation adjustment (CVA) framework it may appropriately reflect CVA risk.
- Work is underway to make the simpler risk frameworks more risk sensitive than existing standardised approaches[49]. However, a number of these changes**,** although purported to be risk sensitive, are in fact unlikely to achieve this goal:

- For *credit risk*, the risk sensitivity of the new standardised approach is likely to be less than the existing approach if external credit ratings are replaced by simplistic risk drivers as proposed. Moreover, under the proposals, capital requirements will also materially increase for good quality, low risk portfolios, creating misguided origination incentives. Changes to the credit risk mitigation framework are also likely to render the approach less risk sensitive.
- For *market risk*, although the Sensitivity-Based Standard Approach (SBA) is an improvement over the current standardised approach, no standardised approach will ever be able to adequately approximate the thousands of risk factors that firms typically take into account when measuring such risk. This new approach also fails to recognise the effects of cross asset diversification. Moreover, as they stand, the proposed risk sensitivities are far from being suitably granular and correlations between these have not been sufficiently taken into account.

[48] Basel 269
[49] The Standardised Approach for Counterparty Credit Risk is however a good example of a standardised approach that has effectively become increasingly risk sensitive

- For *operational risk*, the proposed revisions place the emphasis on the size of the institution but without taking into account the quality of its operational risk management. Moreover, the proposal appears to be based on the assumption that fee-based businesses are riskier than others, resulting in disproportionally high requirements for banks with e.g. leasing, consumer credit or asset management activities.

Capital floors

- The BCBS is considering introducing either an overall capital floor or capital floors by risk category (e.g. for credit, market and operational risk) into its framework. The floor(s) would be based on the revised standardised approaches described above. The proposed calculation mechanism and calibration are currently not known.
- However, depending on these decisions, such floors have the potential to completely undermine risk sensitivity in the capital framework, creating adverse incentives that conflict with the promotion of improved and more advanced risk management practices. In particular, if a floor is binding, any incentive to further improve risk management could be distorted and at that stage the added value of supervisory-validated internal models can rightly be questioned. As explained in Section III above, to be able to allocate capital to the economy efficiently, banks must be able to assess and price risk correctly, and thus find an adequate balance between risk and return, whereby the latter is based on a capital cost that is commensurate with this risk.
- It is not clear whether the introduction of capital floors will help achieve stated goals of risk-sensitivity, simplicity and comparability: i)there is the distinct possibility that they could compromise the risk-sensitivity of the capital framework; ii) given that there is no visibility on how the floors would be calculated, they may not be straightforward for investors and other stakeholders to understand.; iii)floors also the potential to actually reduce comparability between firms if capital becomes dissociated from their underlying risk profile.
- Floors would come as another regulatory overlay that would amplify the affects of the leverage ratio.

Future treatment of infrastructure financing in the context of reduced risk sensitivity

The various combinations of the proposals that affect risk sensitivity would have a negative impact on specialised lending exposures and infrastructure financing. Indeed, a capital floor based on the revised standardised approach for credit risk would imply that banks would need to calculate the capital requirement for infrastructure finance based on the borrowers' turnover and leverage. Neither the quality of the income stream (which are typically long-term commitments with governments or local authorities), nor the quality of the contracts (commitments with big corporations) or of the financing conditions would be taken into account. All specialised lending, including infrastructure projects, could be subject to the extremely high floor of 120% RWA. These measures would multiply bank capital linked to these projects and reduce the amount that banks are able to commit to these projects, which would clearly go against current Commission objectives to ensure the availability of infrastructure finance.

Fundamental Review of the Trading Book (FRTB)

- As noted in our response, banks, as well as being important sources of financing to the real economy, are also crucial as market intermediaries when it comes to facilitation of capital markets activity. There are however certain areas in the BCBS's Fundamental Review of the Trading Book which will likely negatively impact their ability to play this role. Although the precise impact on overall capital levels is not clear, industry participants believe the framework as it stands would likely have a disproportionate impact on certain business lines.
- Some the most affected products would be those with the greatest significance for the wider economy and new capital formation, such as bond markets, SME credit, securitisations, Small Cap equities, and commodity and foreign exchange hedges. For instance, high-yield debt has a 120-day liquidity horizon under the FRTB versus the current 10 days, which would result in a material increase in capital. This could potentially affect the ability of SMEs to access the high-yield bond market. A downgrade would increase capital charges further: by an estimated 40% for high-yield debt and 73% for sovereigns.
- Industry participants see higher trading book capital requirements in these markets leading to an increase in underwriting and funding costs, and reduce liquidity in the secondary market. Faced with lower liquidity, investors will be less willing to participate in the worst-affected markets and less willing to invest in less established companies.

Credit Valuation Adjustment (CVA)

- As noted above, derivatives play a crucial role in the facilitation of the flow of funds and are key risk management tools for corporates and sovereigns. While industry welcomes the direction taken in the BCBS review of the CVA risk framework, there are however certain areas which will likely negatively impact their ability to play this role. The key issue is that BCBS has reserved the right to remove the Internal Model Approach (IMA) from the final rules.
- The industry firmly believes that only the proposed internal models approach for CVA can provide the level of risk sensitivity required to reflect the true economics and pricing of CVA risk. Forcing banks to adopt the same standardized model, based on the same regulatory CVA, with the same simplifications could penalize prudent economic hedging in the normal course of business and promote herding behaviour during periods of market stress.
- Moreover, although changes in the market and regulatory landscape will continue reducing the level of counterparty risk in the collateralised market, CVA will remain material for corporates and sovereigns that are not able, or required, to post collateral. A standardised approach will not only fail to reflect the true level of underlying economic risk, but will raise the cost of prudent hedging, which will be passed on to end-users, potentially driving end-users to leave their risks unhedged, or to pursue less-expensive protection providers outside of the regulated banking sector. Clearly neither of these outcomes is desirable as they will both result in an overall increase of systemic risk.

Interest Rate Risk in the Banking Book (IRRBB)

- The industry continues to believe that, given differences in market characteristics and technical approaches to measuring IRRBB, it is inherently difficult to introduce harmonised regulatory treatment in this area. Harmonisation and standardisation could ultimately lead to more volatile earnings, impact on customer pricing and banks' product offering, and in general pose a systemic risk instead of strengthening financial stability.
- As an illustration, consider a 1-year investment horizon of capital as proposed for the purpose of a Pillar 1 charge on IRRBB. However, banks invest capital at a longer horizon in line with a desired level of stability in earnings. This difference in capital investment horizon assumption accounts for the largest proportion of regulatory capital.
- Applying an artificially short duration may create adverse incentives to (i) place long liability positions in the banking book; and (ii) invest capital over a shorter horizon, which results in less stable earnings. In addition, the cost of capital that the banks carry due to the difference in investment horizon may be passed on to customers through increased lending costs, changed product offering that could transfer risks to the customers, or worst, dampened availability of credit in the economy.
- A Pillar 1 approach, with its inherent methodological simplifications, standardisation and constraints on internal parameters/measures, is therefore not appropriate for IRRBB. The industry supports a genuine Pillar 2 approach.

Securitisation (Basel 269)

- The calibration of the IRBA and SA frameworks for securitisation capital requirements are set at very conservative levels (which partly reflect the disastrous performance of US sub-prime mortgages). They must be re-calibrated according to asset class so that capital requirements are brought more into line with broader global historical loss experience (which in many sectors outside US sub-prime and CDOs has been excellent), other forms of finance and the underlying asset pools being securitised
- The calibration of the various approaches within the securitisation framework needs to be adjusted in relation to each other so that IRBA generally produces lower risk weights than other approaches for the same exposures.

Appendix

Cross referencing of individual consultation questions to the sections in the response above

Consultation Topic	Question Number in the Consultation	Section in the Associations' Response
Capitalisation		
	1	Section I, Section II
	2	Section III
	3	Section I, Section IV
	4	Section VI, Section VII
	5	Section IV
	6	Section VI, Section VII
	7	
Lending to SMEs		Section VI
	8	
	9	
Lending to infrastructure		Section VII, Section VIII
	10	
	11	
	12	
Proportionality		
	13	n.a.
Scope for simplification		
	14	Section IV
Single rulebook		
	15	Section II