Consultation response

European Commission consultation document

- Exploratory consultation on the finalisation of Basel III

12 April 2018

The Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA), collectively 'the Associations', welcome the opportunity to comment on the European Commission's Exploratory consultation on the finalisation of Basel III.

About AFME

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

About ISDA

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

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Overview/Executive Summary

General questions:

a) What are your views on the impact of the revisions on financial stability?
b) What are your views on the impact of the revisions on the financing of the economy?

The Associations consider it important that the final Basel III standard is implemented in a way that drives a robust and effective banking sector, whilst supporting growth and the real economy such as SMEs, funding of corporates and infrastructure, and residential real estate property markets. In so doing we urge the European Commission to assess proposals against the Basel Committee's overarching commitment to not significantly increase capital requirements and ensure the EU's impact analysis goes beyond the aggregate analysis undertaken by the Basel Committee. In line with this, the Commission and the EBA should consider further review of the Pillar 2 requirements and application following the indication from regulators that Pillar 1 increases could be offset through the Pillar 2 framework, especially as this does not appear to be the direction of travel currently being adopted in the ongoing CRR2 deliberations. Further, the granular nature of the Basel III reforms will affect many products and economies in different ways and it will be crucial that the Commission and the EBA understands the potential effects on Member States, specific products and the financing of the real economy, given the essential role of banking in the EU economy. In particular, we urge the Commission to be clear on how it sees the adoption of national options and discretions and how these will be incorporated into CRR3.

In answering this consultation, the Associations would like to note the limited one-month timeframe to respond. The comments below reflect our analysis of areas that were not fully addressed in the final Basel III output and new aspects introduced at the final stages by the committee that have not been subject to impact analysis. While not all the concerns raised by industry were addressed in the Basel consultation process which may have an impact on financing the EU economy, we would note that there were positive changes introduced in the outcome. We will continue to assess the final Basel III standards over the coming months and form our positions more fully. We look forward to continuing this process of consultation with the EU and an open and constructive dialogue with the European Commission and European Banking Authority.

International consistency

The Associations consider it important that international standards such as Basel III are applied consistently across jurisdictions, including in the EU, enabling banks to operate on a global level-playing field whilst also reflecting the specific financial and economic circumstances of Europe (e.g. the residential real estate property markets and higher reliance of corporates on bank funding). Furthermore, it is important for globally active banks that international standards are implemented following a consistent timeline across jurisdictions, including transitional arrangements and with a reasonable implementation period for banks once the legislative process is finalised. If the EU timeline for the process of Basel III legislation and implementation (or parts of it) by banks looks likely to slip beyond the internationally agreed timeframe, we urge the commission to lead efforts to ensure a revision of the timeline at a global level to ensure international alignment.

The Basel III package does not fully account for EU specific ongoing initiatives strengthening financial stability

Since Basel II EU banks have taken considerable steps to strengthen their risk management framework through large scale investment in developing internal models. However, the Basel III package agreed on December 7, 2017 marks in many ways a complete rethink of the approach to modelling. The rationale behind this was to reduce excessive variability of risk-weighted assets and rebuild trust in banks' reported risk-weighted capital ratios. Yet the perceived variability of modelling practices in the past does not necessarily consider that many of the deficiencies in the EU system which are being addressed to ensure model outputs are adequate and at the same time recognise the benefit of risk-sensitivity. This includes for instance the EBA's comprehensive IRB repair work, mandatory annual internal model benchmarking, and the TRIM framework introduced by the SSM. Industry is concerned the reduction in the scope for AIRB modelling would reduce risk sensitivity in the capital framework and potentially create unintended consequences for risk management.

In addition, other EU-specific legislative measures are underway to further strengthen the stability of the financial system for instance the recently launched European Council's action plan to tackle NPLs and the establishment of a Capital Markets Union and Banking Union.

Regarding models specifically, these are not just used for RWA calculation purposes but also for accounting (IFRS9 implementation) and stress-testing purposes and are part of an overall Model Risk Management Framework adopted by several banks in the EU. The far-reaching proposals in this area are likely to have adverse knock-on effects that only emerge through time, for instance the emphasis on Through The Cycle modelling could further reduce the scope for AIRB. We therefore urge the Commission to assess the impact of the Dec 7 package in the context of the wider reforms already underway to support the financial stability of the EU economy and growth, and the reforms that have already been introduced or are being considered in CRR2 to deliver a more resilient banking financial system.

The consequences of segmented finalisation: critical interactions between various elements have not yet been fully assessed

We fully appreciate Basel's post-Crisis reform package was finalised, by necessity, on a piecemeal basis over 2010 – 2017 and that Basel itself recommends a phased implementation globally to lessen the burden on banks. The numerous elements of the Basel III package are however not independent from each other as several standards refer to requirements set in other part of the overall framework. Unfortunately, the segmented approach to rulemaking means elements of the Basel III package will be implemented at different stages in different jurisdictions, which may result in unexpected impacts on products and business lines. Although understandable from a practical point of view, this approach has not allowed policy makers and the industry to date to either develop in-depth understanding of the interactions between the various elements of the overall Basel III package nor to holistically assess the impact on financial stability and financing the economy. Three specific topics exemplify this issue.

1. SA-CCR and other prudential rules:

SA-CCR will be used in many areas across the prudential framework and will affect all banks and users of derivatives. The impact will not be restricted to the small institutions for which SA-CCR was designed. Despite this, the full impact of SA-CCR has not been assessed as current estimates do not consider the impact of SA-CCR's interactions with other areas of the prudential framework including the changes to risk weights in CRR3. As currently set out in the CRR2 proposals, SA-CCR will:

- Replace internal models in the Large Exposure framework. This creates an un-level playing field with the US where the equivalent US regime (Single Counterparty Credit Limits or SCCL) currently allows internal models.
- Replace CEM in the leverage ratio and may affect the calibration of the leverage ratio as a non-risk-based backstop measure.
- Be used for the Central Counterparty ("CCP") hypothetical capital calculation and in the calculation of exposures for the CVA risk capital requirements.
- Be part of an output floor for capital requirements

To date, no impact assessment has been performed by standard setters on the aggregate impact of SA-CCR across different areas of the prudential framework – Basel / EBA exercises have been limited in scope and not considered the aggregate impact. EBA's reply to a call for advice notes that "both the impact and the scale of potential implementation issues may have been underestimated."[1] We believe the impact is significant and that this impact would have been alleviated partially or in full if the credit risk-related standards (SA-CCR and SA-CR) as well as the proposed Large Exposures changes relating to SA-CCR were implemented simultaneously in the EU.

Noting the challenges with the EU implementation schedule however, we do not wish to oppose the implementation of SA-CCR, though we believe it is imperative that the interactions in all areas of the prudential framework are reviewed and a full impact study on the calibration and aggregate impact of SA-CCR is performed. In the interim, we suggest that institutions should continue to be able to use internal models (as part of CRR II) for measuring counterparty risk on derivative transactions within the Large Exposures framework, where the impacts are most drastic.

[1]https://www.eba.europa.eu/documents/10180/1648752/Report+on+SA+CCR+and+FRTB+implementation+%28EBA-Op-2016-19%29.pdf

2. SA-CR and other prudential rules

In relation to changes to the Internal Ratings-Based approach (IRB), replacement of EAD modelling with the Standardised CCF's as proposed by Basel is highly penal and does not reflect industry experience. It should also be noted that the SA CCFs are also referred to in the calculation of the leverage ratio for the determination of the leverage exposure for determining off balance sheet items. Increasing SA CCFs will therefore also impact the leverage ratio and the magnitude of this impact should be reviewed by regulators. Given these interconnections across the framework, it will be extremely difficult to correctly design, calibrate and reflect on the impacts of one aspect of the CCF framework without this holistic view of the full set of proposals that relate to CCFs.

3. CVA and FRTB

A further example is revisions to the finalised CVA framework. The BCBS launched its review of the CVA risk framework in 2015, with part of the objective being to ensure consistency with the proposed revisions to the market risk framework under FRTB. Whilst the CVA standards have been revised and finalised, the market risk framework under FRTB has been re-visited by the BCBS, with revisions to the minimum capital requirements for market risk currently under consultation[2]. The CVA framework will therefore need to reflect any consequential misalignment to the FRTB arising from the changes proposed in the consultation.

Implementation is an opportunity to rethink EU prudential approach

Historically the European Union transposed the Basel standards by applying them to all European banks at solo level, regardless of their size and systemic importance. This approach was understandable when each Member State organised its supervision and implementation into national law and practices, but it is challenging and leads to inefficient allocation of capital for banking groups. This has already become apparent in the discussion on the Risk Reduction Package, where changes to the waiver framework are being discussed. The implementation of the final Basel III reforms is an opportunity more broadly to think about how to transpose prudential regulation whilst maintaining high levels of supervisory oversight. For example, a more proportionate approach would be to apply requirements at a consolidated level or greater use of solo level capital and liquidity waivers. The removal of barriers to the free flow of liquidity and capital in the end benefits the wider EU economy, allowing banks to direct funds to where customers and clients need it. This will contribute to the overall objectives of the European Union and should be fully reviewed in the context of implementing CRR3.

1. Standardised approach for credit risk (SA-CR)

Specific questions:

a) What are your views on the revisions? Please provide details.

Overall the revisions are more granular but more conservative. The main concern for banks using IRB approaches is the interaction between banks' internal models and the introduction of an output floor. As such, we consider that the proposals could end up obscuring underlying risk rather than making capital requirements more understandable and comparable. The Commission should therefore pay close attention to unintended consequences and perform a holistic review of how the SA and IRB approaches interact with the output floor.

[2]https://www.bis.org/bcbs/publ/d436.pdf

b) **How would the revisions impact you/your business? Please specify and provide relevant evidence.**

More specifically:

i. **How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).**

ii. **Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.**

The Associations consider there are several areas which should be carefully considered by the European Commission with regard to SA-CR:

Corporate funding: For non-rated corporates, we strongly support the alignment of risk weights with jurisdictions that use SCRA meaning 65% for non-rated Corporates that would be investment grade. If not, important lending to the real economy could be impacted as a result of low coverage of external ratings of many corporates, impacting not only loans but also corporate treasury hedges. For jurisdictions where external ratings are permitted, more than 80% of exposures to investment grade obligors are to unrated counterparties.

SMEs: We recommend that the SME supporting factor, currently included in the CRR (CRR art 501) is retained in the EU implementation, or as adopted in CRR2.

Specialised lending: We strongly support more risk sensitivity and a recalibration of the risk weights especially for high quality projects. In particular, we consider the 80% risk weight for high quality projects too conservative especially considering the very stringent criteria defined by the BCBS to qualify as high quality. For example, for high quality projects which are secured with physical assets by nature, an 80% risk weight into IRB-F assuming a 20% secured LGD (15% secured LGD defined §85 p69 and taking into account a 40% haircut on collateral §87 p69 and §75 p67), would translate into a rating below investment grade. This calibration seems inconsistent. If the output floor is to be applied to specialized lending with these levels of risk weights, these activities would become uneconomical for EU banks and would be very detrimental for the financing of EU infrastructure projects which heavily rely on specialized lending. Indeed, we note supporting EU banks to undertake more infrastructure lending is already under consideration in the current proposal for CRR2 which includes a supporting factor for infrastructure-related exposures.

In addition, we recommend that the definition of the specialised lending asset class is aligned across the Standardised and IRB approaches to improved consistency and comparability across firms.

Real Estate: The Associations support keeping the loan approach and loan splitting, in particular for the treatment on the portion of the loan below 55% of the property value. Furthermore, application of loan-splitting techniques should be kept at the discretion of the institution, not at the national level. It is important that a bank can determine the most appropriate approach for their own exposures. In addition, granularity of risk weights for loan splitting should be increased to that of exposures not subject to loan splitting.

Residential real estate property: We also consider it very important for the Commission to reflect on the wide variances in the residential real estate property even within the EU, for instance in some Member States LTV is not considered in the borrowers' repayment capacity, rather it is the loan to income ratio. It will also be important for the actual valuation of the mortgage value to be adequately reflected in the risk-weighting as it changes over time**.** In respect of §60 of the BCBS agreement on 'finished property' should also be closely reviewed on the impact for EU markets where banks finance a significant proportion of property under construction.

Leasing: A study regarding leasing activities (Capital Requirements for Leasing: A Proposal Adjusting for Low Risk, A report prepared for LeaseEurope by the University of Cologne), has explored the impacts on these activities and has suggested that a leasing factor could be multiplied to the Standardised Approach risk weights to more accurately reflect leasing risk. A leasing factor of 0.6177 ensures capital requirements that are sufficiently conservative and still above the A-IRB Approach capital requirements.

Equity exposures: The Commission should carefully consider the impact of the 400% RW introduced for speculative unlisted equity which does not appear to align with current treatment of private equity in CRR, which was designed to promote financing of the economy. We recommend the CRR treatment of private equity with a specific risk-weight of 190% should be maintained.

Unconditionally Cancellable Commitments – the current 0% CCF should be maintained subject to supervisory oversight/approval. The risk that a bank does not review its commitment and pays out funds unintentionally is in an operational risk which is captured elsewhere. Similarly, the risk that several clients draw on their facilities at the same time is caught via liquidity rules, as well as sector limits. We therefore see no rationale behind the Basel Committee's decision to set a 10% CCF for UCCs.

The Associations consider UCCs essential in the financing of the real economy. UCC arrangements are commonly put in place with corporates and SMEs and are closely and continuously monitored with banks being able to unilaterally cancel or limit additional drawdowns for instance when they identify any sign of deterioration in the creditworthiness of borrower. Some examples of UCCs are as follows:

- Undrawn commitments to finance receivables where customer facility documentation allows the reduction or cancellation of further draw-downs or requires repayment of existing draw-downs;
- Trade and commodity product customer limits that apply to trade and commodity finance instruments such as letters of credits and guarantees advised to customers but that have not yet been utilized. For example, if a letter of credit (L/C) facility is uncommitted, this means the bank has no obligation to issue any L/C the customer asks it to issue. The bank can refuse to issue for any reason and without any obligation to give reasons. Any "limits" stated in the documentation for this type of facility are not amounts up to which the bank has committed to provide the facilities but an indication of the bank's maximum potential appetite for providing that type of facility to that customer. They do not bind the bank in any way.
- Retail credit card commitments where consumer protection laws and regulations that govern the lender's ability to restrict a customer's right to draw on the unused portion of a credit card line require only that the lender provide after-the-fact notice that customer's line has been cancelled or reduced;
- Credit facilities granted to high net worth individuals are typically secured by eligible collateral and can comprise portfolio finance facilities. These can include real estate mortgage loan facilities, life insurance premium financing facilities and standby letter of credit facilities. The terms and conditions of these credit facilities typically allow a firm to unconditionally cancel and withdraw any facility or undrawn portion of a facility at any time. The firm reserves the right to decline any requested drawdown and may at any time and without prior notice terminate facilities at its discretion.

Transaction-related contingent items: As proposed in Basel the CCF for these off-balance sheet items would increase from 20% as it is in the current CRR (medium/low risk items Annex1) to 50%. This covers bonds and guarantees that support trade finance. The Commission should carefully consider whether a 50% CCF is justified by the underlying risks and the impact this could have on the provision of trade-related finance.

Securities Financing Transactions: We believe that disregarding all collateral received and treating exposures as unsecured where haircuts are lower than the floors is disproportionate and out of line with the economic risk and legal position. We also believe there could be unintended consequences from the implementation of the minimum haircut floors for SFTs because the entities within the scope of the rule could be much broader than intended. The intent of the minimum haircut floors framework is to prevent unsustainable financing to unregulated counterparties and to reduce leverage of unregulated counterparties by targeting insufficiently collateralised lending agreements. Given the scope defined in the Basel 3 finalisation package includes counterparty terminology different to that in the EU (see reference to counterparties are considered to be "supervised by a regulator that imposes prudential requirements consistent with international norms" in para 180), and in order to align with the intent of the rule, the framework should be appropriately and carefully scoped so as to be applicable only to transactions where the intent is to provide financing to unregulated counterparties.

c) Where do you expect particular implementation challenges and why? Please specify.

One implementation challenge will be for banks using approved models to calculate capital requirements to build the capability to also generate capital requirements under the SA and disclose it. It will be necessary for banks to be given adequate time to run and then compare the two outputs (SA vs. model) before being required to disclose.

Furthermore, lack of eligible collateral, i.e. receivables and physical collateral (other than real estate) under the SA for leasing, factoring and other lending activities secured by such types of collateral is counterproductive in terms of supporting finance to the real economy & does not appropriately reflect underlying risk. These types of collateral are however recognised under the F-IRB through reductions in supervisory LGD levels. We therefore recommend SA allowing recognition of non-real estate physical collateral, commodities and receivables under the standardised approach as it is under the F-IRB. This can be done though lower RWs under SA for these secured transactions. Given that the effect of LGDs on RWs is linear, these lower RWs could be calibrated in the proportions as s proposed for the IRBF in the Basel 362 consultation document: i.e. a 56% reduction in RW (for 200% collateralisation or 50% LTV, the prescribed LGD goes from 45% to 20%).

A further challenge for small SA banks is that of data collection, for instance getting detailed data on real estate collateral. In this respect we would urge the Commission to consider how some of this data could be pooled as the Basel Committee is now considering for NMRFs in the context of the FRTB and consider developing specific principles applicable to data pooling. An additional data collection challenge is that specific data required for *banks* as counterparties is not consistently available for banks that have not yet adopted Basel 3.

Another issue is how the implementation of the revised standardised approach will require significant changes to data infrastructure. For example, the new transactor vs. revolver logic will require historical payment behaviours to be analysed and appropriate data flows to be established for this data to be passed into the regulatory reporting system.

Finally, we would note the risk weight add-on for currency mismatch and original valuation requirements for mortgage and retail exposure products will require data that is not currently captured or available to be fed into regulatory reporting systems.

2. Internal ratings-based (IRB) approaches for credit risk

Specific questions:

a) What are your views on the revisions? Please provide details.

It is not clear whether the proposed Basel revisions to IRB strike the appropriate balance between reducing unwarranted variability and reducing risk sensitivity. The Associations consider the shift from A-IRB to IRB-F a regressive step in terms of assessing risk, especially given the EBA's work on IRB repair and the SSM's TRIM exercise. The limited ability to recognise the benefits for secured lending due to LGD floors is counterintuitive and will have a negative impact on lending, specifically to emerging markets where secured lending is prevalent.

The Associations have been very supportive of the EBA IRB repair programme which is a thoughtful, bottom-up analysis of the variance in IRB risk weighted assets. The EBA's approach is the best way to deal with unwarranted RWA variability. The EBA roadmap on the future of the IRB approach, focused on three key areas: review of the IRB regulatory framework, supervisory consistency and increased transparency.

Supervisory consistency and increased transparency has partly been addressed through the annual internal model benchmarking requirement. These studies have helped to identify unwarranted divergences which arise from bank's internal business practice including harmonising the definition of default, such as the days past due criterion for default identification, indications of unlikeliness to pay, conditions for the return to non-defaulted status and treatment of defaulted assets.

The first benchmarking exercise indicated that 75% of the deviation in risk weighted assets for low default portfolios (sovereigns, large corporates and institutions) can be explained by the same drivers. These include differences in (i) the share of the defaulted assets, (ii) geography and associated macroeconomic conditions and (iii) portfolio mix. The remaining 25% of variability is mainly due to differences in bank-specific factors, such as risk management practices. We believe that in Europe supervisory have the appropriate tools to deal with outlier banks and manage unwarranted RWA variability.

Overall, therefore, our Members would support an approach more aligned to that set out in the EBA's work on the future of the IRB approach and for quantitative analysis based on the revised models to be undertaken.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. **How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).**

ii. **Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.**

The activities most impacted by the revisions to the IRB approach are as follows:

- For exposures to Large Corporate and Financial Institutions: application of a F-IRB LGDs for institutions previously applying AIRB LGDs (45%/40% LGDs in the future framework compared to internal LGD levels)
- A limited recognition of collateral in F-IRB approach
- An increase of the exposure due to modification of CCFs and their application on UCCs
- The application of a fixed maturity in F-IRB instead of the actual maturity

- The application of input floors on an overall basis and floors on haircuts, especially for secured financing

In detail:

The commission should strongly consider the impact on large corporates and financial institutions. Although Large Corporates have easier access to markets to finance their debt, they still need banking services for the purpose of their day-to-day activity such as:

- Revolving credit facilities, overdraft, (i.e. : undrawn credit lines)
- Back-up liquidity lines for Commercial Papers issued by the corporate
- Performance bonds, Stand-by letters of Credit, and all other banking facilities needed by the commercial activities of corporates
- Cash management facilities (notional and cash pooling)
- Factoring
- Hedging with OTC Derivatives

A large part of financing products provided to large corporates is made of undrawn credit facilities that cannot be replaced by any capital market issuance.

One area of the Basel agreement the Commission should consider in particular is the interaction between the shift from A-IRB to F-IRB for large corporates, especially where subsidiaries are brought into scope which may otherwise have been treated as an individual entity. This assumes that the subsidiaries of large corporate groups benefit from an implicit support of the group which makes them "low default", yet it is not proven and could lead to different capital treatment of entities of the same credit quality based on whether they are affiliated to a wider group. Furthermore, this same principle could impact upon lending to specialised lending structures undertaken by large corporates. Consequently, the Basel package penalizes more the corporates, mid-corporates and SMEs belonging to group vis-à-vis the stand-alone ones, creating a competitive disadvantage for the former. In the case of unrated local legal entities of large groups, this provision would indeed likely increase their cost of financing (most of them are unrated) with unintended consequences for the real economy as these counterparties typically significantly rely on bank lending and have more limited access to capital markets.

As regards the introduction of 40/45% LGD risk parameters, the Commission should also closely consider the impact for banks required to move from the A-IRB to the F-IRB. Any adoption of such parameters should be done alongside with a detailed impact analysis on these asset classes for institutions moving from A-IRB to F-IRB. LGD parameters undermine the principle of risk-sensitivity built up through years of investment in IRB models and do not reflect experienced distribution of LGDs, as well as the wide variety of activities which are central to the financing of financial institutions and large corporates. Moreover, such granular F-IRB LGD parameters concern all asset classes in CRR, not just those applicable to financial institutions and large corporates.

In relation to CRM, the Associations consider the recognition and applicability of collateral mitigation should align the F-IRB approach with the AIRB as this uses the most adequate methodologies which take into account guarantees and securities in the transaction as opposed to fully unsecured loans (therefore with no guarantee). More thorough studies involving the industry should be undertaken to improve the current CRM framework (see EBA Report on Credit Risk Mitigation framework).

The Associations consider the final input floors and haircuts on risk parameters to be overly conservative and recommend the Commission assess if these have duplicative impact when considered alongside the EBA's future of the IRB approach. Such floors could introduce perverse incentives by penalising high quality exposures and again encourage focus on higher risk activities and reducing transparency. Furthermore, the floor applied on haircuts could create a strong disincentive for banks to model internal haircuts, given that the collateral subject to largest devaluation would be penalized while better quality collateral could not benefit from it (given that input floors are applied at single transaction level).

Essentially this means that banks are encouraged to apply the standardized and FIRB parameter for the collateral evaluation even under AIRB approach.

In the F-IRB approach the maturity is fixed at 2.5 years, with a national discretion for supervisors to require institutions to apply the cash flow methodology instead. The application of the fixed maturity reduces the risk sensitivity of the IRB approach significantly. The Commission should maintain the national discretion and with that the use of the actual maturity for portfolios treated under the F-IRB, as is currently possible in CRR.

Replacement of EAD modelling with the Standardised CCF's as proposed by Basel is highly penal and does not reflect of industry experience. In our view, the scope of modelling available for CCFs should be consistent with that of LGDs. As such we recommend that CCF modelling be retained in particular for corporates, including for non-revolving products, as well as for trade finance and specialised lending exposures. Moreover, they should not be subject to the proposed floor. It should also be noted that the SA CCFs are also referred to in the calculation of the leverage ratio for the determination of the leverage exposure for determining off balance sheet items. Increasing SA CCFs will therefore also impact the leverage ratio and the magnitude of this impact is likely to be significant. In addition, clients that rely on the arrangements to which the new CCF regime will apply will find the availability or accessibility of such products restricted through increased costs of payment and financing facilities. We would assume that the spread charged to the borrower would follow the level of the proposed CCFs linearly.

In the words of the Association of Corporate Treasurers "working capital management is vital for the generation of sustainable cash flow and survival of all companies". Commitments and contingent facilities are an important tool for corporate treasurers to manage their liquidity and deal with unexpected delays or demands in payments. If credit conversion factors no longer reflect the real likelihood of usage of commitments, they will be mispriced and therefore reduce their usefulness as a tool for corporates. In our view, this will be damaging to the wider financial stability, as it will make poor economic performance more likely, which in turn may lead to an increase in risks faced by banks. We are also not convinced that it would be economically likely for non-banks to provide an alternative to these banking services. Unlike a loan, where unregulated activities can play a role, the cost of the risk management of liquidity risk is something that only the banking sector can efficiently bear. It would therefore be perverse if regulators choose to misallocate risk in an area that should be the core role of the banking system.

c) Where do you expect particular implementation challenges and why? Please specify.

The Associations consider there to be significant implementation issues in the following areas

- The introduction of parameter floors adds a significant increase in operational complexity, and there remain a number of areas where more clarity and certainty need to be provided, particularly in regards national discretions and practical application of thresholds. For example, the application of the LGD floors for AIRB will result in institutions having to run three calculations at any given time (internal AIRB models, the calculation with the floors and the actual FIRB calculation).
- Significant implementation issues in regards the application of the revenue threshold for consolidated corporate groups in terms of information availability and monitoring of the threshold.
- Significant implementation issues in regard to systems changes relating to the revised definition for recognising commitments and assessing any impact on EAD model estimates.
- Some LGD and EAD models are used for portfolios that contain customers which will have their AIRB permissions removed (e.g. Corporate LGD models). These will require re-validation on the remaining population, and quite possibly regulatory pre-approval or pre-notification for their continued use. This activity would coincide with the already challenging timelines for the EBA's IRB work programme; which banks are required to comply with by 1st January 2021.

- The way in which Large Corporates with consolidated revenues above 500M€ are identified needs to be clarified for Large Corporate and will be an issue for corporate for which revenues are not available on a regular basis (SME, funds….).
- Regarding CRM framework, it remains unclear how institutions should handle the mix of regulatory approaches they will be faced with. For instance, for bank guarantees which are a common type of CRM often provided in support of midcap corporates, we understand that the use of F-IRB approach will mean that CRM cannot be reflected in a modelled LGD on a corporate exposure under the A-IRBA.
- A commonly used form of collateral such as a "pledge on all assets" which provides effective risk-mitigation effect might be difficult to recognize under F-IRB going forward, as it does not reflect on the specific capturing and updating of individual asset valuations. I.e. in order to be able to apply F-IRB (particularly where we are newly required to do so) and recognize additional collateral, whole collateral valuation processes and infrastructure will need to be built.
- The interaction with the output floor.

3. CVA risk framework

a) What are your views on the revisions? Please provide details.

Whilst there are some improvements in relation to non-internal model approaches, we oppose the complete removal of the use of *any* internal model.

Furthermore, the revised CVA framework has only been subject to a single consultation. We believe, therefore, that further impact studies are required to reliably assess the calibration and the impacts of the final framework. Specifically, we would like to focus on the following elements:

1. **Gap between accounting CVA and regulatory CVA**

   We recognize that the gap between regulatory capital CVA and accounting CVA was narrowed compared to the original proposal. However, significant differences still remain, and banks may have to maintain two separate models to comply with the revised capital regulations as well as local accounting standards, which risk distorting the essential link between economic risk and capital. In this respect, CVA remains the only market risk in the Basel framework where the accounting measure is not used as an input to the capital requirement calculation.

   The main sources of divergence between accounting CVA and regulatory CVA are:

   - **Securities Financing Transactions (SFTs)**

     In the final Basel standard, fair-valued SFTs are included in the revised CVA capital charge on a mandatory basis [BCBS d424, §3]. SFTs and other forms of collateralised borrowing should not be included in the CVA regulatory framework. These instruments are not necessarily captured in accounting CVA. The credit valuation component of SFTs is embedded in the valuation base, much like a traded bond. On the one hand, the variations of fair value of a SFT are essentially driven by variations of repo rates. On the other hand, the IMM metric captures MTM variations due to variations in the SFT collateral value.

     In addition, as only fair-valued SFTs are subject to the CVA capital charge, different accounting policies across jurisdictions could lead to varying capital requirements depending on the reporting entity's jurisdiction.

   - **Margin Period of Risks**

The final Basel standard imposes a regulatory CVA based on "9+N business days" margin period of risk (MPoR) where N is the remargining period. Such MPoR could result in becoming overly conservative and not commensurate with the risk truly incurred nor consistent with accounting CVA practices.

- **Loss Given Default**

  We acknowledge there is a broad-based adoption of market-implied parameters in accounting CVA including PDs, recovery rates and diffusion parameters. The Basel Committee logically imposes a regulatory CVA based on market-implied parameters. We note that some flexibility is granted to use different LGDs in specific cases *where "the bank can demonstrate that the seniority of the derivative exposure differs from the seniority of senior unsecured bonds*" [BCBS d 424 §30]. We advocate that banks should be able to use different LGDs for certain specific type of exposures e.g. because they are secured (such as covered bonds, funds or project finance vehicles) or because their nature does not permit the reliance on the credit market (see for instance the uncertainty around political intervention in the context of sovereign exposures), subject to being able to demonstrate that the use of such parameters are properly governed and validated within the firm.

- **Counterparties with perfect CSAs[3].**

  Such counterparties raise a particular concern. Indeed, it is expected that calculating SA-CVA sensitivities for such counterparties will be computationally very intensive yet accounting CVA on such counterparties is immaterial. The proliferation of mandatory Initial Margin (IM) requirements on bilateral OTC derivative netting sets will further accentuate this trend. Therefore, consistency could be put at risk by including netting sets subject to perfect CSA and IM requirements in the revised CVA capital charge.

2. Calibration of the new framework

The Basel Committee consultative paper on Revisions to the minimum capital requirements for market risk[4] outlined revised risk weights for the FRTB standardized approach. The Committee proposes to reduce the risk weights for the general interest rate risk class by 20–40%, and equity and FX risk classes by 25–50%. The Committee notes that ***"****Upon finalisation of any recalibrated risk weights, the Committee may also consider making corresponding changes to risk weights used in the standardised approach to credit valuation adjustment risk (SA-CVA) given that SA-CVA risk weights were based upon the risk weights included in the January 2016 market risk standard."* We strongly recommend that such changes to the risk weights are subject to adequate review and incorporated in the SA-CVA framework.

It should also be noted that the basic approach (BA_CVA) still shows high risk weights and is expected to increase capital by multiples and should also be subject to review.

In addition, index hedges and proxy hedges are not sufficiently recognized. We observe in practice that index hedges, because they must be decomposed into constituents, tend to increase the capital charge creating a wrong incentive for banks and further widening the gap between sound risk management practices and capitalization rules. The same applies to proxy hedges due to diversification being accounted for through a quadratic formula with penalizing correlations.

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[3] Perfect CSA: CSA with 0 threshold, and daily margin calls

[4] https://www.bis.org/bcbs/publ/d436.pdf

In both instances, we recommend allowing partial netting of risk weighted Counterparty credit spread sensitivities with related proxy hedges. The level of netting allowance would depend on the quality of the proxy hedging.

3. **Selection of CVA eligible hedges**

We are supportive of the inclusion of generic market risk hedges in the new CVA framework (and not just credit risk hedges), but we expect considerable infrastructure challenges to identify what the CVA eligible hedges are under the new scope.

While the selection of credit risk hedges (CDS/Index) is already in practice, selecting Rates/FX/Commodities or other type of generic market risk hedges will be challenging for XVA desks that manage these risks holistically at portfolio level across various valuation adjustments. Furthermore, the additional requirement – for CVA hedges with curvature risk or default risk charge - to identify matching external trades in the main front office desk, will be difficult to implement and it is likely to result in no internal CVA hedges with curvature risk or default risk charge being classified as eligible.

On a more generic level, the CVA capital framework remains disjointed from the generic market risk capital framework, instead of being integrated into the Trading book and capitalised comprehensively.

4. **Trades as clients of clearing member of a Qualifying CCP (QCCP)**

The lack of clarity relating to the treatment of trades when institutions are clients of a clear member of a Qualifying CCP, which are currently exempted under CRR, is a concern for members. We advocate that these trades should continue to remain exempt, not just the trades directly facing a QCCP.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

As a preliminary remark, we recall that the Basel Committee only performed one quantitative impact study on full banks' portfolios in February 2016 prior to finalisation of the revised CVA framework. At the time, the impact study revealed that the revised framework would lead to a surge in CVA RWAs.

Firms are in the course of assessing the impact of the revised Basel standard as part of the December 2017 Basel 3 Monitoring exercise[5]. Preliminary results on the same perimeter of February 2016 provide some indications that the revised own fund requirements for CVA risk would still be a multiple of current own funds requirements, despite improvements compared to February 2016 proposal[6].

We anticipate a potential increase in capital consumption which would increase the cost of hedging for clients. This would be alongside a substantial increase in operational and infrastructure costs to comply

[5] Furthermore, an Industry QIS is currently ongoing (coordinated by the Associations).

[6] It's expected that accurate figures (deriving from the Industry QIS) will be available beginning of May, 2018.

with the rules. For instance, through for instance having to include SFTs which are fair-valued in the computation.

We also expect the requirement to hedge non-linear trades with an external counterparty would increase the cost of hedging for an institution as a whole, as banks' practice is often to hedge CVA non-credit risks internally. The requirement to have a matching external trade in the front office desk will be a challenging requirement for the infrastructure and could lead the CVA desks to hedge these risks externally in order to obtain capital recognition (a more expensive and inefficient way of hedging for banks overall). Internal CVA hedges of FX/Rates/Commodities/Equities risk should be considered eligible.

We would therefore welcome further work in assessing the impacts by European bodies in this area.

Regarding SA-CVA specifically, we reiterate that usual accounting CVA CCR proxy hedges (index hedges and single name proxy) are overall inefficient and can even lead to an increase in capital requirements.

c) Where do you expect particular implementation challenges and why? Please specify.

We are concerned that time constraints could jeopardise the building of a sound and consistent framework. The target deadline set by the Basel Committee – January 2022 – seems extremely challenging, especially in a context where the transposition calendar in Europe is unknown and the ECB has not yet disclosed its expectations in terms of SA-CVA approval process.

As underlined above, the major implementation challenge is to develop the capacity to compute SA-CVA sensitivities on at least a monthly basis. In that respect, we note that the final standard is rather prescriptive in the way such sensitivities must be computed (bumping approach).

We reiterate the need to grant bank the flexibility to carve out from a given netting set, transactions that the bank is not able to manage under SA-CVA and to capitalize such transactions under BA-CVA in a distinct netting set.

Significant implementation challenges are likely to arise from having to include SFTs in the computation and in identifying eligible CVA hedges under the new scope.

While the selection of credit risk hedges (CDS/Index) is already in practice, selecting Rates/FX/Commodities/Equities or other type of market risk hedges will be very challenging for XVA desks that manage these risks holistically at portfolio level across multiple valuation adjustments (FVA, CVA, DVA, CTDVA and others). Banks could implement tools to optimise capital by isolating CVA-only hedges, but that could lead to misrepresentation of actual risks managed by the CVA desks.

As already highlighted, another challenge will be to identify hedges like swaptions (or other type of non-linear trades) where the infrastructure should be able to look-through at the front-office trading desk to be able to determine whether the CVA hedge is ultimately hedged externally or not.

Another important challenge to highlight, is the requirement to model the dependency between the exposure of a trade and the credit quality of the counterparty, in order to use the internal CVA model for SA-CVA application. In practice, modelling this wrong-way risk behavior will be very challenging for banks and the modelling itself will be subject to very different assumptions (correlation used for example) by different banks. We would advise to remove this as a requirement to be able to use SA-CVA model.

Finally, in the light of above considerations, we urge the European Commission to propose a sustainable European implementation timeline of the revised CVA standard such that all parties (banks for validation and ECB for validation) have sufficient time to adapt.

d) What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?

When Basel III was transposed into European legislation via the CRD IV package the European legislator decided to exclude CVA capital charges on the counterparty risk arising from derivative transactions with "end-users", i.e. non-financial counterparties (NFC), sovereign and pension funds, which use derivatives to hedge against potential adverse moves in currencies, interest rates or other financial variables. The European legislator believed end users of derivatives shouldn't have to incur higher costs to hedge risks because they were unable to collateralize their derivatives transactions due to significant infrastructure costs or lack of access to liquid assets. This was also recognized in the European Market Infrastructure Regulation (EMIR) that exempts corporates below a threshold from the clearing obligation for derivative contracts.

As the industry has stated before, application of the exemptions could be reviewed only when the Basel standard proved to be correctly amended, i.e. improvements made to the IMA approach amongst others. Now that the IMA approach has been removed, the industry continues to believe that the mis-specification of CVA risk capital could lead to an overall increase in costs derivatives for end users (corporates and sovereigns counterparties) and creates a disincentive for end users to use these instruments for hedging purposes. Therefore, unless a thorough analysis shows that the impact on end-users is not significant, we believe that the exemptions should remain in place.

4. Operational risk framework

a) What are your views on the revisions? Please provide details.

The Internal Loss Multiplier should be set equal to 1 when the revised Basel III framework is transposed into the CRR, in order to avoid heterogeneous treatments between European countries, depending on national supervisors. An ILM level which deviates from 1 would raise the question of the corresponding impact on own funds requirements in Europe and could undermine the "no-significant capital increase" principle of the new Basel framework. In addition, setting the ILM at 1 would also make up for the shortcomings of the SMA.

It should be made clear for the purpose of Pillar 2 risk charges in any future revisions to Article 104a CRD, that for the purpose of point (a) of paragraph 1, the application of an ILM at 1 sufficiently covers the risk. This will help ensure consistent application of the multiplier across the EU.

Not allowing the recognition of to recognize any forward-looking mitigation is also considered a major flaw of the new methodology, which could jeopardise the management of operational risk itself. Insurance is not encompassed in the SMA approach, despite our strong view that the possibility to use it as an active operational risk management tool should be maintained. Effectively applying an insurance scheme has multiple positive aspects and allows the "pricing" of operational risk against a third party with opposite economic incentives (i.e. buyer and seller). The recognition of insurance recoveries in netting operational losses does not address the above-mentioned aim as it results in only the expected losses being considered rather than taking into account the risk transfer allowed by an effective insurance framework.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

On an individual bank level, for institutions using the Advanced Measurement Approach (AMA), as proposed by the CRR, to measure operational risk, institutions are currently providing impacts for the Basel QIS and impact studies have been made by the EBA.

Based on a study by the ORX (to be published)[7], more than 75 per cent of participating European banks would have higher capital in comparison to current Pillar I levels under the new SMA. In average (median) terms the impact is an increase of +22.5 per cent See table below).

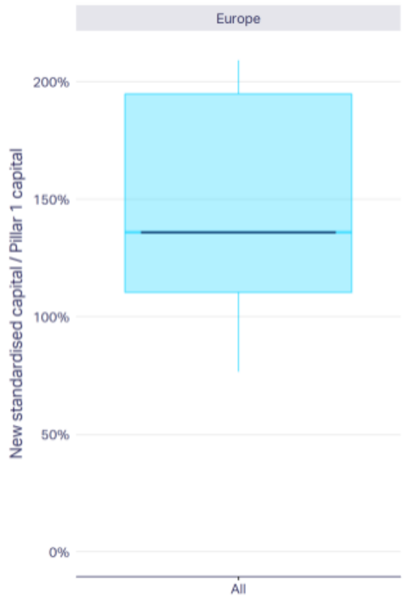

Figure 1: New standardised capital as a percentage of Pillar 1 capital. 100% represents no change in levels.

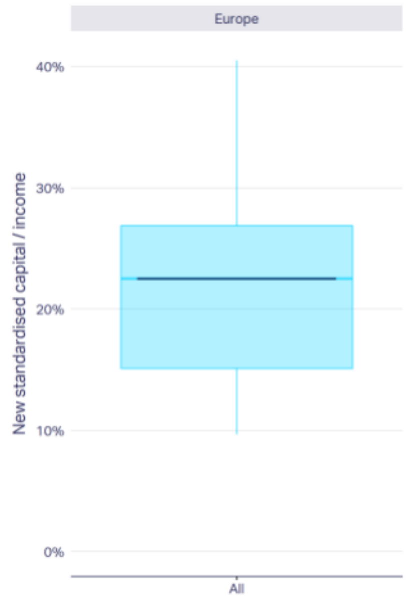

Figure 2: New standardised capital as a percentage of gross income by jurisdiction.

	Capital / Existing Pillar I	Capital / Income
Median %	136	22.5
Mean %	170	23.3

Uncertainty in impact

Supervisors have discretion to modify the role of the loss multiplier within the capital calculation. In the following analysis the ORX assesses three possible implementations.

1. Capital = BIC x ILM (with losses > €20k) – the default approach

2. Capital = BIC x ILM (with losses > €100k)

3. Capital = BIC (no ILM)

By not including the ILM (option 3), in comparison to current levels capital would increase in Europe +28 percent, but down from +36 per-cent when losses are used.

[7] Study done by ORX, views expressed by AFME. 24 banks participated from the EU, US and Switzerland and the survey was conducted anonymously.

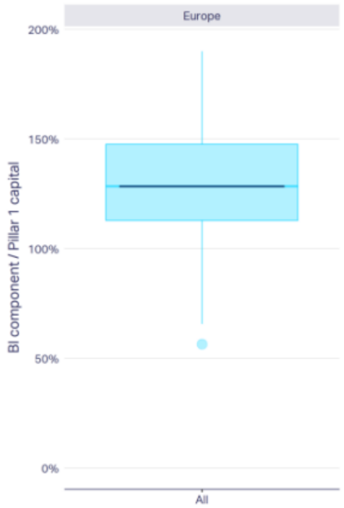

Figure 3: Business indicator component as a percentage of Pillar 1 capital

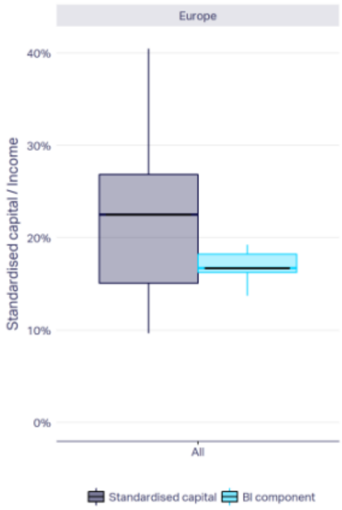

Figure 4: Impact of loss component (losses above €20k). Grey boxplots show the default (option 1) implementation, and the blue boxplots show option 3

The default (option 1) and BIC driven (option 3) are compared above. This shows the ILM can have a significant influence on outcome, giving an increase of +34.7% when capital is considered as a percentage of income (Figure 4). By looking at the difference between the largest and smallest impacts per bank across the three approaches, the ORX sees variability exceeding 30 per cent (Figure 5) for more than half of European banks. Therefore, to accurately assess impact, there is a clear need for greater clarity from supervisors on their expected implementation. Supervisors can also increase the loss collection threshold to €100k from €20k. This results in a relatively minor reduction in capital (20.3 per-cent down from 22.5 per-cent) Figure 6.

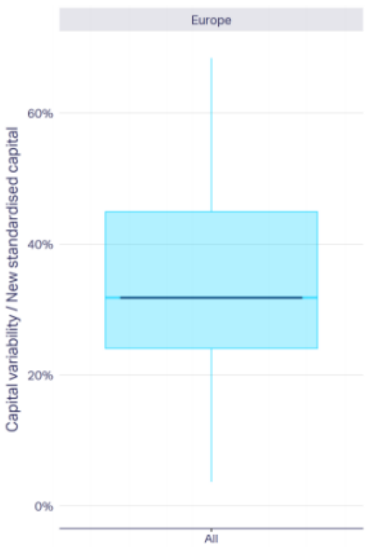

Figure 5: Potential impact of supervisory discretion – maximum variability as a percentage of default standardised capital

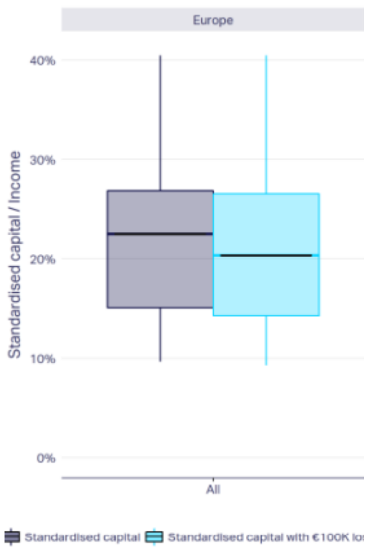

Figure 6: Impact of the loss threshold

Separately to the ORX study, our working assumption is that for those institutions that do not currently use the AMA, the expectation is that regulators would ensure that the cumulative Pillar 1 + Pillar 2 charge remains constant, with any increase in Pillar 1 being offset by a commensurate reduction in the Pillar 2 charge. We would welcome if the Commission could clarify this assumption.

c) Where do you expect particular implementation challenges and why? Please specify.

Implementation challenges will occur due to the change from an advanced measurement approach to a standardized approach. The standardized approach will change the contribution of each business line to the operational risk capital requirements, compared to the current approach. Institutions will face a new challenge to properly allocate these charges internally. If the internal allocation of the operational risk charges to the business lines is based on their contribution, the ROE may be significantly affected for some business lines.

With particular regard to model approval, EU legislation should clarify whether supervisory approval will be necessary for the introduction of the SMA, which replaces all other existing approaches. If supervisory approval were to be necessary, EU legislation should set a realistic timeline and standardise the requirements by supervisors. In a similar vein, the European Commission should clarify the interaction with the recently-adopted RTS (Delegated Regulation C(2018)1446) on the supervisors' assessment methodology for AMA permission to firms (n.b. the Delegated Act is expected to enter into force in late 2018). It requires firms to update their approach and especially disuse Gaussian & Normal-like distributions within two years, i.e. by late 2020.

Finally, we are concerned with the public disclosure requirements. Given the varied range of the quality and quantity of banks' loss information, the extent to which the meaningful sector-wide comparison of the data is meaningful is questionable. The raw data required could lead to misinterpretation and an unlevel playing field.

In addition, it is not clear how external parties will be able to assess a total loss figure to determine the quality of OR risk management as this figure covers very different aspects of the evolution of the loss (additional losses on past incidents, new losses, recoveries, adjustment of provisions …).

Alternatively, it would be preferable and more informative of a bank's actual risk management and operational risk to break down losses by categories, and show a percentage breakdown of risk categories, rather than giving absolute amounts. Adopting percentages and trends, rather than absolute amounts, would be more useful and less likely to raise problems of confidentiality.

There is also the concern that some operational risk losses such as pending litigations and settlements may be subject to confidentiality and not allow for reporting of these incidents (including the ones for which exclusion is requested).

The commission should consider if detailed qualitative and quantitative information about losses should only be provided to European Supervisors.

In short, our concerns are as follows:

- The relevance of the comparison between banks of historical loss data - Given that the definitions of loss (including the national discretions on the threshold), the effectiveness of loss data collection process, and the accounting standards vary across banks, the loss data is not comparable and can be misleading.
- The usefulness to historical loss data - Capital adequacy should be measured against future projected loss considering the bank's current operational risk management framework, instead of just looking at historical loss data which cannot be simply said to be directly relevant to future losses.

5. Output floor

a) What are your views on the revisions? Please provide details.

Regarding key feature 5.1 (application of the output floor):

It is worth legislators specifying that the output floor should not go beyond at the 72.5% level set at Basel, especially given banks are also subject to the leverage ratio minimum requirements as backstop to the internal models. This will be a constraint to the development of market activities and diversified business models. This can be achieved by:

- applying as favourably as possible many of the national discretions that relate to the standardised approaches;
- ensuring that the floor is calculated at the aggregate RWA level, rather than on a risk-type by risk-type basis; and
- applying the floor at the level of the global consolidated group only. Banks may choose, or are being obliged, to arrange their businesses in such a way that lower risk activities, such as residential property lending, are held in one subsidiary whilst higher risk activities, such as in the trading book, are in separate subsidiaries. An aggregate floor that is applied at the regulated legal entity level may result in the capital floor biting at an individual subsidiary level, when it is not an issue at the consolidated level. Should there be constraints on double leverage, the capitalisation of the subsidiaries driven by the capital floors may become the determining factor in the overall capitalisation of a banking group.

Before any floor can be implemented, there are areas of the capital floor, such as the treatment of capital deductions, where further European-specific guidance is required. For example, in the EU, a firm is able to deduct securitisation positions risk weighted at 1250% from capital, whereas there is no choice in Basel. If a firm has elected such an approach, the rules need to consider how this will apply in the context of a floor, where under SEC-IRBA it may risk weighted and, under the floor, it may be deducted (or vice versa). The same is true of the current provision rules, where under there is a difference in treatment between standardised and IRB, which needs further guidance. This could be further exacerbated if the Commission proceeds with its plan to deduct the unprovided for element of non-performing loans.

The implementation of the floor should wait until the full roll-out of the revisions to Basel III has been completed. It should not be implemented in a piece-meal approach, as the elements of CRR2 and CRR3 are finalised, since this is inconsistent with the calculation itself. Furthermore, the timing should factor in other elements of the regime which remain outstanding, such as the timing of secondary legislation under regulatory technical standards. In addition, it should include areas that are outside of the Basel revisions, but which may have an impact upon Pillar 1 RWAs, such as the proposals to introduce a prudential backstop for non-performing loans.

This will also allow for alignment with Basel's output floor, with the following six risk types being included in the implementation of the output floor in the EU: credit, counterparty, CVA, securitisation, market and operational risks.

Regarding key feature 5.2 (disclosure of RWAs / output floor):

The European jurisdiction is facing large Pillar III requirements. We acknowledge the work of the EBA and the ECB in this field, which already require extensive disclosure template regarding internal models. The existing measures ensure the appropriate and transparent use of models, which are sufficient for the regulator and supervisor to have a broad understanding of banks' frameworks. Generally, regarding this topic, we favour striking a balance regarding the density of disclosure, in order to avoid counterproductive measures, redundancy and unduly burdensome requirements.

The proposed disclosure by the Basel Committee could misleadingly establish the standardised approach as the true capital requirement. It will wrongly lead investors to judge banks with respect to the standardised approach, considered as the "correct measure and benchmark", therefore using a much rougher and less-risk sensitive measure. It will implicitly require them to have additional own funds. This situation has occurred in the past, when investors did not consider phase-in requirements (CET1, LCR…), expecting financial institutions to have fully-phased requirements ahead of the regulatory calendar. With the benchmarking of internal models against the standardised approach, market expectations would be permanent, creating undesirable incentives and negative externalities (e.g. on financial stability and credit supply). On top of that, such disclosure will undermine the level playing field by pushing banks using standardised approach to optimize their exposures to comply with this approach, which is not the case for banks using mostly internal models.

Also, disclosures by type of risks or type of assets could dent any gain from the phasing of the output floor until 2027. With such disclosures, starting 2022, the analysts and rating agencies would be able to compare and restate the capital requirements of the banks that are using internal models into standardized approach, without any floor.

Moreover, Hypothetical RWA under standardised approach would provide neither more transparency on internal models nor more understanding of internal models. It would not reflect the risk profile of bank using internally modelled RWA. To provide information on hypothetical RWA under the standardised approach would bring more complexity in reading the Pillar 3 data. It would be difficult for users to understand the relevance of the standard RWA compared to internal models based RWA.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver.

We welcome further work by European bodies to assess the impact in this area.

The Commission should determine whether the floor is appropriately calibrated in a European-specific context via a quantitative impact study, the results of which should be published. This should consider not whether the floor drives capital; but also the situations where banks are constrained by a proximity to the floor. Any analysis should also take into account the impact upon MREL.

ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

The application of the revised output floor on certain assets/exposure classes is difficult to assess as the output floor is calculated at an aggregate RWA level. This is compounded by the need to specify how the national discretions within the framework will be exercised, the final calibration of the market risk and standardised CVA frameworks becoming known, and any European-specific amendments to the Basel framework being agreed. Furthermore, as set out above, the level of application within a group is also material. All of these may affect the relative balance between modelled and standardised RWAs. As a result, before the European version of the Basel III amendments are agreed, a quantitative impact study should be performed.

c) Where do you expect particular implementation challenges and why? Please specify.

The implementation of this proposed floor regime for banks utilising internally modelled approaches is a considerable undertaking: banks do not run both the standardised and the modelled approaches against their full portfolios today. This will involve significant infrastructure, data and reporting enhancements and require long lead times to make the necessary changes across almost all elements of the RWA framework.

Once implemented, the imposition of the capital floors will lead to a greater pressure on processing times. This will affect both the timing of delivery of returns and the frequency in which firms choose to run additional calculations.

In order to ensure that firms are able to build effective reporting systems and processes at the outset, it is important that any regulatory technical standards, or changes to the reporting (CoRep) templates and disclosure frameworks are finalised as soon as possible. Delays to the reporting framework may create additional burden on firms in the long-run.

In the case where the aggregate output floor is binding, institutions will face a challenge to properly allocate the RWA surcharge between business lines internally. A binding leverage ratio will likely lead to cliff effects and volatility of capital allocation, which may be detrimental to long-term financing and growth, and lead to greater volatility and procyclicality.

Kind Regards,

Constance Usherwood

Director, Prudential Regulation

Kind Regards,

Nicola Mariano

Assistant Director, Risk and Capital