AFME/ISDA Initial Comments regarding the French PCY compromise on CRR3

AFME and ISDA (the "industry") would like to take the opportunity to provide initial comments on the French Presidency's (FR PCY) compromise text on the CRR 3 proposal.

European banks have raised hundreds of billions in equity capital since the financial crisis, and their resilience has been proven during recent economic shocks. The co-legislators should therefore uphold their commitment to avoid any significant further increases in capital requirements, which could have unintended consequences for provision of funding to the real economy and the broader economic recovery after the pandemic. Aside from the French PCY proposal to no longer apply the Output floor at consolidated level, which we highly regret, the FR PCY compromise presents a significant and well-balanced development of the Commission's proposal. In particular, we welcome the maintenance of the transitional arrangements and delegated act for the FRTB, as well as other improvements to the credit risk and market risk frameworks. With some further improvements set out in more detail below, we think this text presents a strong basis upon which the Czech presidency should seek to reach a general approach. An overview of our CRR3 priorities is included as an Annex to this note – all our positions can be viewed in full here.

Output Floor

The French presidency compromise has significantly amended the Commission proposal to apply the Output Floor at the consolidated level (with a redistribution mechanism) and instead it will now be applied at the solo level unless a Member State chooses to allow consolidated application within the Member State itself. **We strongly oppose the revised application of the floor at the solo level** and would urge the Council to maintain the original proposal of the Commission, which struck a good balance between the intended application of the floor as calibrated by Basel and the concerns of host Member States. Applying it in this way will ensure it is a truly business model-neutral measure and allow banks to diversify their risks and avoid regulatory fragmentation.

With regard to the transitional measures introduced to mitigate the impact of the floor on unrated corporates, low risk mortgages and SA-CCR among others, we welcome that these are maintained yet we would support further adaptation.

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

For low-risk mortgages, given the specific nature of the European mortgage market and important societal role EU banks play in providing mortgages which are long term exposures, we believe this exposure type warrants a permanent treatment in the standardised approach (i.e. to cover all banks) instead of a transitional arrangement which is only relevant for IRB banks. Furthermore, in the interests of a single market this should be applied by banks across the EU rather than a Member State discretion.

With respect to the SA-CCR transitional, design and calibration issues persistent within SA-CCR warrant its recalibration throughout the prudential framework. A recalibration of the alpha factor in the Standardised Approach (unfloored) capital framework to 1 would be a simple solution, which feeds through to the Output Floor, leverage ratio and large exposures framework respectively. This would address a material aspect of the SA-CCR miscalibration throughout the prudential framework, helping to limit the otherwise potential undesirable impact of reduced bank capacity to provide end-users with risk management products and/or increases in the costs of hedging activity.

In addition, **we welcome article 506f on the prudential treatment of securitisation** in relation to the floor, which recognises the need for EBA to assess the potential need to review the securitization framework. However, we believe that, as part of such report, the EBA should also give consideration to the impact of extending any downward recalibration of the non-neutrality factors under the SEC-SA to all securitisations (originator and investor positions) outside the OF calculation, not just those relating to significant risk transfer.

Credit Risk

The French presidency text has made several significant and highly constructive amendments to improve the credit risk framework.

We **welcome the PCY to recognise in full the low-risk nature of trade finance contingent items** and the full reversion to assigning trade-related items a 20% CCF under Annex 1.

We **also support <u>some</u> of the revisions to the treatment of equity exposures** in terms of by maintaining on a permanent basis the preferential treatment of long-term strategic equity holdings and the treatment of intragroup equity exposures. However, it is important to reflect the diversity of business models in the EU by extending the treatment of strategic holdings to IRB banks where the underling risk is same**.** In addition, we do not support the amendment that removes the consideration of certain venture capital investments as non-speculative, which we believe should be maintained.

Likewise, **we support the changes to the real estate framework** which reinstate the CRR2 provisions for the upward valuation of real estate, rather than subject to a cap.

We also welcome a number of other clarifications to the credit risk framework introduced by the French PCY including:

- Improvements to the framework for the permanent partial use, which can also be applied for government and intragroup exposures;
- A review of the short-term maturity of SFTs which are an important capital markets financing tool;
- The possibility for institutions to apply the effective maturity or 2.5y under F-IRB (The FIRB takes on greater relevance given the reduction in the scope of modelling for FIs and large corporates);
- The exclusion of NPL exposures which are guaranteed ECAs from the Pillar 1 backstop; and
- The beneficial recognition of ERM II currency exposures in Article 123a.

Nonetheless, there are some areas of credit risk which warrant continued consideration. For instance, with regard to specialised lending, the proposal to remove the recognition of high-quality object finance, which is unfortunate.

We would also like to take this opportunity to reiterate the importance of extending the application of Article 500 (the possibility to adjust the LGD estimates in case of NPLs massive disposal) until June 2024. This postponement would provide banks with additional time to complete the dismissal processes in the context of market stresses, such as the Covid-19 pandemic. We think it is in the interests of the regulator to enable banks to offload NPLs quickly to avoid the similar slow NPL recognition process of EU banks from 2009 to 2015 and free-up capital resources for further lending.

Counterparty Credit Risk

Our concern remains that the output floor transitional measure under Article 465(4) only applies to the calculation of SA-CCR for the purposes of the output floor RWA, whilst no measures have been taken to address calibration issues when SA-CCR is applied under the Standardised Approach (or

unfloored capital risk framework), the Leverage ratio or the Large Exposures framework. As such, we believe the adjustment proposed for the RWA output floor, should be applied consistently across the prudential framework. As SA-CCR is used in many areas across the prudential framework impacting all banks and users of derivatives, the impact will be significant for both banks using standardised and internal model approaches. A simple approach would be to re-calibrate the alpha factor to 1 for all SA-CCR applications - i.e. unfloored Counterparty Credit Risk RWAs, Leverage Ratio, and Large Exposures requirements – consistently, with permanent application further considered as part of the EBA's report. For IMM banks, internal models should be permitted when calculating Large Exposures requirements.

We acknowledge that the French Presidency compromise has removed the possibility of making the transitional arrangements regarding the alpha factor in SA-CCR permanent. We believe these questions of calibration of SA-CCR remain crucial. The EBA review mandated under Article 514 should explicitly look at the issue of calibration of the alpha factor and its impact on firms' and end-users' hedging capacity, as well as the international developments, with the view of ensuring adequate competitiveness of EU Capital Markets. The question of recalibration of SA-CCR[1] also calls for a broader review at the Basel Committee to ensure global consistency.

The Standardised Approach for Credit Risk (SA-CR) will be of increasing relevance and its calibration needs to be adjusted, as such **we welcome the review introduced in the French Presidency compromise to review the prudential treatment of Securities Financing Transactions (SFTs), including its impact on the sovereign debt market.** SA-CR risk weights applies to both unfloored RWAs for non-IRB banks, and to the RWA output floor. For Securities Financing Transactions (SFTs), SA-CR risk weights are overly conservative and not commensurate to the low underlying risks as it does not reflect the short-term nature of these transactions. Similarly for derivative contracts, SA-CR risk weights do not reflect that counterparty downgrade risk is already captured by the CVA risk framework. This specific treatment for SFTs is critical for the well-functioning of financial markets, especially the efficiency of the sovereign debt market. We would therefore recommend the Council goes further than a review and directly recognises the short-term nature of SFTs through a reduction in the RW for transactions which have a maturity of three months or less, as is the case for interbank lending.

Fundamental Review of the Trading Book

We strongly support the French Presidency compromise in maintaining and clarifying the objectives underpinning the market risk delegated act to ensure a globally consistent and aligned implementation of the market risk capital rules. A number of major jurisdictions (including the US and the UK) have not yet published their draft rules, inclusive of the implementation timeline, while others have already set different timing expectations and/or are still consulting on their national rulemaking. The flexibility provided in the delegated act under Article 461a, is a critical tool in light of the uncertainty resulting from the lack of visibility on timing, content and impact of the locally adopted FRTB rules in other major jurisdictions. We recognize that the EU as a 'first mover' does not yet have visibility on the rules that will be proposed by other jurisdictions, and it is essential that a mechanism to align and address potential inconsistencies is maintained in the final CRR3 text. Given the timeline for finalization of CRR 3 and the impending start date of 1 January 2025, the Industry understands there are timing and process constraints for the implementation of the framework in the EU The 2-

[1] In the US, the alpha factor has been recalibrated to 1 on a permanent basis in relation to exposures to commercial end-users and it was not limited to the RWA output floor application only. A review was also mandated in the Securitisation Quick fix package for the Commission to review SA-CCR in order to ensure that EU corporates were able to hedge their financial risks in the context of the recovery from the Covid19 pandemic and taking into account, among others, the international level playingfield.

year delay proposed under Article 461a is therefore a necessary option, and the mechanism set in Article 461a to adjust the calibration of FRTB (by setting a '0-1' multiplier to market risk capital) – whilst not being the optimal long-term solution – could prove necessary to deliver a level playing field for specific risk classes and specific risk factors in a timely manner. As proposed in the draft French Presidency compromise, the use of this multiplier could be a transitional measure, and accompanied by a mandate to develop, if needed, a fast-tracked legislative proposal to ensure these inconsistencies are properly and permanently addressed.

We also support the changes made by the French Presidency to lower the basis-point floor for eligible sovereign and covered bonds exposures to 1bps and 2bps respectively. This recognises there is an inconsistency in the Default Risk Charge (DRC) between IMA and SA in relation to sovereign issuers of low risk - such as EU Sovereign issuers, covered bonds or other Sovereign issues denominated in local currency of third countries whose supervisory and regulatory requirements are considered equivalent, that give rise to significant differences in the regulatory capital requirements.

In addition, the industry supports the new implementation changes regarding the Trading book (TB) and banking book (BB) boundary to ease the operational requirements, complexity and potential rigidity in instrument designation. The two-step approach across CRR 2 and CRR 3 to implement the new boundary can lead to significant disturbance unless supervisory authorities and banks have the right tools to avoid a cliff-edge. Having a single implementation date of 1 January 2025 helps in addressing these issues. We would note however that the CRR 2 TB/BB boundary requirements would in principle become live in June 2023 and for the text to have the intended effect, CRR 3 would need to have entered into force by this time. A more robust approach moving the implementation date to January 2025 could be via a CRR Corrigendum. This is also justified against the background of the original intention of CRR2 published in June 2019. As stated in the recitals 39 et seqq. the legislator did not want to deviate from a uniform implementation of FRTB capital requirements in EU. The proposed date of application for Art. 104a, 106 CRR2 of June 2023 was reasonable at the time of the finalisation of CRR2. Against the background of the further delay of FRTB on international level to 2023 as well as the delayed publication of the CRR3 proposal, the correction of the date of application to January 2025 is in line with the original intention of the EU legislator of a uniform FRTB implementation in EU.

We also want to highlight that the decomposition of instruments with embedded derivatives through a prudential split should apply more universally and with a consistent framework. Indeed, the scope of application should be better defined and include for example other type of pay-off as interest rate pay-off which are related to trading activities and symmetrically be apply to liability and asset. In addition, the application of the prudential split on liabilities should be done without discriminating against different organizational models: structured issuances are issued in equivalent manner by a trading desk or a by a treasury desk without preventing institutions from having an adequate prudential and risk management framework after the prudential split.

We further welcome some of the clarifications brought to the treatment of equity investments in funds under FRTB including the extended definition of third-party vendors. Banks offer derivative products to their clients on performance of specific funds and hedge these products with underlying positions in the reference funds. The FRTB allows for equity investments to be included in the scope of the internal models *if* the bank is able to calculate capital requirements based on the assets underlying the fund (i.e. if the bank can "look through" to the underlying assets). Otherwise, three different approaches under the Standardized Approach (SA) are used. Two of them lead to conservative capital charges. The third one (the look-through approach under SA), which is the most risk sensitive approach, introduces computational intensity comparable to the IMA. These provisions regarding IMA

and SA look-through approaches result in operational complexity in relatively simple and low risk strategies and may result in activity in funds being prohibitively expensive. While CRR 3 has introduced a widened use of the look through approach for SA and IMA including the use of data provided by relevant third parties, there are still challenges associated with these elements and further flexibility is needed, such as allowing the use of third-party vendors as CIU data and risk sensitivity providers.

We also want to highlight other material issues which have not been addressed in the French Presidency Compromise text. The residual risk add-on (RRAO) is a capital charge intended to only apply to instruments referencing an exotic underlying or bearing other residual risks. Its capital computation, a flat risk weight on the gross notional of concerned instruments, is risk insensitive and penalizes well-hedged portfolios, which can result in overly high capital charges for banks, and lead to trading services becoming overly expensive. In particular, the industry is concerned with the excessive RRAO charge for interest rate (IR) yield curve spread options. IR yield curve options are widely used as hedging tools against interest rate curve exposure by clients such as pension funds, life insurance companies, corporates, asset managers and the RRAO charge could increase significantly their cost of hedging. **We therefore recommend expanding the list of instruments excluded from the RRAO charge to yield curve spread options**.

Finally, the FRTB introduces particularly punitive charges for correlation trading portfolio in terms of default and credit spread risks and by limiting the recognition of hedges. This may incentivize banks to break economic hedges and effectively take on more risk in order to reduce capital, which should not be an aim of a regulatory capital framework. In addition, the rules still lack clarity, which might result in limited own funds requirements comparability between banks. **The industry reiterates that it is important to ensure a capital outcome that is more aligned with the underlying risk for better recognition of hedging.**

CVA risk

While we acknowledge some of the changes made under the French Presidency compromise, we still want to highlight that CVA risk represents a significant driver of risk-weighted assets (RWAs) for derivatives and capital market activities, and deficiencies in the framework have an impact on banks' ability to provide key financing, liquidity and hedging services and products to end-users (for e.g. corporates, pension funds, and mutual funds). As a result, it is very important that the design and calibration issues be addressed appropriately to ensure that capital requirements are in line with real economic risk incurred by banks.

Increases in capital requirements can have a knock-on effect and any requirements that constrain the use of derivatives may affect the ability of end users to hedge their funding, currency, commercial and day-to-day exposures, which would in turn weaken their balance sheets and make them less attractive as investment prospects.

In terms of more specific recommendations, the industry supports further targeted revisions to the CVA framework including revising the calibration and increasing the granularity of risk weights (RWs), particularly for financial counterparties; improving the recognition of CVA Index hedges; and addressing the misalignment between regulatory and accounting CVA. These changes would also need to be addressed at the BCBS level to ensure incorporation into the final CVA standard which should result in consistent transposition of the CVA framework at national levels.

Operational Risk

We support the Commission's proposal to use the discretion to set the Internal Loss Multiplier (ILM) to one in the EU. This treatment is allowed under the BCBS rules and can be applied at a jurisdictional level to limit the volatility of capital charges caused by using rolling 10-year historical data.

Fit and Proper

We support a **sufficiently harmonised but flexible** approach to suitability assessments, which the presidency text now allows for.

Third Country Branches

We note the positive changes made by the French Presidency through the removal of the threshold and approaches for considering subsidiarisation, and that instead subsidiarisation and/or other measures may be considered where a TCB is deemed to be systemically important for a Member State. We continue to consider that any requirements in relation to the formation of subsidiaries and any proposal to apply those provisions in the CRD regime that amount to such requirements should be undertaken with caution and in full consultation with stakeholders and generally only where it is not possible to obtain sufficient assurance over the ability to adequately supervise a branch based on robust home/host cooperation agreements.

It is positive also that for the time being that intra-group cross border transactions would be permitted, with the EBA to produce a report on these transactions within two years. TCBs should be deemed equivalent to conduct services across EU member states, particularly in light of the increased harmonisation of supervisory requirements which is envisaged.

We are supportive of the introduction of grandfathering provisions for existing TCBs. We had noted that the EC's proposed requirement to re-authorise all existing branches is burdensome and will add significant time and administration costs without adding prudential value, particularly in member states that already have robust TCB regimes.

Central bank deposits are risk-free assets, and high-quality liquid assets ('HQLA') are relatively risk free and we suggest therefore the exclusion of these items from the risk thresholds and capital requirements.

We would strongly suggest that the potential liquidity requirements for Class 1 branches are not applied. Instead, we would advocate that they are waived from the outset under a presumption of supervisory equivalence.

Third Country access requirements

We strongly welcome the French Presidency's proposed removal of the requirement for Member States to require third country undertakings to establish a branch in their territory via deletion of Articles 21c and 48c(1). This would avoid the significant adverse impact on the ability of EU financial institutions, corporates, governmental entities, and individuals to access international markets and cross-border services, as well as the proposals under the CRD conflicting with existing MiFIR market access provisions.

We acknowledge that the cross-border provision of financial services by third country undertakings into the EU is currently not harmonised. A proposal to introduce further harmonisation of the existing market access regime would require further work and careful analysis in order to assess that EU counterparties can continue to access global liquidity sources and manage risk directly from the international financial system on a regular basis. This work would also need to consider the different approaches which exist between Member States. **It is therefore helpful that the compromise text of**

the French Presidency mandates the EBA to conduct a report on this by the end of 2025. We would encourage the EBA to engage and consult with the industry in developing this report.

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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.

Annex - Overview of AFME/ISDA priorities for CRR3

Below is a summary of AFME and ISDA's priorities to be taken into account in the CRR3 amendments.

Issue	Position
Output Floor	• Apply at the highest level of consolidation, to avoid further fragmenting the European market. • Empower the EC to extend transitional arrangement for unrated corporates if underlying issues of corporate ratings not resolved, taking account of international level playing field issues. Apply to all banks (SA and IRB). • Make treatment of low-risk mortgages a permanent feature of the SA (i.e. applicable for SA and IRB banks), to reflect the specific nature of EU mortgage market and long-term nature of this lending. • Re-calibrate the SA-CCR alpha factor to 1 in the standardised approach (and not only in for the purposes of the output floor). • Fundamental review of Pillar 2 (not just freezing) to ensure no model risk is double counted.
Credit Risk	• Trade finance: Maintain the CRR2 treatment of trade finance with trade finance items kept in "bucket 4" (20% CCF) instead of being moved to the more penalising "bucket 2" (50% CCF). Improve scope of definition of "commitment" for trade finance exposures. • Taking into account maturity: Given the new limitations to modelling make the application of the FIRB maturity waiver a permanent feature. Reduce the risk weights for SFTs which are short term in nature and support working capital for corporates and liquidity in bond and equity markets. Confirm CRR2 definition of "short term maturity" as exposures with a residual maturity (as opposed to "original maturity"). • Equity: Maintain the proposed treatment for intragroup equity exposures in the EC proposal, further amendments to improve prudential treatment of strategic equity investments and venture capital. • Further amendments to support specialised lending and massive disposals of NPLs and improve application of CRM techniques.
Counterparty Credit Risk	• Re-calibrate the SA-CCR alpha factor to 1 in the standardised approach so its applied consistently across the prudential framework (including the large exposure and leverage ratio). • Better calibrate SA-CCR in the following areas: allow internally calculated deltas; recognise diversification benefits between FX hedging sets; recognise initial margin. • In line with credit risk recommendation improve treatment of SFTs (short term and low risk in nature)
Operational Risk	• Maintain the Commission's proposal to set Internal Loss Multiplier (ILM) to 1. • Reconsider the need to develop an EU taxonomy prior to any review by the Basel Committee, given that it will add complexity to banks' operations and puts at risk the consistency at international level. • Bring forward the EBA mandate (Article 519d) on calculation and recognition of insurance recoveries. This mandate should also be broadened to capture broader use of insurance as a hedge to mitigate future losses in the BI calculation, in line with current practice under the Advanced Modelling Approach (AMA). This report should also inform the BCBS to potentially review and adjust the international framework in order to recognise the benefits of insurance policies.

Issue	Position
FRTB	• Standards need to be implemented simultaneously and harmoniously across jurisdictions. A delegated act with adequate scope can ensure the necessary flexibility for this. • The scope of the delegated act should include the CVA framework to ensure the concurrent implementation of FRTB and CVA, as the risk weights in CVA are largely based upon the market risk standard. • Collective Investment Undertakings (CIUs): There is a need to ensure a more proportionate calibration of capital requirements to avoid potential impact on availability of investment solutions and liquidity. • Trading and banking book boundary: It is important to have appropriate grandfathering provisions in place, as well as supervisory flexibility for reallocation without undue penalty charges and to allow a consistent framework for all instruments with embedded derivatives. • RRAO should address only risks not capitalized elsewhere in the framework and ensure that only real truly exotic underlying risks are subject to the 1% charge. • CTP treatment should ensure a capital outcome that is more aligned with the underlying risk for better recognition of hedging. • Ensure IMA remains viable with particular focus on PLAT, NMRFS and the 3bp floor for sovereigns in IMA DRC. • Carbon trading: While we welcome the lower 40% RW proposed, the framework still penalizes carry positions. We recommend also addressing the tenor correlation parameter to improve bank intermediation capacity.
CVA risk	• A recognition of the different risk profiles of different financial institutions through the introduction of distinct risk weights per type of financial institutions, instead of their allocation a single bucket • A better recognition of indices used to hedge CVA risk • A greater alignment of regulatory and accounting CVA
Third Country Branches	• We support the objective of a proportionate and less fragmented treatment of third country banks operating in the EU through branches. • Subsidiarisation should be considered only as a last resort, and liquidity requirements are justified only in exceptional circumstances. • Central bank deposits and HQLA should be excluded from the calculation of thresholds and capital requirements owing to their relatively 'risk free/low risk' nature.
21c	• The proposed new Art. 21c represent a major change to the existing regimes regulating cross-border business into the EU, rather than a clarification of existing treatment. • It would have a significant adverse impact on the ability of EU financial institutions, corporates, governmental entities, and individuals to access international markets and cross-border services. • It would introduce a cross-border regime significantly more stringent that those of other key jurisdictions.
Other issues	• ESG: Support proposals but further improve treatment of carbon certificates. Await outcome of EBA report on green/brown assets (support consistency with traditional principles of risk based prudential regulation). • Governance: ensure consistency with national frameworks, and smooth processes; revert to CRD5 definitions • Crypto: Consultation will be important to ensure the full implications for the EU landscape are understood.