AFME Response:
EC Consultation on improving the EU's macroprudential framework for the banking sector

March 2022

Overarching comments:

AFME and its members welcome the opportunity to respond. We are supportive of the principle of the on-going development and maintenance of a robust and proportionate macroprudential framework with sufficient counter-cyclical flexibility to mitigate systemic risks and to support lending and the financing of economic activity through the cycle.

We would note at an overarching level, that a priority for macroprudential policymakers in the past appears to have been more the design of a buffer framework to absorb potential losses rather than necessarily to support lending and the financing of the European economy at times of downturn. We explain in more detail later in our document how the buffer framework might strike a better balance between its objectives to absorb losses and support lending.

We set out below in the main body of our document, AFME's response to the consultation which is presented with reference to the four main sections of the EC's document and to the extent relevant and practical individual questions. To facilitate a clear summary, we present in the table below an overview of some of our main comments and priorities.

The Framework Overall	- Importance of a coherent and transparent regime that works uniformly across the EU. The existing framework is overly-complex, opaque and measures overlap. - Recommendation for a rebalancing of the CCoB and CCyB, without increasing overall capital requirements, to allow greater and more timely responsiveness through the cycle. - Additional option for the ability to authorities to release CCoB in times of systemic crisis. - A holistic view of all buffer requirements and their calibration to most appropriate levels of loss absorbency should be taken. We would recommend also an increased transparency around the components of P2R and P2G requirements, and clarity around the extent to which elements relate to systemic risk. - A clear distinction between microprudential tools applied to microprudential risks only and macroprudential measures which should be applied at an industry wide-level.
The G-SIB buffer	- The G-SIB buffer is not the only or necessarily most effective way to address and mitigate the negative externalities associated with institutions assessed as systemically important. - The G-SIB assessment methodology relies heavily on relative rankings, and thereby reallocates the same amount of systemic risk across the group of G-SIBs. It does not, however, take into account the increasing

	systemic importance of the non-banking sector and therefore may overstate the risks posed by credit institutions and their groups. - Recommendation for an exemption for intra Euro-zone exposures in cross-jurisdictional scores, in line with BCBS recognition of cohesion inherent in the Eurozone supervisory and resolution frameworks. We suggest also that the cross jurisdictional score for international banking groups should be adjusted for claims in other countries which are funded locally.
The O-SII buffer	- The O-SII buffer should be reviewed in the interests of reducing complexity. The EBA has defined common criteria for setting the O-SIIbuffer but national discretions result in a diverse range of O-SII buffers across Member States. Consequently, the buffer setting is seen as overly complicated and it is not fully predictable.
Other buffers and tools	- An additional leverage ratio buffer for O-SIIs is not considered appropriate owing to its inherent complexities and potential overlaps with a range of other measures including MREL, the new output floor and Pillar 1 and Pillar 2 capital requirements. - Recommended removal of the systemic risk buffer owing to complexities surrounding its calibration and that risks can be more adequately addressed through other instruments, including over time through more straight-forward sectoral requirements away from the lack of clarity and levels of complication inherent in the current framework. - Capital surcharges may not always be the most appropriate tool, and other such as demand side measures, for instance, may be more effective.

There are accordingly a significant number of changes and adjustments that might be made at a European level, including for example the removal of the systemic risk buffer, a review of the O-SII buffer, improvements to arrangements for rebuilding the CCyB and possible adjustments to the definition of MDA. There are clearly other changes that would necessitate changes or development at an international BCBS level, but which nevertheless should be pursued owing to their importance and the relatively long timeframe for the on-going development of macroprudential policy.

Assessment of the buffer framework

<u>Question 1:</u>

As a general consideration, a review of the overall framework aimed at simplifying it and at greater clarity on how to use the toolkit would be welcome. The existing macroprudential framework in Europe is complex, it suffers a lack of clear design, overlapping measures and inconsistent activation procedures. Macroprudential policy instruments should be clearly identifiable and their purpose made clear and explicit in the policy framework. There should be a clear range of instruments addressing different forms of risk (structural and cyclical) and the forms in which they might emerge (e.g. system-wide, activity based). Increased clarity from supervisors on P2G and P2R risk drivers would also be important in addressing potential overlaps, and the UK framework might help to provide an illustration for consideration.

Question 2:

Given the challenges to the usability of buffers under the existing framework experienced during the recent Covid-19 crisis, an important policy recommendation would be to review and where necessary revise the functioning including the possibility of releasing buffers at an international and European level.

Question 3:

In terms of the G-SIB buffer, which is a capital measure, it is not the only or necessarily most effective way to address and mitigate the negative externalities associated with institutions assessed as systemically important (owing to their size, interconnectedness, complexity, lack of substitutability or global scope). The buffer should also take into account the resolvability of institutions.

It is important to recognise the measures adopted to date with a view to reducing the likeliness and impact of the failure of large banking group. Banks are now much better capitalised and resolvable, riskier businesses and funding sources are less prominent, and bank resolution schemes have progressed substantially. Accordingly, we believe that the cumulative amount of systemic risk in the banking sector has reduced – and in no small part aided by the efforts of the BCBS and the Financial Stability Board (FSB), and initiatives that include Total Loss-Absorbing Capacity (TLAC), the Liquidity Coverage Ratio (LCR), OTC derivatives market reforms and central clearing.

The GSIB assessment methodology relies heavily on relative rankings, and thereby re-allocates the same amount of systemic risk across the group of GSIBs,. . It does not, however, take into account the increasing systemic importance of the non-banking sector and therefore may overstate the risks posed by credit institutions and their groups.

More specifically concerning EU G-SIBs, as emphasised by the EBA, "the progress made in terms of the common approach to resolution resulting from the reinforcement of the Single Rulebook and from the establishment of the SRM has significantly increased the ability to resolve cross-border groups within the Banking Union in an orderly manner", making the case for an alternative score reflecting that progress.

We would recommend therefore that the BCBS recognises the levels of cohesion inherent in the Eurozone supervisory and resolution frameworks, and that there is a specific exemption for intra Euro-zone exposures in the cross-jurisdictional score, without affecting the data supplied to the BCBS for the determination of international denominators. Such a treatment would better reflect the relative risk profile of the Eurozone banking sector, and remove an important obstacle to the development of pan-European flows, which are essential for the efficient funding of the European economy, and to reinforce financial stability.

In addition, we consider that the cross jurisdictional indicator unduly penalises more diversified European banking groups with subsidiaries in third countries. We would suggest therefore a review of this category, especially the treatment of local claims funded locally, and we recommend that activities undertaken by an affiliate in local currency should be considered local activities and not cross-border activities. This review and adjustment could also be considered in the context of the O-SII buffer.

One further EU specific aspect of the buffer framework which should also be considered is the way in which the O-SII buffer operates. Although the EBA has defined common criteria for setting the O-SII buffer (e.g. size, importance, complexity, interconnectedness), national discretions result in a very diverse range of O-SII buffers across the European countries. Consequently, the national buffer setting is perceived as overly-complex and it is not fully predictable, for instance in the scoring criteria, some national authorities take national parameters (e.g. GDP%) into account, which puts banks in a relatively smaller country at a disadvantage. As a result, there often appears no direct link between scoring and buffer requirements. As a broader point, we would note that national competent authorities have the ability to impose higher buffer rates than the minimum levels set by the ECB but that the ECB is not able to lower the rates if needed. As a minimum, there could be a mechanism for a formal review of outliers above ECB assessed levels.

These aspects in relation to the O-SII buffer should be reviewed in the context of creating a coherent and transparent capital buffer regime that works uniformly across the EU.

<u>Question 4</u>

As recognised by the BCBS, buffers may need to be more releasable, but this should not lead to creating more buffers on existing ones nor increasing the overall size of the buffers, rather, rebalancing the existing micro and macro buffers that are already in place. It would not be correct to rely on an assumption that that financial stability increases linearly with increases in capital requirements. Although there is no consensus on what is the 'optimal level' of capital for financial institutions, it should be recognised that capital accumulation beyond a certain level stifles investment and deteriorates institutions' revenue generation capacity. A recent ECB research paper evidenced a 10.9% turning point, meaning that banks' creditors perceived capital accumulation beyond 10.9% of their RWA as "inefficient and hampering their profitability". As emphasized by the authors of the ECB, paper '(…) these results could also inform the calibration of macroprudential capital policy measures, such as the countercyclical capital buffer, which aim to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate and protect the banking system from periods of excess aggregate credit growth often associated with the build-up of system-wide risk'.

<u>Question 4.1</u>

Over time there may be a case for a greater use of targeted measures, including sectoral requirements, for specific markets at risk of over-expansion or to support recovery during a down-turn. This would have the clear benefit of avoiding the application of macroprudential requirements to the entire lending book of a bank rather than the elements which may be at risk of over-heating or which may need particular support. We would note that at present the composition of the P2R requirement is opaque and it not clear which elements are assigned for systemic risk which is necessary for effective coordination between national and European authorities.

As a general principle, it is important that there is a clear distinction between microprudential tools that are applied to bank specific risks only and macroprudential measures which are applied on an industry-wide basis.

<u>Question 4.2</u>

By way of background, we consider that they are several drivers in the current framework that have the potential to limit the usability of buffers:

1) **The role of market pressures to avoid the erosion of capital buffers and the stigma associated with breaching MDA thresholds** (which in the event of such breaches leads to restrictions on the remuneration of equity and other instruments (shares and AT1 instruments) when operating below the combined buffer). The payment of dividends is seen as a signal to the market that a business is profitable, or even if it is not there is still capacity to pay out dividends from capital retentions rather than current earnings. As a result, banks may be reluctant to cut their dividend payments, particularly

if they view losses as temporary for fear of the impact on their share and debt ratings and ultimately their funding costs. The role of macroprudential authorities in releasing buffers across the industry can therefore be appreciated in removing the potential stigma for individual institutions. It can be noted that even a reduction in surplus capital in excess of combined buffer requirements may trigger market concerns in relation to distribution capacity and especially where the reduction results in a bank's capital ratios falling to below its previously communicated target capital range. One of the reasons a reduction in surplus capital in excess of buffers causes concern is because of the risk that MDA restrictions would follow if capital consumption continued that trend. Banks may also wish to maintain high levels of capital to be able to take advantage of potential M&A opportunities that may arise at times of crisis.

As acknowledged by the BCBS, a very important metric to explain banks' reluctance to use their capital resources in times of stress is not the amount of capital they hold but rather their "capital headroom" i.e. the "distance to the MDA": "quantitative work regarding a large sample of international banks and more granular analysis in the euro area suggest that banks closer to their regulatory buffers have been more likely to constrain lending"[1]

We would note at this point that aside from structural risks, macroprudential policies relate to risks inherent in macroeconomic conditions and should not therefore be applied on institution specific bases but applied to system-wide or activity specific risks, for example exposure to the real-estate sector. The application of O-SII and G-SII buffers would be an exception as they relate to ex-ante identifiable structural characteristics of institutions.

2) **Uncertainty regarding the timeline for rebuilding buffers**. The lack of clear timelines can result in uncertainty regarding capital planning and the extent to which banks can continue to support the economy through increased lending and start paying dividends again, thereby avoiding any further stigma. Banks will be concerned by the impact on rebuilding the buffers when they have increased lending during the period of buffer flexibility. From a market/investor perspective the long-term perspective on what banks will be required to hold also plays an important role, especially regarding sufficient predictability on future rates of the CCyB. For instance, the UK FPC has indicated that any decision to increase the CcyB will be taken in 2022 with a one-year period before the increase is effective and the baseline will be 2%.

3) **Lack of alignment between regulators and supervisors**. While buffer flexibility may encourage banks to operate below their capital levels to provide more financing to the economy, supervisors continue to require entities to strengthen their capital ratios and to maintain significant 'management buffers' (for instance, while flexibility on buffer usage was granted in respect of EU on buffers, this was not implemented uniformly across EU competent authorities. More widely, it appears that designated and competent authorities have roles that are not well-defined and that can be frequently overlapping, and the activities of national authorities can detract from the application of flexibility from European bodies. In this context, it is important for the SSM to apply a holistic view of buffer requirements across EU countries which take into account designated authorities' decisions on capital requirements.

[1] Early lessons from the Covid-19 pandemic on the Basel reforms (bis.org)

4) **Other regulatory/prudential requirements that are not as risk-based** (such as the leverage ratio and resolution requirements). These could also be binding, at least temporarily. The Bank of England's most recent consultation on the Leverage Ratio does not attach MDA restrictions to the Leverage buffers to avoid complexity and encourage buffer usability, thereby demonstrating the importance of these restrictions in terms of overall usability of buffers.

   We would continue to note that the macroprudential framework should support lending and the financing of the European economy at times of downturn and that an associated challenge remains the inherent pro-cyclicality of capital requirements.

In terms of the ability to release buffers, one of our recommendations would be to review the small relative weight of counter-cyclical components within the overall buffer mix. The CcyB, which is the only buffer specifically designed to be released at low points in the cycle, accounted for just 0.1% of risk-weighted assets in the euro area at the start of the pandemic and had not been activated in most EU jurisdictions.[2] The systemic risk buffer (SyRB) has also only been activated in a limited number of jurisdictions. The CcoB, on the other hand, is set by law at 2.5% and its use would automatically trigger MDA restrictions. Equally, this is the case for the global and local systemic risk buffers (GSIB and DSIB). Hence, if the CcyB were larger and the CcoB smaller, this would provide more headroom over MDA restrictions, even if the overall size of the combined buffer is kept the same.

Basel and national regulators should therefore consider lowering the CcoB, and other systemic buffers and use this capital difference to meet a target level for the CcyB in normal times without increasing the overall amount of buffers or changing the basis on which a breach of the correspondingly lower CcoB led to the suspension of distributions. While the benefit of such a capital rebalancing would increase the amount of capital that could automatically be released in a stressed environment and alleviate the stigma issue which could result from a capital release generated from a reduced CcoB, such a switch could raise a number of issues. Amendments might need to be made to the way national regulators released the CcyB to ensure that this was done on a uniform basis using consistent criteria and avoid macro distortions from the release of the buffer in some jurisdictions but not others. This need not mean that the CcyB be adjusted by an equal amount in every territory, but it could allow a uniform set of criteria to be applied when determining any change to the buffer. Furthermore, this could be supported by putting in place a transparent framework for how and when the release would be expected to be made, which would in turn address concerns around market transparency and predictability.

Increasing the proportion of capital held in the CcyB and shifting the decision making over this capital which has been moved from the CcoB away from banks would allow greater flexibility and speed of response during any future crisis, and it would reduce the issue of stigma. It would transfer the responsibility for this from the banks' managements to the relevant macroprudential authorities depending on which bodies were charged with operating this buffer.

One challenge, should this proposal be taken up, is the calculation of how the CcoB is redistributed to the CcyB as the former is based on an internationally agreed level, while the latter is left to national supervisors and

[2] Behn, M., Rancoita, E., Rodriguez d'Acri, C. (2020), "Macroprudential capital buffers - objectives and usability", ECB Macroprudential Bulletin, Issue 11, October 2020.

could therefore lead to inconsistent application. A simple way of calculating this would be to transfer an amount from the CcoB to the CCYB which corresponded to a certain % of RWAs. Nonetheless, there are still other aspects of the regulatory framework which interact with these buffers such as the MREL requirement which entails a Market Confidence Charge which is equal to the Combined Buffer Requirement less the CcyB.

An additional option would be to empower macroprudential authorities to allow the release of part of the CcoB in the event of an exogenous shock or significant systemic stress. This decision would therefore be applied to all banks across the industry and not rest with individual institutions thereby helping to avoid stigma or associated adverse market reactions as MDA restrictions would be adjusted accordingly.

The pros and cons of the US stress capital buffer system could also be studied. Merging the CCoB, CCyB, SyRB and Pillar 2 components into one buffer would result in a very significant simplification of the currently complex framework, both in terms of buffer architecture and governance. Importantly, it could be implemented without any deviation from Basel standards, provided a 2.5% floor is introduced (as a way to preserve the CCoB), while other options depend on a relaxation of BCBS standards. On the downside, it would necessitate a full reshuffling of the combined buffer framework, In addition, the outcomes in terms of capital requirements would strongly depend on the severity of the stress tests and on the nature of regulatory scenarios (countercyclical scenarios would be needed).

It would be important that any solution adopted did not lead to overlapping macroprudential requirements and the extent to which reciprocity would apply would need to be considered. Accordingly, there would need to be an agreed clarity on how an increased CcyB requirements would interrelate with other macroprudential measures and it is clear that any risk of duplication in the use of macroprudential tools will need to be avoided. In particular, we would note the current differences in the risks that the CcoB and CcyB cover (non-cyclical and cyclical) and how the CcyB is not at present intended to be maintained to reflect normal levels of credit growth. These are areas that would need further consideration and adjustment as necessary, including possibility at an international level.

Question 4.3

In relation to the restoration or replenishment of capital buffers after an adverse shock, existing regulatory standards already require banks to prepare a capital conservation plan which is subject to supervisory approval. To facilitate predictability, we would suggest that banks are able to distribute a growing proportion of their earnings under the MDA framework as capital buffers are progressively replenished.

Question 4.4

We believe that it is important that any 'relief' granted through the useability of buffers is not counterbalanced or eliminated by other aspects of the prudential framework which might become binding, e.g. risk-based measures, leverage constraints , resolution requirements. It is therefore very important that at times of stress the authorities involved have the necessary powers and that they work in close cooperation to ensure consistent policy implementation.

We would note that in particular that the dynamics of the leverage ratio are very different from those in relation to risk-based capital constraints. The leverage ratio is connected very closely to balance sheet size which itself can be impacted to a large extent by liquidity reserves provided by the central banks in times of stress. It is therefore necessary that central bank deposits should be exempted from the calculation of the leverage ratio on a permanent basis to avoid the risk that it becomes a binding constraint and undermines the release of macroprudential buffers. The current arrangements for the exemption of central bank deposits by the ECB under exceptional circumstances is overly complex and lacks transparency. Along the same grounds, if Pillar 2 leverage ratio requirements are applied then they should adjust through the economic cycle in line with their capital solvency counterparts.

To avoid an overlap between capital buffers and MREL requirements in crisis times, we recommend that any implementation of the MREL MDA should be commonly approved by Competent authorities and Resolution authorities. Indeed, MREL MDA can be triggered in a case where all capital requirements are met, but buffers on top of MREL are breached, because of difficulties to renew MREL debts coming at maturity. If at all serious, those difficulties are generally not due to the financial situation of the bank (which meets its requirements), but are most likely due to external factors beyond the bank's control. In this case, the application of MREL MDA should not be left to the discretion of the resolution authority but more simply subject to a joint decision with the Competent authorities that may have relief measures due to the general situation.

Also, when relief is granted on risk-based and/or on leverage prudential requirements in times of stress, commensurate relief should be swiftly provided with regards resolution constraints. It is important that a specific procedure be introduced to ensure close coordination between Competent and Resolution authorities and sufficient reactivity and countercyclicality on the resolution side, as following the standard resolution notification process would unduly and significantly delay relief measures.

Missing or obsolete instruments, reducing complexity

Question 5:

We would note at a conceptual level that it would not be appropriate to consider that any possible risk, 'risk driver' or 'source of risk' should be addressed by a specific layer of capital. Instead, it is necessary to consider the levels of capital that can provide reasonable assurance that losses incurred in times of severe stress could be absorbed while preserving banks' ability to provide funding to the economy. As a general observation, it would appear impossible that every risk covered by the capital framework would materialise at the same time and therefore requiring banks to hold capital against a cumulative set of risks is not appropriate. In this context, it would not seem appropriate to use the macroprudential framework to encourage or manage a shift to EU clearing.

Question 6:

The extension of an additional leverage ratio buffer for O-SIIs is not considered appropriate owing to its inherent complexities and therefore potential overlaps with a range of other measures including MREL, the new output floor and Pillar 1 and 2 capital requirements. We note that the report from the European Commission of February 2021 on the possible extension of the leverage ratio buffer framework to O-SIIs mentions the heterogeneity of firms in the O-SII group, and the leverage ratio can be viewed as a simple back-stop measure which should not attract MDA requirements.

We would in addition specifically recommend a removal of the systemic risk buffer for non-cyclical risks owing to the complexities surrounding its calibration and that the risks that it seeks to cover can be adequately addressed through other instruments. We would note also that CRR Article 458 enables designated authorities to impose requirements which are outside of the existing and defined toolkit and we do not envisage circumstances under which this would be warranted.

Question 8.1:

Capital surcharges may not always be the most appropriate tool for sectoral imbalances, and demand side measures, for example in relation to real estate, may be more effective. We would though advocate for caution and full industry consultation if in time any additional borrower-based measures were to be considered.

Question 8.2

As part of the measures to support and encourage buffer usability and mitigate banks being unduly impacted by stigma from breaching MDA restrictions during the pandemic, the ECB and other regulators introduced a blanket ban on dividend distribution. Overall, we consider it best to avoid suspending dividend payments ahead of any breach in MDA to limit undue impact on bank share ratings and uncertainty over future actions (the capital saved during the pandemic was minor in the context of banks' overall capital resources, and while some dividend restraint may have been appropriate, the formal cancellation of dividends added little to lending capacity and reduced market values by a multiple of the capital saved). We would note also that any dividend restriction undermines the concept and usefulness of MDA and that asymmetric treatments emerge in relation to minority interests.

Instead, we consider this issue could be more efficiently solved either by rebalancing the buffers as suggested above (whereby if the capital requirement is transferred from the CcoB to the CcyB, and, in exceptional circumstances, the CcoB is lowered, the distance from the MDA trigger would be commensurately increased, thus allowing banks to continue with their dividend payment), or alternatively/ in addition introducing a rule-based and transparent approach with regard to MDA triggers.

It might also be appropriate to consider whether the definition of MDA could be adjusted. In particular we observe that the EU through CRD V defines the MDA as interim and year-end profits net of distributions and does not permit profits already included in CET1 to be distributed. In contrast, the UK PRA has redefined MDA as the sum of all earnings over the last four quarters net of any distributions, including certain profits already recognised as CET1.

Question 8.3

During a crisis, a relaxation of prudential could be very appropriate to support economic recovery following a shock and in theory this has the potential to be provided through CRR Article 459. In our view CRR Article 459 is, however, unlikely to be sufficiently responsive to allow any temporary relaxation of prudential requirements owing to the requirement for the adoption of delegated acts.

There may be the potential to adapt CRR Article 459 to allow it to be more responsive but as mentioned earlier it would be important that authorities act in coordination to ensure that easing by one authority is not unintentionally constrained or undermined by another policymaker.

Internal market considerations

Question 10:

We consider that there is a case for individual countries to have a macroprudential authority to take into account regional specificities and systemic risks at local or regional levels. It is essential though to consider further the transnational aspects of macroprudential policymaking. This would entail the ability for the ECB to loosen macroprudential requirements where necessary in addition to their current ability to tighten national measures, or at least for the establishment of a mechanism for the review of outliers beyond ECB levels and expectations

Global and emerging risks

Question 16

We would note that not all systemic risks need a macroprudential solution and when considering the use of a macroprudential tool for targeting a systemic risk there would need to be sufficient clarity from regulators that this is the most effective approach.

Question 16.1

The risks to financial stability resulting from banks' new competitors should logically be addressed by regulating such new entrants, making sure that they are subject to financial regulation and financial supervision as they commence the provision of financial services and that their operational resilience is subject to adequate monitoring. This can be achieved via "entity-based rules" as recommended by the Bank of International Settlements.

In the meantime, EU DORA will be introduced shortly. This is designed to further enhance banks' operational resilience in regard to use of BigTech (e.g. cloud), FinTech and cybersecurity. We would recommend that policymakers pause until DORA is in place and has been well established, before considering any further macroprudential requirements or increased capital requirements in respect of technology related issues. More widely, while the consultation paper focuses on financial institutions, other entities have also the ability to pose risk to financial stability from their activities.

We believe that a global framework is needed in relation to crypto-assets owing in part to their international nature and scope, and levels of variety in assets and their complexity. We would note in addition that it is intended under the current CRR3 draft that Article 461b should provide the European Commission with a mandate to review whether there should be a dedicated prudential treatment for exposures to cryto-assets by 31 December 2025 and macroprudential tools should clearly not be considered before this time.

Question 16.2

In relation to Cybersecurity, we understand that a BCBS standard will soon be formulated and we would not suggest additional work in this area until it has been introduced and there has been sufficient time to consider its appropriateness.

We would note in particular that imposing an additional layer of capital to specifically address cyber-risk would not seem an appropriate solution as i) other tools are likely to be more effective to deal with this source of risk, ii) it would create overlaps with existing the Pillar 1 and Pillar 2 frameworks, and it would iii) put banks at a disadvantage vis-à-vis non-banks competitors.

Cybersecurity risk is already covered through the operational risk framework. Banks include cyber risk in both their current Pillar 1 Advanced Models Approach and in Pillar 2 scenarios in order to address the following risks: intrusion and contamination of critical IT assets, unavailability of workstations due to malware, hacking, phishing… unavailability of an IT service following the execution of a threat.

When the Pillar 1 Operational risk standard approach (SMA) enters into force, the CET1 capital requirement will substantially increase for European Banks (+ x % according to EBA). In addition, banks will continue to include cyber risk in their pillar 2 scenarios.

Question 16.3

We would note also that there is considerable work remaining in relation to climate risk and agree with the EC's observation concerning the current degree of methodological and data uncertainty. In February 2022, the Financial Stability Institute ('FSI') highlights in its Brief No. 16 'The regulatory response to climate risks: some challenges' that applying the macroprudential framework to systemic climate-related financial risks is likely to be ineffective and potentially counterproductive for financial stability. The FSI states that 'supervisors may increase the resilience of financial institutions by using the pillar 2 framework. Indeed, through stress tests supervisors take into account adverse macroeconomic developments, such as the failure of carbon intensive industries. Hence while potentially helpful, it is not obvious that a climate macroprudential framework is essential to ensure that the financial system is able to absorb systemic shocks generated by climate-related events.' and separately 'macroprudential measures aimed at reducing exposures to carbon intensive firms and sectors may not always be conducive to reducing aggregate climate-related financial risks. In particular, a significant increase in capital requirements for brown exposures, by curtailing the availability of credit to carbon intensive industries would increase the vulnerability of those sectors and hinder affected firms from adjusting their business models.

The potential interplay between macroeconomic cycles and climate risk factors has yet to be clearly established and so the use of macroprudential tools in this area would not be appropriate at this stage. For the time being, significant climate related risks are already covered as part of banks' stress testing and Pillar 2 arrangements and it will be important to ensure that over time overlap or double counting does not occur.

In the meantime, we share BCBS's and EU regulators' and supervisors' view that climate factors are not a new category of risk per se: they are 'risk drivers' of the existing prudential risk categories, especially credit risk, with a potential positive or a negative impact. Given the nascent nature of the collective understanding how the climate risk drivers will impact the existing prudential risks, it seems premature to define a regulatory capital treatment. The introduction of additional capital buffer requirements would also have the effect of disincentivising banks from investing in their own risk management capabilities and take up the capital resources that are needed for such investment.

At a wider level, while banks can clearly form a very effective part of the solution to achieve the objective of net-zero greenhouse gas (GHG) emissions in the EU economy by 2050 they should not be the primary enforcers of the EU climate policy. There is a political responsibility in defining the relevant industrial and tax policies that could ensure an orderly transition and limit transition and physical risk levels, for both climate and financial stability purposes. This was expressed well by the Bank of England in its statement (Climate-related financial risk management and the role of capital requirements, Bank of England, PRA, 28 October 2021) : 'regulatory capital cannot substitute for government climate policy'.

Banks and regulators continue to invest significant resource to understand the transmission channels between climate risk drivers and prudential risk categories (for example through exploratory supervisory scenario analysis and stress testing exercises – ACPR 2020 and SSM 2022). A progressive and iterative development of methodologies and data availability would enable banks to strengthen their risk management frameworks (for example through the building of risk and IT infrastructure and the development of climate specific scenarios) and effectively continue to include climate drivers in their Pillar 2 frameworks.

Additional observations/further points:

We would highlight that the EU buffer framework is derived largely from BCBS standards. This has several consequences on the way this consultation should be considered:

- First, discussions on design and calibration should be undertaken not only in the EU but also at a global level.
- Second, as BCBS standards have changed recently and are being implemented in many jurisdictions, it is essential to take into account the changes introduced by these new rules. The most significant changes are probably the Output Floor and operational risk considerations, which substantially modify the nature of the risks that are addressed as part of Pillar 1.

This supports our argument that all buffers should be considered (P1 & P2, as well as so-called "management buffers" or "capital headroom") that exist on top of minimum capital requirements. A holistic view is necessary to avoid overlap between requirements that may address similar risks and "risk drivers".

While the avoidance of overlaps would require specific definitions of risks to be covered by each buffer, another approach, potentially more pragmatic, could be to calibrate the buffers in a holistic way. For instance:

- At a practical level, there are not different "layers" of capital that are meant to absorb losses stemming from specific risks. Instead, banks hold a certain amount of capital (mostly CET1) that is available to absorb losses.
- In practice, losses do not always stem from one specific risk but from a certain number of risks that can materialise at similar or distinct times and are sometimes interdependent.
- Every risk should not (and cannot) be addressed by a macroprudential tool. We would advise and caution against an approach which would entail the drafting of a list of risks that banks could be exposed to and thereby lead to the creation of additional layers of capital.

We would also like to emphasise two important considerations on the optimal amount of capital to be accumulated by banks and on the way it can be used in order to absorb losses while supporting lending:

- The consultation paper seems to rest on the basic axiom that financial stability increases linearly with increases in capital requirements. Although there is no consensus on what is the "optimal level" of capital for financial institutions, it should be at least recognised that capital accumulation beyond a certain level stifles investments and deteriorates institutions' revenue generation capacity: in other words, too high capital requirements themselves represent a risk to financial stability.

- Also, as acknowledged by the BCBS (although more research is needed), a very important metric to explain banks' reluctance to use their capital resources in times of stress is not the amount of capital they hold but rather their "capital headroom" i.e. the "distance to the MDA": "quantitative work regarding a large sample of international banks and more granular analysis in the euro area suggest that banks closer to their regulatory buffers have been more likely to constrain lending".

Structure of MDA requirements:

With a view to further reducing the risk of MDA stigma, some of the following steps might be considered:

- Removing/reducing cliff effects by reducing the "penalty function" of the upper MDA buckets. In the US, the 23 March 2020 FRB & FDIC joint interim final rule revised the definition of Eligible Distributable Income, enlarging the base to the four last quarters of income gross of distributions and associated tax (rather than net of distributions). The rule also made any automatic limitations on capital distributions less binding, and applied to both capital and TLAC restrictions.
- Avoiding retroactivity: MDA triggered in year N should not apply to profits generated in year N-1.

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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.

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