
CRR3: A Risk-Sensitive and Proportional Approach to the Credit Risk Framework

Executive Summary

Changes in the treatment of credit risk¹ reached at the BCBS's (Basel Committee for Banking Supervision) 2017 Agreement on Basel III¹, and partly already introduced in the European Union through Regulation (EU) 2019/876 ("CRR2")¹, represent some of the widest-ranging and potentially most impactful measures in terms of facilitating or restraining the ability of banks to finance the real economy. When considered in conjunction with the internationally agreed commitment to no significant increases to capital requirements, AFME is broadly supportive of the agreement reached at Basel and implemented so far through CRR2. Nonetheless, we consider that crucial changes to the current framework need to be made in order to facilitate bank lending to the real economy in the post-COVID economic context. In this paper, AFME sets out recommendations for the application of Basel III in the EU, under seven sub-areas of the credit risk framework:

- the treatment of unrated corporates
- the SME and Infrastructure Supporting Factors
- trade finance
- equity investments
- prudential treatment linked to maturity of exposures
- real estate finance
- specialized lending.

These changes are meant to propose more granularity and responsiveness of the prudential framework to the risk profile of different exposures, while ensuring the continued ability of banks to finance the real economy. In addition, the recommendations demonstrate the need for further development of the Capital Markets Union.

Credit Risk: A Brief Primer

In December 2017, the BCBS finalized its addendum to the Basel III standards where the adjustments to credit risk are widely considered to be the most significant. This is because credit risk, or the risk of loss resulting from a borrower defaulting, accounts for the majority of a bank's risks that need to be considered when determining the minimum regulatory capital requirements for the mitigation of unexpected losses¹.

The standards agreed at Basel, and which have been partly implemented through CRR2, introduce significant revisions in terms of the ability of banks to use internal model approaches (IRB - split into Foundation-IRB

¹ Expected losses are accounted for through Loan/loss provisions in P&L, while regulatory capital is built for instances of unexpected losses. For an introduction to some key concepts (capital, liquidity and loss-absorbency), please see [this](#) short AFME note.

and Advanced-IRB²) and standardized approaches (SA) for the calculation of their risk-weighted assets (RWAs), and subsequently, for determining their capital requirements. Namely, the use of the IRB approach has been removed for a number of asset classes and has been constrained elsewhere by placing limits on certain input values (input floors³) to calculate capital requirements. Finally, more granular risk weights (RWs) have been introduced for calculations under the SAs.

In addition, the framework introduces the output floor – a non-risk based backstop sets a floor to the capital requirements calculates under internal models at 72.5% of those required under the standardised approaches for calculating capital requirements for all Pillar 1 risks.

Basel III Reforms: Key Goals

The set of measures agreed at Basel in December 2017 are meant to achieve, inter alia, the following objectives:

- a more risk-sensitive approach to the calculation of RWAs through the introduction for specific RWs for different asset classes under the Standardized Approach (SA);
- constraining the use of internally-modelled approaches;
- complementing the risk-based RWAs with the “Output Floor”, a non-risk based backstop meant to reduce excessive risk-weight variability.

The prudential treatment of credit risk is crucial when considered in conjunction with the current reliance of EU-based corporates on bank lending⁴, as well as the facilitation of the development of the Capital Markets Union (CMU).

Based on these considerations, and in line with the international⁵ and EU commitment⁶ that the upcoming reforms should not result in significant increases to capital requirements, AFME would recommend that the co-legislators consider the following crucial areas in the forthcoming CRR3 proposal.

Implementing a risk-sensitive credit risk framework to aid the post-COVID economic recovery

In the following sections, we set out recommendations for the application of Basel III in the EU, under seven sub-areas of the credit risk framework:

1. the treatment of unrated corporates
2. the SME and Infrastructure Supporting Factors
3. trade finance
4. equity investments
5. prudential treatment linked to maturity of exposures.
6. real estate finance
7. specialized lending

² For the Standardized Approach (SA), risk-weights are pre-determined in the CRR2 regulation, for the Foundational Internal Ratings Based Approach (F-IRB) banks can determine their probability of default (PD) with their internal model, while loss given default (LGD) and Exposure at Default (EAD), as well as Maturity, are determined in regulation. Finally, for the Advanced Internal Ratings Based Approach (A-IRB), banks can determine all the aforementioned parameters using their internal model.

³ Input floors are applied to metrics such as probabilities of default (PD) and loss-given-default (LGD)) to ensure a minimum level of conservatism in model parameters for asset classes where the IRB approaches remain available.

⁴ According to the ECB's March 2020 report, “Financial Integration and Structures in the Euro Area” bank loans continue to feature as the main funding vehicle for the real economy in the EU. While the trend is indeed leveling out to form a more diversified picture, the reliance on bank-lending continues to be dominant.

⁵ <http://www.g20.utoronto.ca/2017/170318-finance-en.html>

⁶ https://www.europarl.europa.eu/doceo/document/TA-8-2016-0439_EN.pdf

1. *The treatment of unrated corporates*

The majority of corporates⁷ in the EU are unrated. While the BCBS has conceded that unrated corporates are not higher-risk assets in the absence of other parameters to determine their credit-worthiness, they nonetheless receive a 100% risk weight (RW), aside from in the case of SMEs⁸, under the External Credit Ratings Approach (ECRA).

EU banks using the IRB approach will need to apply the 100% RW for the purpose of calculating the output floor - while an internal rating may be much lower. All other things being equal, the requirement to apply a 100% RW to unrated corporates in the standardised approach could result therefore in financing becoming more expensive for the EU corporate sector.

On the other hand, according to Basel III, a more favorable RW of 65% is applied to “investment grade” corporates⁹ which are listed on a recognized exchange in jurisdictions where external ratings for regulatory purposes are not allowed (such as in the US), this approach is known as the Standard Approach to Credit ratings (SCRA).

Analysis undertaken by the EBA as part of the Call for Advice exercise which compared the ECRA with the approach for jurisdictions that use the SCRA showed that at least 10% of investment grade unrated corporates (based on proxy data) would be subject to a higher RW of 100% under the ECRA, compared to 65% under the SCRA. However, this analysis fails to take account of the consequent contribution of this impact to the output floor for banks using IRB to calculate capital requirements specifically for unrated corporates. Hence, it is essential that this is addressed in the forthcoming CRR3 proposals.

AFME recommendations on unrated corporates

AFME would recommend a consideration of the following alternative options as potential ways to achieve more proportionate treatment of unrated corporates:

- For the purposes of the calculation of the output floor only, banks using the ECRA could use IRB to calculate the Probability of Default (PD) for their unrated corporate exposures. Depending on the outcome, these exposures would then receive respective risk weights ranging from 20%, 50%, 75%, 100% or 150%, instead of a flat risk weight of 100%. The viability of this option would be further bolstered by the strict approval process required for the use of internal models by the ECB’s TRIM and the IRB repair work undertaken by the EBA.
- Banks should be allowed to “opt-in” to the SCRA for investment grade corporate exposures when calculating the output floor, in order to prevent a disproportionate impact to banks with higher unrated composition of their portfolio.
- Banks should be allowed to apply a 65% RW for “investment grade” corporates (both rated and unrated), and 100% for non-investment grade corporates. The process to assess the creditworthiness of investees is one that all banks undertake, and should underpin the determination of investment grade. Additionally, the Basel requirement for a listing on a recognised exchange should be re-considered given it is not a determinant of banks investment grade decisions.

⁷ The category of “corporates” covers incorporated entities, associations, partnerships, proprietorships, trust funds and other entities that do not qualify under another exposure class. The definition includes insurance companies and financial corporates that do not meet the definitions of exposures to banks, securities firms or other financial institutions, as determined by paragraphs 16 and 37 of the Basel III agreement.

⁸ For unrated exposures to corporate SMEs (defined as corporate exposures where the reported annual sales for the consolidated group of which the corporate counterparty is a part is less than or equal to €50 million for the most recent financial year), an 85% risk weight will be applied. Exposures to SMEs that meet the criteria in paragraph 55 will be treated as regulatory retail SME exposures and risk weighted at 75%.

⁹ An investment grade rating is one set at “BBB” or higher.

In addition to these recommendations, it is important to note that the EBA, the European Commission, and Member States, have already considered alternative options for addressing the impact of the Output Floor on unrated corporates. The two most widely noted approaches are the “Banque de France ratings proposal” and the “hybrid approach”, the latter allowing banks to apply the ECRA to rated exposures and the SCRA to unrated IG corporate exposures, while the former proposes the creation of a “Central Bank rating process for corporates” based on FIBEN¹⁰. Both of these options warrant further analysis by the Commission prior to the publication of CRR3 and should be investigated with a view to assessing whether it would address the impact of the floor, whilst also achieving the objective of ensuring the same capital requirements are applied to borrowers of equivalent risk irrespective of the rating methodology used.

2. The SME and Infrastructure Supporting Factors

A key component of the Basel III reforms, already introduced in previous iterations of the framework, is the introduction of “supporting factors” (SF) to facilitate lending to specific types of small and medium sized enterprises and infrastructure projects. The rationale behind the introduction of the supporting factors was the need to offset higher capital requirements introduced by CRR and CRD IV in order to ensure that SMEs and infrastructure projects support European growth. As such, banks may apply the SF as a “discount” on the risk weight, reducing the regulatory capital they need to hold against these specific exposures. This frees up additional capital to be lent to SMEs or infrastructure projects.

According to Commission data, SMEs constitute 99% of all business in the EU, have created 85% of all new jobs in the past five years, and have provided two-thirds of total private sector employment¹¹. As such, they comprise a significant driving force for growth, innovation and social cohesion in the EU. At the same time, investment in infrastructure has steadily declined since 2009, with EIB estimates pointing to the infrastructure investment gap for energy, transport, water and sanitation at EUR 688 billion a year, while the gap for health, education, and social housing at EUR 142 billion a year.

The significance of ensuring the availability of adequate credit flows to SMEs and investing in infrastructure is also reflected in the recently-agreed text for the CRR Quick Fix¹², in which the SME SF is maintained and the Infra SF’s application brought forward from June 2021 to the date of entry into force of the Quick Fix.

The need for a favorable prudential treatment is intensified in the backdrop of the macroeconomic conditions created by the COVID-19 pandemic. Since March 2020, SMEs widely report a deterioration in economic outlook, as do expectations about access to external finance¹³.

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In terms of the Infrastructure Supporting Factor, its introduction follows the same rationale as the one for SMEs. In this case, the “discount” is applied to exposures to companies linked to infrastructure promotion or,

¹⁰ BdF bases its ratings on the FIBEN Companies Database – created in 1978 – which was initially created in order to facilitate the implementation of the monetary policy. Updated on a daily basis, it is based on information obtained from various stakeholders, including banks, businesses, registries of commercial courts, the National Institute of Statistics and Economic Studies, newspapers with legal announcements (legal bulletins) and many others.

¹¹ https://ec.europa.eu/growth/smes_en

¹² <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0873&from=EN>

¹³ Source: ECB Survey on the Access to Finance of Enterprises, May 2020. Specifically, the net percentage of SMEs reporting an improvement in the availability of bank loans declined by 5%, reflected in a concurrent decline in the willingness of banks to provide credit. Interestingly, EU SMEs have started perceiving their own financial situations as a potential impediment in the access to more credit. In addition, for the first time since its 2014 edition, the ECB’s Survey on the Access to Finance of Enterprises has reported a -2% decline in turnover, in net terms. This data paints a picture of uncertainty in terms of the economic prospects for SMEs, even if credit lines and expectations around access to finance may be expected to normalize (reach the pre-COVID levels) upon a stabilization of the impacts of the pandemic.

more specifically, to “entities that operate or finance physical structure, facilities, systems and networks that provide or support essential public services”.

The economic benefits of promoting robust infrastructure are multifaceted, such as the triggering of demand across multiple sectors (i.e. construction material), while, on the supply side, for example, leading to increased labor productivity and reduced business costs through the creation of safer and efficient public transport networks. Investing in infrastructure is also one of the key routes through which the financial sector can promote sustainable finance in the European Union.

AFME recommendations on the SME and Infrastructure Supporting Factors

AFME would recommend that the treatment of SME and infrastructure exposures be maintained as per CRR2 and as brought forward in the CCR quick fix. The implementation of the use of the factors should be maintained, to avoid regulatory uncertainty, and should be monitored to ensure that these SMEs continue to have access to credit in the restrained conditions brought by the COVID-19 pandemic.

3. Trade Finance

Trade finance is linked to short-term transactions in which banks may act as intermediaries between buyers (importers) and sellers (exporters), to facilitate the flow of goods, both domestically and internationally. The key instruments used to facilitate these transactions are confirmed letters of credit, representing approximately 20% of all trade finance instruments, in addition to Unconditionally Cancellable Commitments (UCCs). It should be noted that these instruments, due to their short-term nature, have very low default rates¹⁴, making them a broadly safe asset. These instruments are treated prudentially through the introduction of respective Credit Conversion Factors¹⁵, in addition to specialized RWs.

In terms of provisions made in this regard in the Basel III agreement, the credit conversion factors (CCFs) introduced for the prudential treatment of short-term off-balance sheet instruments in previous iterations of CRR, such as the 20% CCF for trade-related contingent items, should be maintained. According to data by the International Chamber of Commerce, based on real default data from the main trade finance banks, the actual CCFs for these instruments is closer to 8% in default - a determination which would imply they are less risky than the current prudential treatment under Basel III. The 10% CCF treatment for UCCs will necessarily impact end-users and consequently trade, as banks will look to offset the resulting increased cost of capital by providing their services at a higher cost. It is thus significant that the prudential treatment of trade favor its facilitation as a tool to aid economic recovery post-COVID, and that the prudential treatment of trade-related instruments reflect their demonstrated lower default rates.

In this respect, it is important that, at a minimum, the forthcoming CRR3 proposal include Footnote 53 of the final Basel agreement¹⁶, allowing for the interpretation that certain arrangements under specific conditions can be exempted from the definition of commitments.

¹⁴ <https://iccwbo.org/publication/icc-gcd-performance-guarantee-paper/>

¹⁵ A CCF is of less than 100% would thus reduce the capital requirement to be held against the relevant instrument.

¹⁶ As a national discretion, a jurisdiction may exempt certain arrangements from the definition of commitments provided that the following conditions are met: (i) the bank receives no fees or commissions to establish or maintain the arrangements; (ii) the client is required to apply to the bank for the initial and each subsequent drawdown; (iii) the bank has full authority, regardless of the fulfilment by the client of the conditions set out in the facility documentation, over the execution of each drawdown; and (iv) the bank's decision on the execution of each drawdown is only made after assessing the creditworthiness of the client immediately prior to drawdown. Exempted arrangements that meet the above criteria are limited to certain arrangements for corporates and SMEs, where counterparties are closely monitored on an ongoing basis.

AFME recommendations on trade finance

AFME would recommend that:

- Footnote 53 of the Basel Agreement be reflected in the CRR3 proposal, noting that the exemption should be available to all counterparties and not solely limited to corporates and SMEs. Doing so would ensure that the current 0% CCF for UCCs, set in CRR2, be maintained.
- Annex I of CRR2 be amended through the splitting of the “medium risk” category as follows, allowing for more accurate allocation of risk weights in response to the default rates of the respective instruments:
 - Medium-upper risk: documentary credits (issued or confirmed), note-issuance facilities (NIFs) and revolving underwriting facilities (RUFs);
 - Medium-intermediate risk: shipping guarantees, customs, tax bonds, undrawn credit facilities with an original maturity of one-year, short-term self-liquidating trade letters of credit arising from the movement of goods.

These categories should be accompanied by respective CCFs, amending Article 111 of the CRR2: medium-upper risk kept at 50%, medium-intermediate at 40%, medium-low kept at 20% and low risk set at 10%.

4. Equity Investments

In order to reduce perceived variabilities in the calculation of RWAs and resulting capital requirements, Basel III restricts the use of internal models for certain asset classes. Exposures to equity is one of those asset classes, binding banks to use risk weights (RWs) set by regulators in order to calculate their regulatory capital held against equity exposures. The EBA has recognized in part the challenge of this new constraint and recommended to the Commission, as part of its call for advice on implementation of Basel III, that there be a five year phase in to move equity exposures from the IRB approach to the SA.

When compared to the treatment of equity exposures under CRR2¹⁷, the RWs proposed under Basel III constitute a 67% increase for equity exposures generally (from 150% to 250%) and a 167% increase (from 150% to 400%) for venture capital exposures, which are deemed as especially risky “speculative unlisted” assets. Furthermore, under CRR2, private equity exposures as part of a well-diversified portfolio under the current IRB simple method receive a RW of 190%, but diversification of equity exposures does not appear to have been considered in Basel III. Hence, this necessitates a closer consideration of how the concept of “diversification”, as set out in Article 155 of CRR2, can also continue to apply in CRR3. As part of a well-diversified portfolio, it would be prudentially sound for private equity exposures to receive a lower RW.

Another crucial component in recalibrating the treatment of equity exposures is the definition of venture capital. The final Basel III agreement¹⁸ broadly defines companies falling under the category of Venture Capital as “investments which are subject to price volatility and are acquired in anticipation of significant future capital gains”. This definition lead to the highest increases in risk-weights being applied very broadly across this asset class. In closer alignment with the EBA’s guidelines of January 2019¹⁹, the definitions should be adjusted to reflect a smaller number of clearly quantifiable variables behind these definitions, such as the purpose of investment, business age, turnover and profitability.

Finally, this new treatment of equity exposures will also have a disproportionate impact on decentralized banking groups, which because of their business model have significant holdings on financial subsidiaries.

¹⁷ Article 155

¹⁸ Paragraph 51

¹⁹ “this includes exposures to firms that provide funding to newly established enterprises (e.g. funding for the development of a new product and for the related research for the enterprise to bring this product to the market, and funding for the build-up of the production capacity of the enterprise or for the expansion of the business of the enterprise).”

This treatment can disincentivize cross border investments, including the acquisition of banks inside or outside the EU.

AFME recommendations on equity investments

AFME would recommend that:

- The co-legislators adopt the EBA's recommendation for a five-year phase-in to move equity exposures from the IRB to the SAs
- The definitions of venture capital and private equity investments be separated, acknowledging their distinct characteristics and risk profiles. In particular, the definition of venture capital the definition of "venture capital" should focus on a small number of quantifiable variables for example the purpose of the investment, business age, turnover and profitability.
- Equity exposures as part of a well-diversified portfolio should be defined for the purposes of CRR and attract a RW below 250%. Intragroup exposures should maintain the current RW under the SA.

5. *Treatment of exposures in accordance with their maturity*

The ability to consider the length or maturity of an exposure is a key component of a risk-sensitive approach to calculating RWAs. To this end, Basel and CRR framework set out how the maturity of exposures should to be incorporated into capital requirement calculations for the SA and IRB. In this respect the standardized approach to maturity does not differentiate to the same extent under the IRB approaches, for the length of the maturity, apart from short-term interbank exposures which receive a preferential treatment. The IRB approaches, however, recognize and reflect that the longer the maturity of an exposure - the higher the risk. For example, given two exposures to a particular obligor, one with a maturity of 1 year and the other with a maturity of five years, we would expect that the 5-year maturity exposure would be more likely to be downgraded or to default before its maturity than the 1-year maturity exposure, as there is more time for negative events to occur before the 5-year exposure fully pays back. While the maturity treatment has not significantly changed in Basel III, given the new constraints introduced to the use of the IRB (for instance, banks will only be able to use the less risk-sensitive Foundation-IRB for exposures to large corporates and financial institutions), the maturity requirements should be given due consideration to promote as risk-sensitive an approach as possible. For instance, Basel III grants a discretion to jurisdictions for regulators to allow banks to use an "explicit maturity adjustment" under FIRB instead of a fixed 2.5-year maturity. This is more reflective of the actual maturity of exposures and has also been recommended in the EBA's advice on Basel III.

In addition, as mentioned, under the standardized approach for short-term interbank exposures, Basel and CRR2 grant a preferential maturity treatment (less than three months) so as to not inhibit short-term liquidity between institutions. This same treatment could be considered for short term exposures to corporates such as SFTs, which are usually very short dated and generally have a maturity of less than three months.

AFME recommendations on maturity of exposures

AFME would recommend that:

- National discretion be given for maturity determination when using the F-IRB, instead of the application of a fixed maturity of 2.5 years – as recommended in the EBA's call for advice on credit risk.

- The removal of a one-year maturity floor for use with the F-IRB, as is the case the A-IRB. The one-day floor already exists in CRR and it consists of the clarification of the article 162(3) of CRR. This is particularly important for trade finance transactions which are shorter than one year.
- A lower RW for corporate exposures of short-term maturity of < 3 months, recognizing short-term maturity as a form of risk mitigation. This is currently a provision for intra-bank exposures. Such a provision is crucial for the development of the CMU, as it is linked to capital markets transactions such as Securities Financing Transactions (SFTs), which have a maturity of less than one year and are thus safer.
- A lower RW for interbank exposures linked to the movement of goods across national borders with maturities beyond 3 months up to 6 months – better reflecting the nature of products.

6. Real Estate Finance

The financing of real estate under Basel III, refers to the prudential treatment of exposures linked to mortgages taken for either residential or commercial purposes.

Much of the current treatment of real estate financing under Basel III is linked to a loan's loan-to-value (LTV) ratio, which sets how much a lender finances in proportion to the entire asset value. The LTV is a key tool used to categorize borrowers according to their credit-worthiness – a high LTV (typically over 80%) may call, for example, for additional mortgage insurance to be taken as part of the deal, while a low LTV would imply a creditworthy borrower. The key issue linked to the use of LTV ratios in the calculation of appropriate RWs is the variability of valuation of a property throughout the life of a mortgage – LTVs are themselves set in relation to collateral valuations, which are periodically renewed, which should be reflected in the respective capital requirements held against them. As such, the risks associated with a loan taken are not a function of its value in a single point in time, and not predictive of true mark-to-market values. This is especially the case when markets fall, and banks are more likely to be under stress. As such, the capital required to be held against loans may differ during the lifetime of a mortgage, depending on whether it is re-mortgaged or not, and with all other risk characteristics remaining the same. Consequently, capping the property value at loan origination (as is set out in Basel III) may have a non-risk based, cyclical effect on the calculation of capital requirements held against specific loans.

In terms of the more granular treatment of different components of the same loan, again based on the LTV, the Basel III standards allow for an approach that would allow different prudential treatment for the collateralized part of a loan (the loan splitting approach), or the assignment of a RW to the whole loan (the whole loan approach). The latter recognizes mortgage loans as specific products, with a holistic risk profile, influenced by the LTV. The former allows for flexibility in ensuring that the type of borrower is also considered, as it introduces a specific RW based on the counterparty, to the unsecured part of the loan.

AFME recommendations on real estate

AFME would recommend that:

- Banks should be allowed to decide whether to adopt the whole loan or the loan splitting approach to its portfolios on a consistent basis. This is also supported by the EBA in its credit risk advice on Basel III.
- Current provisions on loan valuation as stipulated in Article 208 of CRR2 should be maintained, as they are sufficiently prudent. Values should reflect the best possible view of current risk, and be subject to upward and downward adjustments, not capped at the origination value.

7. Specialized Lending

Specialised lending (SL) refers to lending towards an entity specifically created to finance or operate physical assets, where the primary source of income and repayment of the obligation lies directly with the assets being financed²⁰. Generally, this type of financing supports many aspects of the economic value chain, from the exploration and production of raw materials and energy, the transportation sector (e.g. rail, aircraft) to public infrastructure. Specialised lending will therefore underpin a large financing part of the European Green deal for the economic recovery in Europe and supporting the green and digital transitions.

Under Basel III, project finance²¹, object finance²², commodities finance²³, income-producing real estate²⁴ and high-volatility commercial real estate²⁵ are considered as sub-categories of specialised lending. There are also three agreed options for banks to calculate the capital requirements for these exposures. Under the standardised approach, which is particularly important in the context of the impact of the output floor, a limited differentiation of RWs is applied to specialised lending exposures. For instance, if it is a project finance exposure, it is assigned a 130% RW in the pre-operational phase, 100% for when it is operational and, for the most high-quality projects, a 80% RW. Whilst for Trade and Commodity Finance and Object Finance a 100% risk weight is applied. As these categories do not fully take into account the security packages and covenants that allow for control over future cash flows, it can result in exposures which carry very different levels of risk being assigned to the same RW bucket.

Basel III maintains the discretion for banks to use internal models for specialized lending exposures, but this is constrained by placing limits on certain parameters (“input floors”) used to calculate the IRB capital requirements, and by applying a fixed haircut to the value of the collateral. These constraints were not subject to an impact assessment when developed at Basel, and the proposed methodology is more appropriate for transactions with liquid collateral at publicly available market prices, which is not usually the case for specialised lending. The methodology also does not properly reflect the broad variety of structures, credit risk mitigants, contractual commitments, future cash-flows and the step-in rights given to lenders. Nor does it reflect the ability to cure and then restructure or sell the project or assets being financed with very limited loss. Overall, the proposed input floors are too high and particularly penalizing for the best-quality structures. Due to the nature of specialised lending, many structures (including most projects) do not rely on a collateral with a market value, potentially leading them to be considered as “unsecured” according to the regulation. And, in other structures, the market value of collateral is less relevant as security is rarely exercised in case of insolvency. Moreover, the very high single level of proposed haircut (40%) does not take into account the wide variety in the quality and liquidity of assets, which is more appropriately taken into account by internal models.

The third way which some banks opt to calculate their capital for specialised lending exposures is the “slotting approach”, whereby they assign each of their specialised lending exposures to one of four risk categories (a slot). Under this approach, Basel gives a discretion to supervisors to allow banks to assign preferential risk weights of 50% to “strong” exposures, and 70% to “good” exposures, provided they have a remaining maturity of less than 2.5 years, or the supervisor deems the bank’s underwriting and other risk characteristics to be stronger than set out in the slotting criteria. Much like in the case of the standardised approach, this could also be adapted to reflect the very highest quality mature operations, and provide more granularity than the four

²⁰https://eba.europa.eu/regulation-and-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-exposures?p_p_id=169&p_p_lifecycle=0&p_p_state=maximized&p_p_mode=view&_169_recordId=1158022&_169_struts_action=%2Fdynamic_data_list_display%2Fview_record

²¹ Project finance is the funding (financing) of long-term infrastructure, industrial projects, and public services using a non-recourse or limited recourse financial structure.

²² A method of funding the acquisition of equipment (e.g. ships, aircraft, satellites, railcars, and fleets).

²³ Commodity finance broadly fits under trade finance, and refers to transactions facilitating metals and mining, energy, and soft commodities.

²⁴ Lending referring to providing financing for real estate where the prospects of repayment depend on the cash flows generated by the asset.

²⁵ Lending referring to financing of commercial real estate that exhibits higher loss rate volatility, compared to other types of lending.

slots available. This provision should be reviewed, as the Basel committee has committed to do so.²⁶ Any supervisory discretion on the application of slots should be applied consistently across the EU. In addition, clarification is needed under the slotting approach on the treatment of guarantees such as unfunded credit protection or Export Credit Agency guarantees.

Overall, with regard to specialised lending, it should be recognised here in particular that the under-developed status of the Capital Markets Union as well as the ambitious objectives of the European Green Deal and Digital Strategy are especially relevant. EU-domiciled funds invest largely in US or Asian markets, driven by higher return expectations and more liquidity – including in the context of project or object finance. It would take a significant amount of time for EU capital markets, let alone a single CMU, to gain the same depth as in the US, or Asia. This is significant because, on top of this consideration, specialised lending assets are very heterogeneous in terms of risk profile and volume, further reducing their attractiveness as investment options within the EU. To this end, the prudential treatment of these assets must encourage and facilitate investment and should not run counter to the EU banks commitment to supporting the financing of the energy and digital transitions

AFME recommendations on specialised lending

AFME would recommend that:

- The standardised approach be recalibrated to introduce more granular RWs to consider the quality of the project, transactions, contractual structure, LTVs (where appropriate for the specialised lending sub-sector) and structuring features (e.g. reflecting self-liquidating trade related exposures). Legislators should also consider adapting the eligibility criteria for applying the different RWs.
- The IRB input parameters should be refined to better reflect quality and collateral of transactions by reducing the input floors (currently 10-25%) to a 10% of loss given default, across all exposures and removing the collateral haircut of 40%.
- Under the slotting approach, the discretion for strong and good exposures should be adopted across the EU and further granularity introduced until it is reviewed at Basel, as well as clarification on the treatment of guarantees.

²⁶ Stated in footnote 3 of the [high-level summary of Basel III](#)