Finance for Europe

CRR3 - Prudential Levers for the Capital Markets Union

Executive Summary

The further development of the Banking Union and of the Capital Markets Union will be at the forefront of financial regulation for years to come. The interactions between these two initiatives cannot be underestimated, as banks are crucial intermediaries in capital markets – primarily providing liquidity through their role as market makers.

The prudential treatment of banking activities linked to market making activities should thus facilitate the functioning and development of European capital markets. In this paper, AFME proposes key prudential considerations that will ensure that banks continue to support the real economy, while at the same promoting a more diversified risk-sharing model in the European financial system.

Introduction

The impact of prudential regulation on the further development of the Capital Markets Union (CMU) is critical. At a time when the European financial system has been challenged, despite showing impressive overall resilience, by the COVID-19 pandemic, the upcoming proposals on the implementation of Basel III in the European Union ("CRR3"), as well as the release of the Action Plan on the Completion of the Capital Markets Union, constitute a unique opportunity to ensure that the upcoming banking reforms and the CMU become complementary and mutually-reinforcing projects.

Capital markets have shown notable resilience during late Q1 and Q2 2020, covering the months most significantly impacted – so far – by the COVID-19 pandemic[1]. Funding originating in capital markets showed a significant increase, while the cost of capital raising has gone up, it has also polarized the market. The best credit quality issuers continue to access capital markets for funding, while lower credit quality issuers have been frozen out of the market, depending on bank credit lines for working capital during the 'dash for cash'[2]. This trend brings to the fore the increased funding needs of European corporates during this uncertain macroeconomic environment, with expectations that corporates will remain dependent on capital markets and banks for funding during this extended period of lower business activity.

As also highlighted by the Final Report of the High Level Forum on CMU[3], it is crucial that the upcoming CRR3 proposal be considered in the context of EU's CMU ambitions, and ensure that the prudential framework achieve two concurrent and inter-linked objectives:

i) Continue to facilitate economic recovery and growth in Europe by encouraging banks to finance the real economy through their balance sheets and through their role in capital markets.

[1] Impact of COVID-19 on European Capital Markets: Market Update: https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME-%20Impact%20of%20COVID-19%20on%20European%20Capital%20Markets%20-%20Update%20-%20Final%20Draft_1-1-1.pdf

[2] https://www.ft.com/content/6b299c42-6c66-11ea-89df-41bea055720b

[3] https://ec.europa.eu/info/news/cmu-high-level-forum-final-report_en

ii) Enable the diversification of funding sources and the reduction of over-reliance on bank lending and provide the European economy with a 'spare tyre' during economic turmoil, when banks' ability to lend is constrained. This 'private' risk sharing mechanism is a key component of a well-functioning and resilient financial system.

This paper provides recommendations aimed at ensuring that the implementation of Basel III in the European Union can contribute towards the achievement of these objectives.

Prudential Levers to support the completion of the Capital Markets Union

The agreement on Basel III reached in December 2017 will be implemented in the European Union through the upcoming legislative proposal for CRR3, expected in 2021.

AFME would recommend that the European Commission and co-legislators consider the following areas as the crucial "prudential levers" for the further development of the Capital Markets Union, in the context of the forthcoming proposal, and wider legislative initiatives:

Key CRR3 revisions for the promotion of the Capital Markets Union			
CRR3 element	**Markets impacted**	**Significance**	**Recommended approach**
Credit Risk - treatment of equity exposures	Equity markets	Banks will only be able to use the SA for equity exposures, where a 250% RW is applied generally and a higher 400% RW applies to venture capital exposures. As the current risk-weighting for a diversified equity portfolio is 150%, banks will become less likely to invest in listed companies, particularly in innovative startups and scale-ups, hampering the development of equity financing and CMU.	The currently very broad definition of venture capital should be aligned with the 2019 EBA guidelines, and all well-diversified equity portfolios should be defined for the purpose of CRR and attract a RW below 250% RW. For more details, please refer to AFME's paper on Credit Risk.
Credit Risk - treatment of Securitization	Securitisation Markets and Real economy	Due to the impact of Covid-19 the level of NPLs is expected to rise. It will be important that any rise in NPLs not impede the ability of banks to finance the recovery. Securitisations can be a key tool in helping banks to manage capital constraints, as well as a useful way of diversifying risk.	Ensure the prudential framework recognises, supports and delivers a level playing field for securitisation as an appropriate tool for both funding and capital management for banks, in each case to support more lending for the real economy.
Market Risk – Fundamental Review of the Trading book (FRTB)	All secondary markets (bonds, equities, derivatives)	Banks' intermediation role in capital markets is particularly important in the EU, where capital markets, and end-users' ability to have direct access to them, are not fully developed. Disproportionate increases in capital requirements for certain trading activities would thus undermine the CMU project.	A globally consistent and simultaneous implementation of the FRTB framework is a key concern. Also, a number of remaining issues need to be addressed both at EU and international level, to avoid interpretive and operational challenges (e.g. Residual Risk add-on - RRAO; rules for Correlation

			Trading Portfolio's - 'CTP', the rules regarding Collective Investment Undertakings and the loss given default for products with multiple underlyings to reflect updated Basel standard). For more details, please refer to AFME's paper on the FRTB.
Counterparty Credit Risk - Standardized approach for counterparty credit risk (SA-CCR)	Derivatives markets	Businesses, investment managers, governments, insurers, use derivatives to better hedge their risks. The flaws in the current SA-CCR calibration increase capital requirements for banks significantly and particularly penalises transactions with end-users that do not have the ability or requirement to margin. This is especially harmful for SME hedging activity in the context of the COVID-19 pandemic.	The risk mitigation effects of netting and margining should be better reflected in the CRR text, as well as the standard re-calibrated to better reflect the true risk as well as to reflect the recommendations of the CMU HLF report, in particular as it relates to addressing hedging costs for end-users. For more details, please refer to AFME's papers on the recalibration of SA-CCR.
Credit valuation adjustment (CVA)	Derivatives markets	The CVA framework is overly conservative with a lack of risk sensitivity. The calibration and design result in costly transactions and do not provide the right incentives for optimal hedging of CVA risk. thereby creating inefficiencies in the functioning and liquid capital markets.	A greater differentiation of risks, particularly as it relates to financial counterparties, should be reflected in risk weights, as well as a better recognition of index hedges and a closer alignment between the accounting and regulatory CVA framework. For more details please refer to AFME's paper on CVA.
Leverage Ratio	Repo markets	Market makers have traditionally played a central role in providing liquidity in relatively less liquid securities, particularly corporate bonds. Repo markets are an important source of funding for market makers' inventories. Banks' inability to net repos and reverse repos in the Leverage Ratio has contributed to a reduction of inventories in corporate bonds.	The LR framework should allow netting of repos and reverse repos to remove the current constraints on market making activities. This would have positive effects on the liquidity of bond markets.

Appendix: a closer look at banks' role in capital markets

The key functions of banks in capital markets

The purpose of the European financial system is to provide diverse and cost-effective credit options to real economy actors, thus facilitating the competitive, sustainable and long-term growth of the European economy as a whole. Banks, specifically, contribute to this objective through the following roles:

1. **Credit provision and capital formation -** Banks act as intermediaries in allocating funds from savers and investors to borrowers, whether they are individuals, businesses, corporations or the governments. Their loans support economic activity by enabling businesses to invest beyond their immediately available cash or individuals to purchase homes without saving the entire cost in advance, and governments to finance large infrastructure and other projects and to smooth out their spending by mitigating the cyclical pattern of tax revenues. When active in primary capital markets, banks help companies and governments to access finance by providing underwriting services by guaranteeing that the amount of financing that the client wants to raise will be available by committing to purchase, at a pre-determined price, any newly issued equity shares or bonds that are not taken up by investors. By removing this uncertainty for the client, investment banks facilitate access to capital markets.
2. **Liquidity provision -** In addition to providing businesses and households with the ability to deal with unexpected needs for cash (through bank deposits that can be withdrawn any time and/or lines of credit), banks are at the centre of the capital markets, by acting as market-makers - offering to buy and sell securities and related products at need, in large volumes, with relatively modest transaction costs. Market-makers bridge sellers' and buyers' needs which often do not coincide. This role of banks, but not just specific to banks, is crucial in injecting liquidity into financial markets.
3. **Risk management -** Banks, mainly through derivatives contracts, offer businesses and investors tools to remove or mitigate risks linked to changes in interest rates, exchange rates, prices of commodities, raw materials and energy products.
4. **Enabling payments -** Banks are largely responsible for the payments system. Electronic payments are becoming more important as people use less cash. This means that banks are processing more card payments, transfers, direct debits, etc. every day. The payment system also includes capital market infrastructure for payments, securities and derivatives, which is a core component of the financial system. Without the ability to conduct transactions safely and efficiently, modern economies would not function smoothly.

Market-making: A closer look

Liquidity is critical to effective market functioning. Corporates, governments and investors need consistent and constant access to funding and investment opportunities at fair, accurate and transparent market prices. Liquidity is also critical for the effectiveness of monetary policy and for financial stability. Banks (and non-bank intermediaries) can greatly facilitate the injection of liquidity into markets through their role as market-makers.

Market-making refers to the creation and maintenance of liquid markets, by ensuring the availability of enough volumes of stocks, bonds, or other instruments, at consistent buying and selling prices. Without this crucial function played by banks, as well as non-bank intermediaries, corporates and governments would find it difficult to raise capital as investors would find it harder to sell their securities (leading to an unwillingness to buy them). By providing liquidity, market-making thus facilitates the efficient allocation of economic resources.