

Priorities and industry recommendations for the CRR3/ CRD6 bank reform package

Implementing Basel III in the EU

March 2021



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* This chapter has been drafted by ISDA and AFME jointly



Introduction

As the European Commission and the EU legislators are preparing to start their work on the next bank capital legislative package, the sixth Capital Requirements Directive and the third Capital Requirements Regulation (CRD6/CRR3), AFME is pleased to present its views and recommendations on key priority areas.

This legislative proposal is expected to be published in mid-2021 and will implement the final elements of the Basel III framework agreed in December 2017 by the Basel Committee on Banking Supervision. Additional issues are also likely to be included in the reform package.

The Covid-19 pandemic has caused an unprecedented economic shock both in Europe but also well beyond. Fortunately, due to the multiple areas of progress since the last financial crisis, banks entered the current downturn in robust financial health. Together with significant fiscal and monetary support from the EU authorities, national governments and central banks, as well as flexibility from regulators and legislators, this has allowed banks to play a pivotal role in helping their customers to raise funding in banking and capital markets or to otherwise manage their debts through the implementation of moratoria. Collectively this support has helped to cushion the impact of the severe downturn on individuals, companies and the economies in which they operate.

The CRR3 proposal will therefore come at an important juncture when policymakers while still dealing with the fallout from the Covid-19 crisis are also beginning to consider the tools that are necessary to ensure a strong and sustained economic recovery. This makes it even more important that the impact of CRR3 is correctly assessed and carefully calibrated, so that it is designed and implemented in a way that does not, unintentionally, constrain banks' ability to support their customers and the economic recovery.

The EBA's evaluation of the Basel III proposals shows Europe's largest banks, which account for most of the region's assets, are still facing a minimum increase of approximately 20% in their capital requirements from the European implementation of Basel III. This estimate, which already runs counter to the G20 and EU commitment of no significant increase in capital requirements, takes no account of the higher actual levels of capital that banks must hold and being based on 2019 data excludes any detailed quantification of Covid-19. It is therefore likely to underestimate the full impact on banks.

At the same time CRR3 needs to be considered in the context of EU's urgent priorities to complete the Banking Union, reduce fragmentation of financial markets and develop and deepen Europe's capital markets through the establishment of a genuine Capital Markets Union.

In this publication we present our recommendations for a CRR3 that is faithful to the overarching objectives contained in Basel III for resilient and comparable banking systems but which at the same time reflects the priorities outlined above and certain European specificities.

It is drafted, as much as possible, with the objective of being accessible to a non-technical / political audience. However, the more technical and expert reader will also find a comprehensive and detailed picture of our positions.

We wish to thank all those who have contributed to this work, including the International Swaps and Derivatives Association with whom we have collaborated on several parts of this publication (FRTB, SA-CCR and CVA). The report is the result of the in-depth discussions with AFME members, many exchanges of views with the real economy actors and constructive dialogues with European policymakers and regulators. We are grateful to them all.

We hope the proposals outlined will contribute to a stronger, more competitive, and sustainable financial market in Europe.



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Overview of AFME's key priorities

Output Floor

- It should be applied at the **global consolidated level**, in order to ensure business model-neutrality.
- It should be calculated using the **Parallel Stack Approach**.

Credit Risk

- **Unrated corporates.** The requirement to apply a 100% risk weight (RW) to unrated corporates in the standardised approach could result in financing becoming more expensive for the EU corporate sector. Possible alternatives include:
 1. For the calculation of the output floor, all banks should use IRB to calculate their PD for unrated corporates –and assign respective RW (instead of a flat 100% RW), or
 2. banks should opt—in to the SCRA for investment-grade corporates, or
 3. banks should be allowed to apply a 65% RW for investment grade corporates, rated or unrated, and 100% for non-investment grade.
- **SME & Infrastructure Supporting Factors.** Both factors should be maintained and brought forward, as in the CRR Quick Fix.
- **Trade Finance.** The “medium risk” category in Annex I of CRR2 should be split further, with respective RWs. All counterparties should be able to exempt certain arrangements from the definition of commitments, following footnote 53 of the Basel Agreement. A 0% CCF for UCCs and a 20% CCF for trade-related contingent items should be maintained.
- **Equity Investments.** A five-year phase-in for the transition to the standardised approaches (SAs). A separated treatment of the “venture capital” and “private equity” definitions, and diversification should be considered as a factor for lowering risk weights (RWs).
- **Maturity.** National discretion for the determination of maturity duration under F-IRB. Removal of the one-year maturity floor. Lower RWs for corporates with short-term maturity, and for short-term interbank exposures linked to trade.
- **Real Estate.** Choice between whole-loan and loan-splitting approach, maintenance of loan valuation provisions in Article 208 of CRR2.
- **Specialised Lending.** Granularity in RWs for the SA. Input floors should be reduced to 10% of LGD for all exposures. Removal of the 40% collateral haircut. Under slotting, further granularity for RWs should be introduced, as well as clarification on the treatment of guarantees, until Basel review.

Operational Risk

- **Internal Loss Multiplier.** Set to 1 across the EU, with appropriate Pillar 2 framework to complement the Pillar 1 framework.
- **Insurance policies.** Recognition of insurance policies as risk mitigation.

SA-CCR

- **Removal of the alpha factor.** This change should be made immediately, via a CRR3 fast-track proposal to limit the cliff effect on bank counterparty credit capital requirements and its impact on the hedging activity by end users and on the real economy. This is consistent with the urgent ask from co-legislators ("Securitization Quick Fix" package - Recital 7b) to review the calibration of SA-CCR by 30 June 2021, and with the approach in other major jurisdictions.
- **Initial Margin (IM).** Better recognition, to reflect risk-reducing properties.
- **Diversification Benefit.** Better recognition across hedging sets within an asset class.
- **Recognition of margining and netting.** Allowance across multiple margin agreements/credit support annexes (CSAs) under one qualifying master netting agreement (QMNA).
- **Alignment with US Implementation.** Allowance for decomposition of commodities and index hedges and use of Internal Model Method (IMM) in context of Large Exposures.

FRTB

- **Collective Investment Undertakings.** No mandatory look-through requirements for Internal Model Approach (IMA), flexibility allowed for look-through in the SA.
- **Residual risk add-on (RRAO).** Only truly exotic instruments subject to 1% charge.
- **Correlation Trading Portfolios.** Decomposition to product constituents to achieve better risk sensitivity.
- **Products with multiple underlying risks.** Calculation based on the LGDs found in MAR22.12.
- **Ensure the viability of internal models.** Remove IMA DRC floor and ensure a workable level 2 approach to Profit and Loss Attribution Test (PLAT) and Non-modellable Risk Factors (NMRF).

CVA

- **Improve RW granularity.** Introduction of distinct RWs by type of financial institution.
- **Better recognition of indices** used to hedge CVA risk e.g. through higher correlation parameter.
- **Greater alignment between regulatory and accounting CVA.** Adjusting margin period of risk (MPoR) floor from 9+N days to 4+N days. Use of expected loss given default (ELGD) for secured exposures.

Sustainable Finance

- **Taxonomy.** The European Commission and co-legislators should focus on the development of a robust, dynamic green taxonomy in the first instance, and then carefully assess the possibilities for any further development of a brown taxonomy.
- **Interaction with prudential framework.** Any adaptation of the prudential framework should be based on a risk-based approach and subject to common disclosure frameworks, lexicons, statistics, and forward-looking risk methodologies.

Prudential levers for CMU

- The European Commission and co-legislators should duly consider the interaction of the implementation of Basel III in the European Union with the **imperative to develop a well-functioning Capital Markets Union.**
- The CRR3 proposal should concurrently encourage: 1) the facilitation of economic growth by facilitating bank lending through appropriate/granular RWs, 2) the diversification of funding sources for private risk-sharing, and the reduction of over-reliance on bank-lending.
- Specifically, the European Commission and co-legislators should consider the **role of credit risk framework (in promoting equity investments), the FRTB, SA-CRR, and CVA** – and their interaction with the ability of banks to maintain a robust role as market makers.

1. CRR3 - Implementation of Basel III reforms in Europe in the context of Covid-19

Executive Summary

The Covid-19 pandemic has had a profoundly negative impact on individuals, businesses and economies - and its multifaceted consequences have still to be understood. European banks are playing a pivotal role in seeking to channel effective and speedy financial relief to where it is most needed. Their ability to do so has been assisted by a combination of regulatory and supervisory relief, as well as action by central banks. However, the upcoming CRR3 legislative proposal to implement Basel III in the EU was already set to raise banks' capital requirements substantially, potentially curtailing their ability to support their customers (or increasing costs for end users). The financial fallout from Covid-19 is expected to exacerbate this partly through deteriorating credit quality amongst banks' customers, which will add to capital requirements. A proper understanding and quantification of these additional impacts and, more importantly, a well-calibrated implementation of Basel III in Europe, consistent with international obligations, is necessary if banks are to continue to play their vital role in supporting customers and markets. To this end, the EBA's analysis of the Covid-19 impact, which was commissioned by the European Commission, falls – by their own admission – far short of what is needed as it is based on end 2019 data which will not capture the impact of the pandemic and assumptions made on qualitative analysis.

It is therefore vital that the European Commission commits to undertaking a further thorough impact analysis of the Covid-19 impact using year-end 2020 data prior to the finalisation of CRR3. Such analysis should be reviewed and updated throughout the CRR3 process, as new data becomes available. Based on this analysis, the Basel III reforms should be tailored in CRR3 to ensure banks can continue to contribute to a smooth recovery from the economic shock of Covid 19 and support deep and integrated European capital markets to drive economic growth.

In summary, all resources should be dedicated to legislative measures that are needed to support the recovery including implementation of the Next generation EU, accelerating the CMU action plan and potential extension and adaptation of Covid related measures.

Introduction

On December 7, 2017 the Global Governors and Heads of Banking Supervision agreed a final set of measures establishing a framework of common standards for internationally active banks to adhere to and operate by to mitigate risk – “Basel III”. These Basel III reforms represent an important step in terms of the finalisation of the G20 reforms, and to make banks and the financial system more resilient to future shocks. However, due to the impact of the Covid-19 pandemic, Europe along with the rest of the world, now finds itself in a very different economic environment to early 2020 when, following an extensive industry consultation, the Commission was preparing to propose measures to implement the final Basel III reforms as part of the upcoming CRR3 proposal. In this new context, it is important to understand the way in which the EU economy has been impacted and how this may affect banks' ability to continue to support their customers and the recovery, while not being unduly constrained by the Basel reforms.

Impact of Covid-19 and immediate policy response

The Covid-19 pandemic has given rise to unprecedented challenges. Businesses across all sectors have faced a massive macroeconomic shock, which has significantly tested their financial and structural resilience. While banks have been a source of relative stability during the pandemic, demonstrating the considerable success of the post-crisis reforms, they have not been immune to recent market liquidity stresses, including multiple days through March to May of historic price volatility amidst diminishing market depth and high transaction costs. Moreover, the Commission's Summer 2020 Economic Forecast projects that the euro area economy will contract by 8.7% in 2020¹. The third quarter EU GDP data published by Eurostat in October showed a strong rebound over the Summer, but the is uncertainty surrounding the duration of the second wave of the pandemic make these improvements very fragile.

International and European authorities, as well as central banks, have responded by providing substantial fiscal, monetary and regulatory relief, including a degree of flexibility on regulatory and supervisory requirements. Interventions by central banks reduced market volatility, and relief measures, such as use of capital buffers and changes to the leverage ratio, enabled banks to free up additional balance sheet capacity to facilitate client transaction and extend lending to real economy. Several of the regulatory adjustments were implemented as part of the CRR Quick Fix² which entered into force on June 27 last year. These measures have been complemented by additional administrative measures, such as the adoption of moratoria and mortgage holidays, aimed at alleviating the impact of the economic downturn on businesses and individuals. Some flexibility was also provided by resolution authorities to seek to ensure that MREL requirements do not overly constrain lending to support the economy. On top of the various regional relief measures instituted in response to the effects of Covid-19, the Group of Central Bank Governors and Heads of Supervision, Basel's oversight body, have agreed a postponement of the implementation of Basel III by one year, to 1 January 2023.

AFME strongly welcomes the quick interventions of central banks and rapid regulatory responses in making these necessary changes. Nevertheless, given the still-considerable uncertainties surrounding both the short term and medium/long term economic impacts from Covid-19, it will be important to review the adequacy of this regulatory support and, specifically, the impact of applying the final Basel III reforms in the new economic environment. In particular, we would note that the one-year delay to the international implementation deadline for Basel III was set at a time when the duration of the Covid-19 pandemic and its impacts were both considered to be relatively short term. Subsequently it has become apparent that the economic disruption caused by the pandemic will be longer lasting and in due course this may warrant a reconsideration of whether the implementation timeline for Basel III should be extended further. At an EU level, the CRR3 proposals could also embed appropriate phasing in of certain elements of the new measures.

Understanding the Covid 19 impact for banks

While the EBA's most recent analysis as part of the Commission's 2020 Call for Advice exercise (CfA) shows a significant drop in the Tier 1 capital shortfall banks will need to meet to comply with Basel III under an EU specific approach, it would still result in an overall increase of 15.9% in minimum required capital for EU banks on average. This is despite the commitment of European Finance ministers in the July 2016 of ECOFIN that *"the [Basel III] reform package would not be expected to result in a significant increase in the overall capital requirements for the banking sector; therefore, not resulting in significant differences for specific regions of the world."* In this respect, the actual increase in capital requirements would be still greater as banks maintain a capital buffer above these minimum requirements which would not be met by banks' current capital surplus which the EBA assumes in its policy advice. Put another way, the EBA's assessment of MRC assumes a 10% CET1 ratio³ compared to an average current ratio of 14.6%. Any shortfall should therefore be measured against the higher level of capital banks hold in practice rather than a purely hypothetical minimum requirement. It should also be noted that no further analysis of the Basel III impact in the Covid-19 context has been possible in 2020, as the regular quantitative impact analysis and data collection exercises were suspended to allow banks to focus on responding to the pandemic.

1 https://ec.europa.eu/ireland/news/summer-2020-economic-forecast-an-even-deeper-recession-with-wider-divergences_en

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

3 This is the amount of capital needed to restore the current level of capital ratio which is of 14.6% CET1 in the EU. While the EBA does not disclose this information as part of the CfA's it's undertaken on Basel (only the capital shortfall to the minimum level of capital requirement), we consider the minimum level of capital requirement to be a broad estimate round 10% CET1 according to SREP 2019 (without P2G).

1. CRR3 - Implementation of Basel III reforms in Europe in the context of Covid-19

While the reprieve from data collection was necessary at the time, an important set of data collection has been missed, and little is understood of the impact of Covid-19 on the economy and bank balance sheets at the height of the pandemic. Furthermore, many of these impacts, which affect banks' capacity to support their customers and finance their recovery, will only be seen with a lag of between twelve and twenty-four months. As a result, we expect the impact of Covid will exacerbate the already significant increase in required capital from Basel III through a rise in risk weighted assets, which is a consequence of deteriorating credit quality. Indeed, this view is confirmed in the ESA's report on risks and vulnerabilities in the financial sector from September 2020, which highlights the impact of the pandemic on credit quality as a key concern, noting that on average, around 57% of EU banks' loans to non-financial companies were towards the sectors most affected by the pandemic, i.e. accommodation, food services, manufacturing, transport and storage, and electricity.⁴

It is welcome that some further analysis has been undertaken in the EBA's response to the EC' CfA on the Covid-19 impact, however, this falls far short of providing an understanding the true impact of the pandemic, given it will not consider any data from 2020, let alone from 2021. This is acknowledged in the EBA CfA, which states: *"There is uncertainty with regards to how banks' balance sheets will change as a consequence of the COVID-19 crisis. The interaction of the Basel III framework and the impact of the COVID-19 crisis can only be properly assessed once the full effects of the crisis on bank balance sheets have played out."* AFME therefore recommends that, at a minimum, the European Commission and the EBA undertake analysis based on Q4 2020 data and this should be updated regularly throughout the CRR3 process and prior to finalisation to ensure a comprehensive assessment of the crisis consequences are taken account of. While we expect much of the impact to filter through later in the cycle, using 2020 data will still give a more accurate account of what the consequences of the pandemic have been for bank capital requirements and asset quality. In addition to the capital impact, it is also very important to carefully consider the impact on MREL/TLAC requirements arising from the expected RWA inflation, as such requirements must be met at all times and are set as percentages of an institution's RWAs and Leverage Exposure. Any inflation resulting from the implementation of the final Basel III Standards will automatically feed through to resolution requirements. The EBA's CfA captures only a subset of the possible impact, with analysis focussing on the difference from current requirements under the first Bank Recovery and Resolution Directive (BRRD), to minimum subordination, and not total MREL requirements, under the BRRD2.

This analysis is crucial, considering that the European economy continues to be predominantly reliant on bank lending, despite data pointing to a slow diversification of lending sources in recent years.

Tailoring the CRR3 proposals to mitigate the impact of Basel III

While precise near-term quantification of the impact of Covid-19 will not be possible within the aforementioned timeframe, there is as discussed above no doubt that, through the impact of the pandemic on credit quality, the effect will be to raise banks' capital requirements beyond the already high estimated impacts flowing from Basel III implementation which preceded the pandemic.

Therefore, it will be crucial that the final CRR3 proposals be tailored to ensure that Basel III be implemented in the most appropriate way, until more informed analysis on Covid-19 can be done. This will allow banks to continue to lend and support growth and capital markets, in order to limit the impact of the pandemic on the European economy in the longer term. AFME's position papers on the specific elements of CRR3 set out several ways in which CRR3 can be tailored in this context, but, in brief, the EU legislators should:

- Implement the calculation of the output floor according to the "parallel stack" method (as set out in our separate paper on the output floor, this would compare the Basel floored capital stack to the non-floored EU capital stack and applying the higher of the two); and, apply it at the global consolidated level.
- Explore different options for the treatment of unrated corporates (as set out in our Credit Risk paper) with the objective of ensuring the same capital requirements be applied to borrowers of equivalent risk, irrespective of the rating methodology used.
- Maintain EU specificities already embedded in the CRR.

⁴ See page 12 https://eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20Assessment%20Reports/2020/932012/JC%202020%2067%20Autumn%202020%20Report%20on%20Risks%20and%20Vulnerabilities.pdf

- Set the Internal Loss Multiplier to 1 for the calculation of capital requirements linked to operational risk, with Pillar 2 capital to complement the Pillar 1 framework.
- Recalibrate the treatment of specialised lending in the standardised and advanced approaches.
- If not done in a separate undertaking to CRR3, review the design and calibration of SA-CCR and reflect market developments, considering its total impact in the prudential framework, including from its use in the calculation of risk-based capital requirements, the Leverage ratio, Large exposure framework and the Output floor.
- Review and potentially recalibrate elements of the FRTB market risk framework to mitigate potentially significant impacts on market liquidity in some asset classes.

International alignment and review

The required time necessary for an impact analysis in preparation for a well-founded CRR3 proposal, in conjunction with the expected negotiation timeframe, means that the ability of the EU to meet even the revised international deadline of January 2023 may be challenging. If the EU process means that there is a need to adapt the timeline for implementation, we recommend that the EU seek to do so in an internationally coordinated way, through a decision at Basel-level. It is important for globally active banks that international standards be implemented following a consistent timeline across jurisdictions, including transitional arrangements, and with a reasonable implementation period for banks once the legislative process is finalised.

Furthermore, the global pandemic has tested the financial system in unexpected ways, which could be a useful catalyst to re-examine some parts of Basel III in a more fundamental way once more data becomes available. Indeed, the BCBS has undertaken to closely monitor the impact of Covid-19 on banks and respond as necessary, in coordination with the FSB and other standard setting bodies. From an EU perspective, they should support a Basel review which considers measures that have had an adverse or pro-cyclical impact on financing the economy. This should include an analysis of the extent to which reduced market liquidity at the height of the pandemic has been driven by post-crisis reforms; calibration and usability of capital buffers⁵; IFRS9; credit quality deterioration and rising NPLs; and regulatory fragmentation. The review should also take account of whether the temporary measures adopted – such as the supervisory discretion to exempt central bank deposits from the leverage ratio (without offsetting) – should be considered on a more permanent basis. Alongside this, it will be important to integrate the longer term macro-economic impacts of the pandemic in respect of Basel III and more generally explore the consistency of implementation and cumulative impact of the reforms. Indeed, we understand that the BCBS will review the post crisis reforms and how the capital and liquidity frameworks functioned during the stress events of March and April, which is welcome. Consequently, the EU should incorporate flexibility in the CRR3 proposals to take account of international efforts to review the framework in light of Covid-19.

⁵ For example, Covid-19 has demonstrated that banks have much less flexibility than expected / desirable to use their capital in times of stress. In this respect, issues to consider include the composition of the buffers, the design of the MDA framework.

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

Executive Summary

Changes in the treatment of credit risk reached at the BCBS's (Basel Committee for Banking Supervision) 2017 Agreement on Basel III, and partly already introduced in the European Union through Regulation (EU) 2019/876 ("CRR2"), 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
- specialised 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 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.

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.

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

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. Specialised lending

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.

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.

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.

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.

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.

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.

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

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, 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 recommends that the treatment of SME and infrastructure exposures be maintained as per CRR2 and as brought forward in the CCR quick fix 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. The implementation of the use of both the SME and Infrastructure supporting factors should be maintained to avoid regulatory uncertainty.

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.

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 specialised 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.

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 or 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%.

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.

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. 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.

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).”

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 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. Specialised 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 European 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 specialised 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 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.

20 https://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.

26 Stated in footnote 3 of the high-level summary of Basel III

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

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.

3. CRR3 - Output Floor: Implementation as a genuine backstop

Executive Summary

The introduction of the Output Floor is expected to have the single largest impact on the minimum capital requirements banks should hold against unexpected losses. Its purpose is to limit the perceived benefit that banks may derive from the use of internal models in assessing capital requirements compared to those calculated using the standardized approaches. According to the EBA's most recent call for advice (CfA), an EU-specific implementation of Basel III will result in an increase to the Minimum Required Capital for EU G-SIBs of 15.9%, with over a third of the required capital increase attributable to the Output Floor itself¹. Although the impact of the floor may be lower than previous EBA analysis, this is largely due to the impact analysis for large institutions, where the gap between modellable and non-modellable RWA has decreased and for other institutions where the baseline capital requirements (current MRC) have increased². Moreover, the CfA also shows that under the EU specific approach that almost half of the banks assessed would be constrained by the Output Floor, representing 60% of their risk weighted assets (RWA)³ making it the key driver in terms of the cost of funding the economy and overriding the function of the leverage ratio. It is therefore crucial that the implementation of the Output Floor reflects the policy intent behind its design: that it functions as a genuine backstop to risk-based requirements - not a constraint, and that its implementation is consistent with the EU and internationally-made commitment to no significant increase in overall capital requirements in the context of Basel III. This is all the more relevant to ensure banks have sufficient capacity to fund the post-COVID economic recovery.

To this end, **AFME recommends that the Output Floor is applied at the consolidated group level, and the EU adopts a "Parallel Stack Approach" for its calculation described below.**

Output Floor: A Brief Primer

One of the central aims of the Basel III reforms was to introduce measures that would reduce any unwarranted variability in RWAs observed across different banks when using the Internal Ratings Based Approach (IRBA)⁴ compared to similar portfolios measured under the Standardized Approach (SA)⁵. To achieve this, in addition to refinements introduced to the risk-based measures (e.g. more risk-sensitive weightings in the credit risk framework), Basel III incorporates two further measures to act as backstops to internal modelling and excessive build-up of leverage, respectively: the output floor and the leverage ratio (which has already been implemented under CRR2).

1 The EU specific approach includes five main EU specificities: supporting factors (which have been applied on top of Basel RWA reductions); maintenance of the CVA exemption; setting the ILM = to 1 under the Operational Risk framework; changes to the treatment of software; and changes to the compositions of Pillar 2. See latest EBA Call for Advice 2020, table 9, "EU specific scenario". By comparison a full Basel implementation will result in a 22.4% increase in MRC for EU G-SIBs for which 6.7% of the increase is attributable to the Output floor (table 8 the EBA CfA): https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961423/Basel%20III%20reforms%20-%20202019Q4%20update%20and%20Covid%20impact.pdf

2 See paragraph 48 of the EBA CfA.

3 See table 20 of the EBA Call for Advice.

4 Internal ratings-based models: internal models used for the calculation of capital requirements, for the use of which approval must be sought by supervisors.

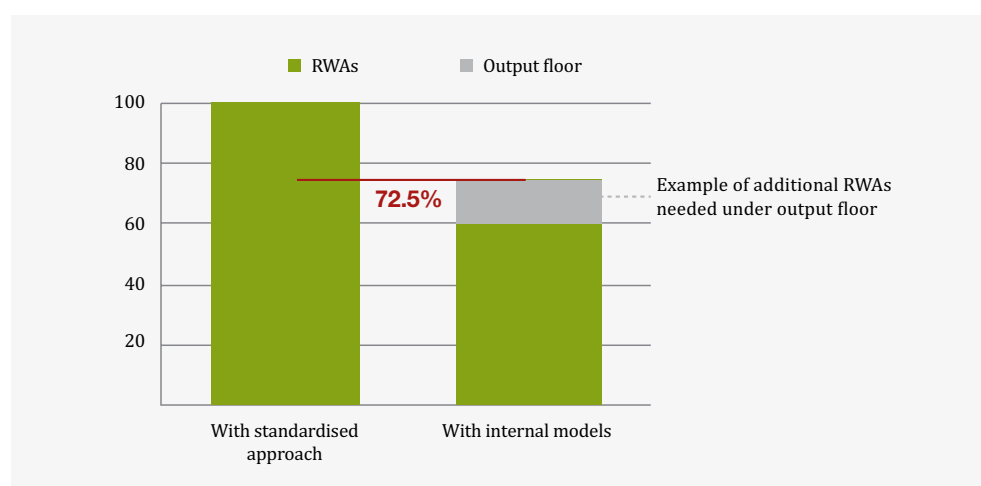
5 Standardized approaches: approaches for calculating capital requirements for which the RWs are set in regulation, and not determined by banks.

3. CRR3 - Output Floor: Implementation as a genuine backstop

Specifically, the revised Output Floor, which replaces the capital floor set in Basel I, limits the amount of capital benefit a bank can obtain from its use of internal models, relative to using the standardised approaches. Banks' calculations of RWAs generated by internal models cannot, in aggregate, fall below 72.5% of the risk-weighted assets computed by the standardised approaches.

The Output Floor will also be phased in over 5 years, thus, taking into account the internationally agreed delay of one year to Basel implementation, the full 72.5% limit should in practice apply as of 1 Jan 2028.⁶ Nonetheless, market expectations often result in banks having to apply measures as soon as they enter into force, because market analysts look at the end state position rather than giving banks the benefit that they will be able to reach targeted levels over the permitted transition period.

Figure 1: **The output floor at work**



In combination with the risk-based changes introduced in the credit risk framework - namely increases in RWAs for unrated corporates, Secured Financing Transactions, equity exposures, and more – it is expected that the Output Floor will have the greatest single impact on European banks of any of the reforms in the final December 2017 agreement. Notably:

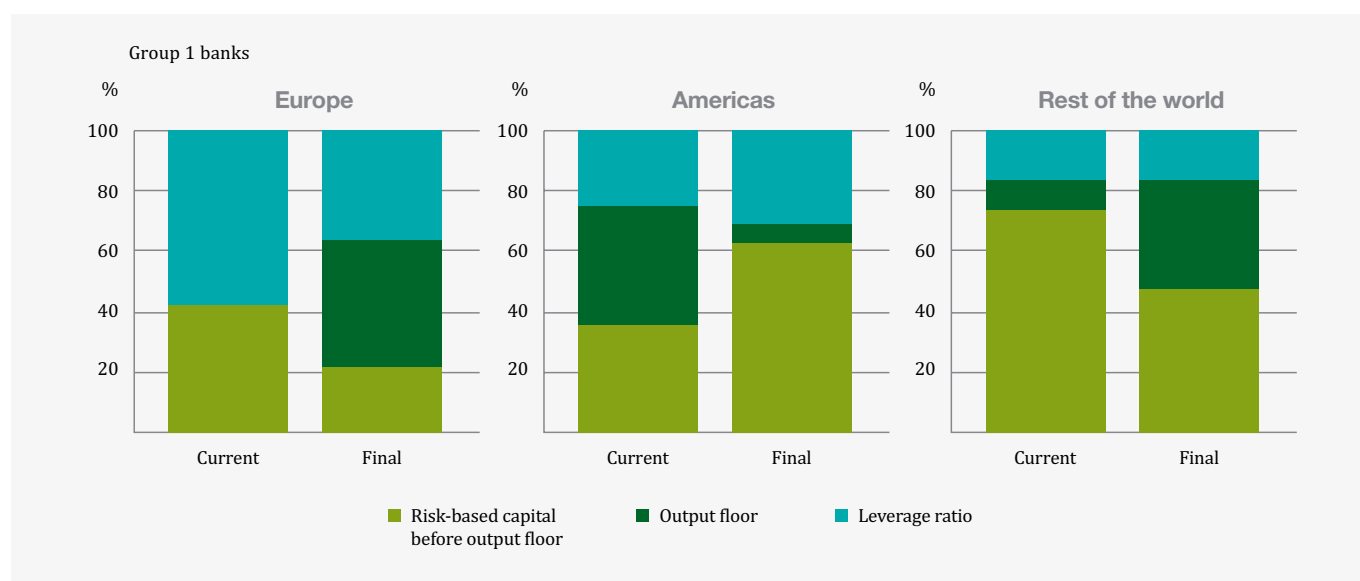
- According to the latest EBA Advice⁷, there would be an increase in minimum capital requirements (MRC) and related capital shortfall (relative to current Tier 1 MRC) of 9.9% points.
- The Basel III monitoring report of October 2019⁸ shows that, due to their use of IRBs, 80% of the largest internationally active European banks would be bound by the Output Floor or the Leverage Ratio) rather than the risk-based requirements.

6 The Output Floor will be phased in starting with a 50% floor on 1 Jan 2023 and rising incrementally by 5% each year until 1 Jan 2028 when the 72.5% will fully apply.

7 See Table 9 EU Specific Approach (combined credit risk and Output Floor increase): <https://eba.europa.eu/eba-advises-the-european-commission-on-the-implementation-of-the-final-basel-iii-framework>

8 <https://www.bis.org/bcbs/publ/d477.pdf>

Figure 2: Percentage of banks constrained by different parts of the framework, by region



Source: BCBS (N.B. the absence of any impact of a floor in Europe currently is due to the fact the Basel 1 floor no longer applies)

The impact of the Output Floor must also be considered alongside the restrictions in the use of IRB approaches introduced by Basel III, which will lead to further increases in capital requirements. Beyond the credit risk framework, the Output Floor is expected to negatively interact with the calculation of RWAs under other parts of the Capital Requirements Regulation, such as the new Standardized Approach to Counterparty Credit Risk (SA-CCR), where the interaction was never considered as this approach was developed prior to the conception of the Output Floor.

At the same time, since 2015 other measures have been developed to address unwarranted variability in RWAs, such as the **ECB's Targeted Review of Internal Models (TRIM)** and the **EBA's repair work for internal risk-based approach (IRB repair)**.

These developments have significantly overhauled how banks use their internal models and have set common EU supervisory approaches to assessing banks' methodology for doing so. EU banks have actively and positively engaged in the development and implementation of these reforms, pre-empting to some extent the objective of the Output Floor and rendering it largely duplicative. In this respect we would note:

- According to the EBA's 2019 Annual Assessment of the Consistency of Internal Model Outcomes⁹, significant progress has been made in terms of accounting for variabilities. The report highlighted that for both the IRB approach and the SA, a top-down analysis of the default mix (share of defaulted exposures) and the portfolio mix (the share of regulatory (sub) exposure classes) **explain more than 70% of the observed variability**, thereby negating the need for a further new backstop to tackle RWA variability.
- A more recent analysis published by the EBA in September 2020 ("Time to go beyond RWA variability for IRB banks: an empirical analysis") concludes: *"the variability of RWA resulting from the IRB approach has been steadily lower than the variability generated by the SA but also that the variability stemming from the IRB approach has remained substantially unchanged in recent years"*;
- The Output floor will not necessarily improve comparability between banks: instead of two RWA categories (SA and IRB), investors and analysts will likely need to analyse a minimum of three (SA, IRB with OF and IRB without OF). Investors wishing to compare across banks are still expected to look at RW before the floor that reflect better the underlying risks.

9 <https://eba.europa.eu/eba-releases-its-annual-assessment-consistency-internal-model-outcomes>

Implementing the Output Floor

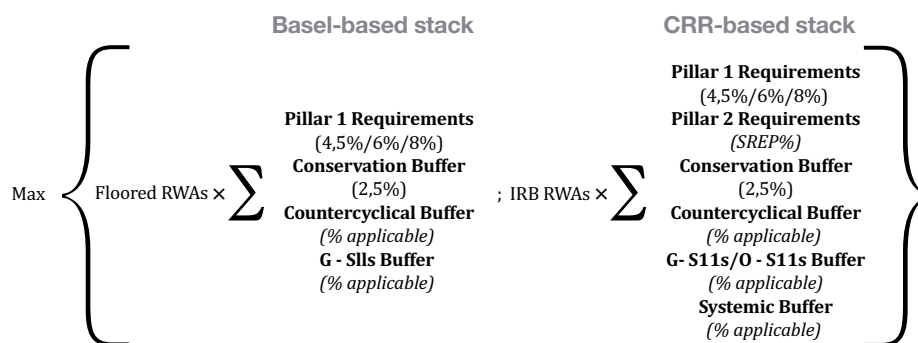
AFME’s recommendations for the implementation of the Output Floor fall under two broad categories. The first one relates to **the method of its calculation**, and the second one to **the level of application**.

1. Calculation Approaches: The “Parallel Stack”

In its Call for Advice on the Basel III Reforms, focused on the Output Floor (submitted on 2 August, 2019¹⁰ and updated on 15 December 2020¹¹), the EBA sets out and analyses three possible approaches for the calculation of the Output Floor – the Main and Alternative Approaches (please see Box 1), and the “Parallel Stack” Approach.

The Parallel Stack approach gets its name from the fact that it would require the calculation of two sets (or stacks) of capital requirements. The first stack would be the product of Floored RWAs i.e. RWAs based on an overall limit equivalent to 72.5% of those calculated under the Standardised Approach and the capital requirements set at Basel, while the second stack would include internally modelled RWAs, capital requirements set at Basel, and capital requirements set by the CRR which, includes the EU-specific Systemic Risk Buffer (SyRB) and Pillar 2 requirements. as further described in Box 1 below.

The Output Floor would then be determined based off of the stack with the highest amount:



AFME considers this approach to be the one most aligned with the intention and drafting of the Basel floor and providing a true ‘backstop’, and simpler when compared to the Main and Alternative Approaches proposed by the EBA (See Box 1). Nonetheless, the Parallel Stack approach has come under the most criticism by supervisors for potentially being non-Base compliant, as it would only require a comparison between two capital stacks, meaning potentially the floor will not be applied at all times if the sum of the non-floored internally modelled capital requirements is higher. This has been refuted by analysis of the Legal High Committee for Financial Markets of Paris¹² which has determined the Parallel Stack is indeed legally compliant with Basel III, which only requires banks to apply the “maximum of” either the floor or the modelled RWA. Moreover, there is some concern from regulators that banks would use elements of the Pillar 2 requirements and the Systemic Risk Buffer (SyRB) which cover “other risks” to meet the Output Floor requirement. However, it has not been set out what these “other risks” might include, nor is it clear how much capital this would amount to as under Pillar 2 as there is no breakdown of what capital is assigned to address the additional risks banks might face under this requirement. On the other hand, if the Commission does not adopt a parallel stack approach, one could consider that Europe has a super equivalent framework (additional specific buffers and pillar 2 capital requirements).

10 <https://eba.europa.eu/sites/default/documents/files/documents/10180/2886865/d00198e3-82ab-4bc8-bb4b-8d95e7e777c1/Policy%20Advice%20on%20Basel%20III%20Reforms%20-%20Output%20Floor.pdf?retry=1>

11 <https://www.eba.europa.eu/eba-updates-its-basel-iii-impact-study-following-eu-commission%E2%80%99s-call-advice>

12 https://www.banque-france.fr/sites/default/files/rapport_28_a.pdf

Indeed, the Parallel Stack approach is the one most likely to reduce any risk of gold-plating of the Output Floor during its implementation. This is because the other two approaches go beyond the Basel III rules in basing the calculation of capital requirements on a consolidated capital stack, **including the EU-based capital requirements** of Pillar 2 and EU-specific capital buffers. However, Basel III only requires the capital floor be calculated based on Basel-based capital requirements and international capital buffers. The addition of EU-specific capital requirements specifically Pillar 2, would introduce a level of variability between banks' capital ratios that would make comparability difficult – since Pillar 2 capital requirements are bank-specific, and decided by national supervisors, varying greatly by jurisdiction. Moreover, the SyRB is also designed to address macro-systemic risks such as asset bubbles, not model risk. The application of Pillar 2 and the SyRB also range widely between member states¹³.

Finally, it should be noted that a faithful Basel implementation is essential in the context of international consistency, given the significant impact for EU banks relative to other parts of the framework.

AFME recommendations on the calculation of the Output Floor

AFME recommends that:

- The “Parallel Stack approach” is adopted uniformly for the calculation of the Output Floor. This should be based on setting own funds based on the higher of:
 - The capital requirement resulting from the application of the capital ratios that are mentioned in the Basel text (minimum capital requirements, capital conservation buffer, countercyclical capital buffer and G-SII buffer) and the floored RWA; this would not consider the SyRB and P2R ; or
 - The capital requirement resulting from the application of all capital requirements (including P2R and the SyRB) and the RWA stemming from internally modelled approaches.
- The Output Floor would then be limited to minimum capital requirements set through Pillar 1 and internationally agreed capital buffers so that it is a genuine ‘backstop’.
- Given the impact of the floor, the European Commission should investigate and explain why it is so binding for EU banks relative to other parts of the framework. This could be undertaken as part of the impact analysis the Commission is required to do prior to the publication of the CRR3 proposals. In light of this, they should also consider whether there are any global consistency implications in terms of outcomes. If any are identified, the EU should consider re-addressing these at the global level, failing which it should be addressed in the EU.

13 <https://www.bis.org/bcbs/publ/d465.pdf>

Box 1: Limitations of the Main and Alternative Approaches

In its Policy Advice on the Output Floor, the EBA described two additional approaches for the calculation of the floor in determining minimum capital requirements – the Main Approach and the Alternative Approach. In brief, the purpose of the different calculation approaches is to determine the extent to which the Output Floor should be applied to the capital requirements set additionally by European regulations (CRR), beyond the ones stipulated at Basel level.

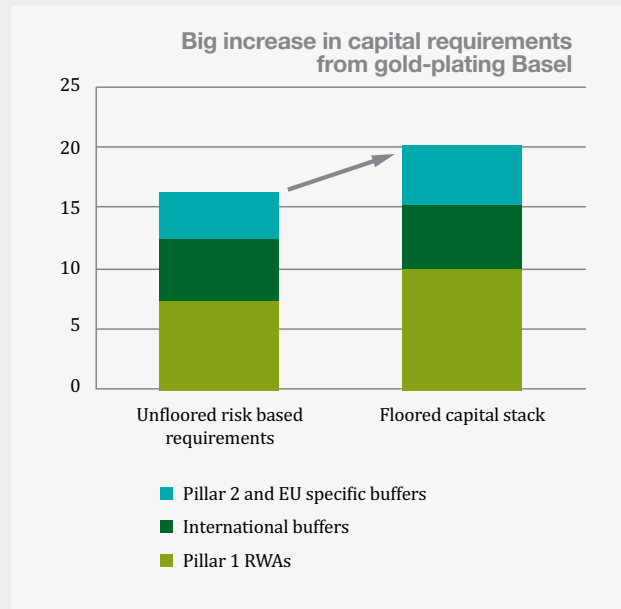
The Main Approach stipulates that the Output Floor must apply to all regulatory capital requirements, including both those set at Basel level, and those set at EU level, hence gold-plating the international agreement. The floor would be the product of two components: floored RWAs and international capital buffers (set by Basel) and the floored capital requirements stemming from EU and banks specific requirements, namely the Systemic Risk Buffer (SyRB), the other systemically important institutions (OSII buffer) and Pillar 2 requirements, which is additional capital set by the supervisor to cover individual bank risks not captured by the CRR.

The Alternative Approach likewise includes all components of the capital stack (both Basel and EU) but applies the floor just to the Basel RWAs and international capital buffers, whereas the EU specific SyRB and Pillar 2 capital requirements are calculated on the basis of the bank’s RWAs from internally modelled approaches (meaning this would still be a gold-plating of Basel).

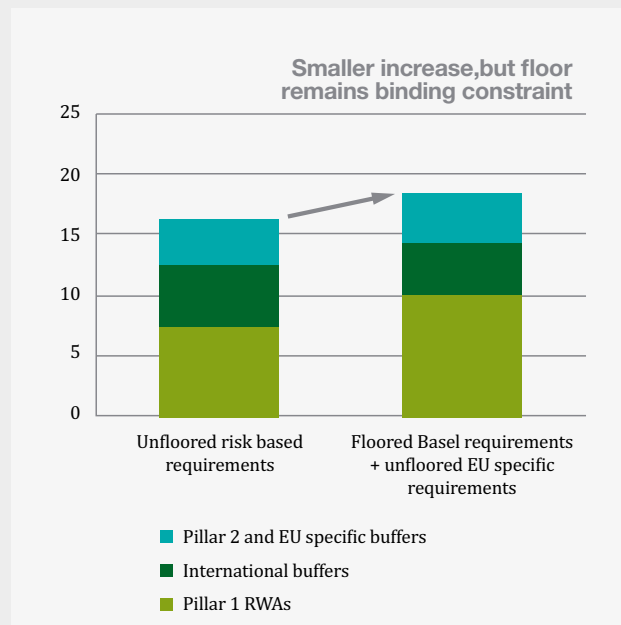
It is AFME’s view both these approaches go beyond what was set out in the Basel text in determining the application of the floor so that it acts as a ‘backstop’. Indeed, while the EBA has argued that taking into account Pillar 2 and SyRB would make for a simpler EU calculation of the floor, it is our view that neither Pillar 2 nor the SyRB are specifically targeted at risk weighted variability which the Output Floor is designed to address.

For more information concerning the estimated increases in capital requirements for EU and US banks, please refer to: the EBA’s Basel III Reforms: Impact Study and Key Recommendations. Please note, this has also been more recently updated in terms of impact analysis in the EBA’s 2020 Basel III impact analysis.

Option 1: ‘Main approach’ - (fully floored Basel and EU specific requirements)



Option 2: ‘Alternative approach’ - (floored Basel + unfloored Pillar 2 and EU specific requirements)



2. Application of the Output Floor at the Consolidated Level

When the final agreement on Basel III was reached, the only assessment of impact and calculation of the Output Floor was based on analysis calibrated at the consolidated group level. This would imply that the floor should be applied at the aggregate RWA level of the group, and not at the level of each jurisdiction in which a bank has an entity. Indeed, the only empirical analysis of the Output Floor to date has been made on the consolidated basis, apart from limited policy analysis and advice undertaken by the EBA¹⁴, which did demonstrate nonetheless some impact on specific business models including corporative and universal banks.

Should the Output Floor be introduced on an individual entity (solo) level as well as a consolidated level, then banks which choose or are obliged to arrange their business model in such a way so as to lower risk, by spreading activities across different subsidiaries may be constrained in doing so. Furthermore, if the Output Floor applied at the level of the regulated entity, it may result in overly penalizing a subsidiary for exposures that are not relevant at a consolidated level. This may result in the Output Floor being more favourable to one business model over another, reducing and limiting the tools banks have at their disposal for the management of their risks, for which subsidiary structure is an important consideration. This is especially the case in Europe, where the universal banking model allows for risks to be diversified at group level. The results of an Output Floor calculation at the solo level would therefore constrain banks wanting to diversify risks, without any practical implications for better risk management and bias a more consolidated business model.

This view has received public support from the SSM. In a recent speech at the November 2019 European Commission hearing on Basel III, Andrea Enria, Chair of the SSM, stated the following, which AFME supports: *“...they should apply it [Output Floor] at the highest level of consolidation. This would be simpler, because each banking group would only have to calculate the output floor once. It would also be in line with our goal of supporting a truly European banking market. If the output floor were to be applied at the individual level, the European banking market would fragment further. This cannot be in our interest.”*

Furthermore, from an international perspective, the co-legislators should reflect on the requirement for the level of application of the floor at the global consolidated group level as, in the interests of international consistency, if all global regulators take such an approach it will not be necessary to apply at the level of each jurisdiction in which the bank has an entity.

AFME recommendations on the level of application of the Output Floor

AFME recommends that: The Output Floor is applied at the global consolidated level, in order to ensure it is truly business model-neutral, allow banks to diversify their risks, and avoid regulatory fragmentation.

14 <https://eba.europa.eu/about-us/missions-and-tasks/calls-for-advice>

4. CRR3 - An efficient, forward-looking framework for Operational Risk

Executive Summary

The final agreement reached by the Basel Committee on Banking Supervision (BCBS) in December 2017 (“Basel III”) has brought significant changes in the way banks are expected to calculate capital requirements linked to their management of operational risk. Notably, the ability of banks to use internal models for these calculations has been removed, replaced by a single Standardized Measurement Approach (SA-OR) that applies to all banks. The SA-OR is strongly based on the use of banks’ own historical loss data through the Loss Component (LC) in the Internal Loss Multiplier (ILM), with the assumption that historical loss from operational risk is an accurate predictor of future loss. While AFME welcomes the BCBS’s intention of streamlining measurement approaches and introducing risk-sensitivity into the operational risk framework, we maintain key concerns as to the suitability of the SA-OR for achieving this purpose – primarily due to the evidence showing the unreliability of the historical loss data. The other key omission in the framework is that it lacks a forward-looking component that would allow for dynamic risk assessment, as well as the consideration of risk-sensitivity, while maintaining adequate capitalisation. Additionally, SA-OR does not account for areas of risk that have yet to generate material losses, such as cyber risk, other new technologies and operational resilience. Such risks should be captured in a harmonised Pillar 2 framework.

In order to mitigate these effects, AFME makes the following recommendations:

- Setting the Internal Loss Multiplier (ILM) to 1 - By setting the ILM to 1, as is currently the supervisory discretion that can be applied at a jurisdictional level, the limitations and volatility of capital charges caused by using rolling 10-year historical data can be neutralized.
- Appropriate recognition of insurance policies in the SA-OR. Insurance policies are a significant form of risk mitigation and should be recognized under SA-OR with a cap on the own fund requirement reduction to 20% of the amount of the own fund requirement before the recognition of risk mitigation techniques. The SA-OR is the only part of the BCBS framework that does not provide for a straight and forward-looking risk mitigation benefit for hedges bought to limit underlying risks and only recognises loss mitigation through recoveries under the loss component after the bank has received the payment.

Operational Risk: A Brief Primer

The Basel III standard introduces significant changes to the prudential treatment of operational risk, which refers to risk of loss resulting from failed internal processes and planning, people (human error) or from external events, including legal risk¹. The BCBS and the EBA concluded that capital requirements for operational risk, particularly under the Advanced Measurement Approach (AMA) had proved insufficient to cover operational risk losses, particularly relating to misconduct charges in the aftermath of the financial crisis. However, past failures that resulted in losses are often addressed by other regulatory reforms. These include the change in the calculation of benchmark rates (e.g. IBOR transition), the Market Abuse Regulation², the Senior Managers Regime (covering global FX code of conduct, in some jurisdictions) and MiFID³, which has directly addressed many of the conduct risks that were big contributors to past losses in the lead-up to the financial crisis. AFME is strongly of the view that, accompanied by a well-calibrated prudential treatment, sound operational risk management can be a key component of the maintenance of financial stability, and the ability of banks to channel capital to the real economy.

The key change introduced by the 2017 BCBS agreement is the introduction of the Standardized Measurement Approach (SA-OR), applicable as of 2023, as the sole measurement method, replacing all previously used approaches agreed at Basel II⁴. The SA-OR is meant to be more risk-sensitive and foresees the calculation of capital requirements as the eventual function of two variables: the Internal Loss Multiplier (ILM) and the Business Indicator Component (BIC).



The ILM indicator is predicated on an individual bank's internal loss history over the preceding 10 years. The implications of this characteristic of the framework are that banks are expected to have very robust historical internal loss data, which is necessary to support their claims for setting a specific ILM.

In terms of the remaining parameters, the Business Indicator (BI) is comprised of the sum of the interest, leases, and dividends component, the services component and the financial component, all comprising specific combinations of P&L items that constitute a bank's gross income. The Business indicator Component (BIC) is calculated by the multiplication of the BI with certain marginal coefficients (12, 15 or 18%). The marginal coefficient used is predicated on the range of the BI, which places banks in different "buckets" in accordance with their income – the higher the BI range (as BI is linked to income), the higher the marginal coefficient.

BI bucket	BI range	Marginal BI coefficients (α_i)
1	≤ €1 bn	0.12
2	€1 bn < BI ≤ €30 bn	0.15
3	> €30 bn	0.18

1 <https://www.bis.org/bcbs/publ/d424.pdf>, p.128

2 MAR aims to increase market integrity through the prohibition of insider dealing unlawful disclosure of insider information and market manipulation.

3 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en

4 The approaches replaced include the Basic Indicator Approach (based on the annual revenue of the bank), the Standardised Approach (based on the annual revenue of the bank per broad business line), and the Advanced Measurement Approaches (based on internally-developed RWAs, within certain parameters).

4. CRR3 - An efficient, forward-looking framework for Operational Risk

The assumptions behind the formula are that operational risks increase more than proportionately to a bank's income.

Aside from the intended risk-sensitivity through the consideration of individualized internal 10-year loss history through the Loss Component (LC), the SA-OR is meant to also facilitate the comparison of RWAs between banks by reducing the use of various different calculation approaches, as well as through the removal of the use of banks' individualized internal models. These provisions have respective reporting (Pillar III) implications.

The Internal Loss Multiplier: A Closer Look

The ILM is a historical loss-based parameter for calculating capital requirements linked to operational risk. The "risk-sensitivity" is theoretically achieved due to the ILM being a function of the BIC and the Loss Component (LC), the latter indicating 15 times a bank's historical operational risk losses over 10 years, while allowing discretion for some banks to use a 5-year data. According to the BCBS calibration, when the BIC is equal to the LC, the ILM is equal to 1, thus neutralizing its effect on the calculation of capital requirements. The Basel III agreement also allows for the ILM to be set to 1 under supervisory discretion for all banks within the jurisdiction. This implies that the calculation of capital requirements would not be linked to the historical loss data and is solely based on the BI.

While AFME is broadly supportive of the aim to simplify and streamline calculation approaches, as well as to introduce more risk-sensitivity to the operational risk framework, we maintain our key concerns as to the suitability of this approach to properly address the operational risk of institutions, as explained in detail the following section. It is also worth noting that the Basel Committee is updating its Principles for the Sound Management of Operational Risk, which banks will need to adhere to. These guidelines provide a much more comprehensive view of operational risk and how it should be managed than the overly simplistic and backward-looking SA-OR.

Implementing an efficient framework for Operational Risk

AFME's reservations as to the suitability of the SA-OR framework are predicated on:

- The historical loss data is not a robust predictor of future losses.
- The lack of accommodation of recognition for improvements within the 10-year period covered the data used for ILM calculation, or for new regulations adopted by the regulators.
- The lack of recognition of risk mitigation methods, such as insurance policies, in the framework; and
- the expected increase in capital requirements as a result of the SA-OR, as concluded by the EBA's Policy Advice on Operational Risk is disproportionate for majority of large EU banks. This reduces the supervisors' ability to assess minimum operational risk capital requirements and to address any institution specific weaknesses via Pillar 2 capital requirements.

The degree of accuracy of the risk sensitivity in the SA-OR framework is based on the reliability of historical data, which comprises a key component for the calculation of the ILM. Academic literature, expert research and empirical evidence suggests that past operational risk events are not an accurate predictor of future performance, despite this being one BCBS's assumptions in proposing the SA-OR:

- **Curti and Migueis⁵**, suggest that the information value of past losses, as predictors of future losses, reduces significantly as such losses become older than three years. In addition, the frequency and severity of losses as indicators of potential future exposure behave differently. While recent loss frequency data and changes in average frequency perform better as future loss indicators (see Graph 1 below), the severity component is more volatile (e.g. due to large conduct-related fines) and is thus a less reliable indicator. Curti and Migueis observe that treating frequency and severity separately results in better information of likely future losses compared to relying solely on past loss totals, as the ILM does. This separation would imply that frequency and severity are not strictly linked.

⁵ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3353446

- **The Institute and Faculty of Actuaries** has noted the value of using factors in addition to internal loss data in order to better estimate the appropriate level of operational risk. In particular, it observed that “a key limitation of both internal and external loss data is its historic perspective of loss exposure. A forward-looking perspective of operational risks is required, which has regard to changes both in gross exposure and in the controls environment. Business Environment and Internal Control Factors (BEICF) can contribute to such a perspective.⁶
- It is evident by observing the industry-wide operational loss history in the run up to the 2008 financial crisis that consistently low losses are not a safe predictor of future levels. (see Graphs 1 and 2 for periods 2008 – 2012).

Figure 1: Mean Annual Loss Frequency per bank:

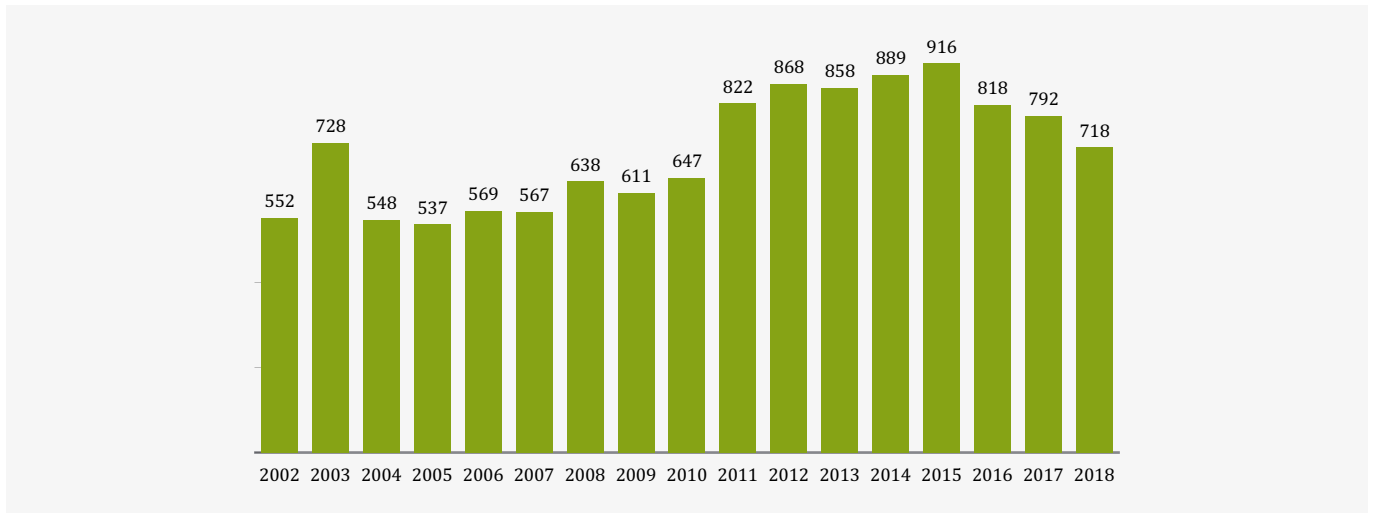


Figure 2: Mean Annual Gross Loss per bank:



⁶ <https://managingrisktogether.org/loss-data/annual-banking-loss-report>

4. CRR3 - An efficient, forward-looking framework for Operational Risk

As such, the capital requirements resulting from a variable ILM does not seem to reflect the level of operational risk that banks are actually facing, or are intending to assume through their business model, nor the resulting current and future risk exposures that they manage.

On that point, the EBA's Policy Advice⁷ notes that: “[i]t is assumed that exposure to operational risks is increasing [...]; therefore, any gains in competitiveness that may result from setting the ILM equal to 1 in the short run for some banks could eventually be offset by insolvency issues or capital shortfalls in the long run.” It is unclear however, as one can see from the above data how the ILM, being backward looking, could help authorities and banks predict such increasing risks and how it could help to avert capital shortfalls.

The challenge of using past losses to predict future losses is that such an approach assumes a steady-state world rather than the reality of the changing environment in which banks operate. In practice, past failures which give rise to losses are often addressed by other regulatory reforms. These include the change in the calculation of benchmark rates (e.g. IBOR transition), the Market Abuse Regulation⁸, the FCA's Senior Managers Regime⁹ (covering global FX code of conduct, in some jurisdictions) and MiFID¹⁰, which has directly addressed many of the conduct risks that were big contributors to past losses in the lead-up to the financial crisis. Although new methods could give rise to different problems, it is assumed that the introduction of regulatory reforms substantially mitigates the risk that the same type of issues will cause. Conversely, the changing technological and economic environment presents entirely new risks, e.g. cyber-risks, which could at some point materialise in loss events for some banks.

Another key limitation of the SA-OR approach is its lack of provision of adequate incentives. Except for divestment of loss-creating activities, the SA-OR with a variable ILM fails to recognize improvements made by banks after loss events. Such improvements include revised risk management, enhanced legal analysis, additional client and transaction vetting on origination, increased training and compliance scrutiny. Furthermore, because of the 10-year duration, the SA-OR with variable ILM this may create incentives for inertia in Operational Risk management in the short-to-medium term.

As a result, and when considering the internationally-reached agreement to no significant increases in capital requirements as part of the Basel III implementation, AFME considers that the SA-OR parameters need to be carefully considered by the co-legislators in the upcoming CRR3 proposal. According to the EBA's Policy Advice, the introduction of the SA-OR would lead to a total increase of operational risk RWAs by 37%¹¹ and over a 50% increase for the largest banks in the EBA's sample.

To mitigate this increase in capital requirements, as well as the limitations based on the use of historical data, AFME would recommend that the ILM be set to 1 uniformly, across all European jurisdictions and banks, which is currently a discretion granted to national supervisions by the BCBS standard. According to the updated EBA response¹² to the Commission's Call for Advice, the EU-specific scenario of setting ILM to one for buckets 2 and 3 would result in 2.1 percentage point reduction in the increase in overall MRC compared to the baseline scenario (which includes full ILM implementation). Given the shortcomings of SA-OR and to underpin the Pillar 1 capital requirements, the EU should instead consider a Pillar 2 framework to capture excessive and likely recurring losses, **as well as forward-looking treatment of specific risks related to cyber, technology and unauthorised (misconduct) activities.** Such a Pillar 2 approach could partially offset the reduction in MRC due to setting the ILM to one, but based on individual banks' risk profiles rather than the loss history that may include data that is not relevant to the current risk profile of the bank.

7 <https://eba.europa.eu/file/113256/download?token=R3Q2uetO>

8 MAR aims to increase market integrity through the prohibition of insider dealing unlawful disclosure of insider information and market manipulation.

9 <https://www.fca.org.uk/publication/corporate/applying-smr-to-fca.pdf>

10 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en

11 <https://eba.europa.eu/sites/default/documents/files/documents/10180/2886865/5db69327-7d3f-4e6c-9ac9-fc54430781eb/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20Operational%20Risk.pdf>

12 https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961423/Basel%20III%20reforms%20-%202019Q4%20update%20and%20Covid%20impact.pdf

In addition, the SA-OR should give better recognition to risk management and risk mitigation processes, such as insurance policies. They are so far only recognized through the Loss Component and thus not in a forward-looking approach as per the above. Insurance **should be included in the SA-OR framework as it was in the AMA, i.e with a reduction capped at 20% of the initial own fund requirement.** This recognition would be consistent with the Basel II framework¹³, as well as Article 323(5) of CRR2¹⁴. This change should be achieved by an inclusion of a mandate in the forthcoming CRR3 legislative proposal, which would allow for the EBA to develop an RTS to ensure banks and supervisors have more specific technical guidance on the inclusion of insurance.

In addition, we believe that the SA-OR should be reviewed by the Basel Committee of Banking Supervision (BCBS), in order to improve the risk sensitivity of the international standard and provide incentives to active operational risk management as described in this paper and our feedback to the Basel Committee. The main recommendations are in this paper.

As a fallback option, AFME would recommend a phase-in period for the SA-OR, over a 5-year period. This period would be sufficient for financial institutions to ensure that loss data collection requirements be up-to-speed and put in place appropriate strategies for the management of operational risk. This option would be a straightforward one in terms of introducing the SA-OR gradually, while allowing for a more proportional impact on banks with larger historical losses.

AFME's global affiliate, the GFMA, together with the IIF, provided joint feedback during the BCBS consultation process on Basel III, highlighting how the proposed framework could be improved in various areas, such as better recognition of insurance protection and the use of a forward-looking risk component. Notwithstanding these recommendations, we are supportive of the EU adopting the Basel standard and our comments on adoption of the rules relate to (a) the supervisory discretions available in the global standard and how they should be applied in the EU, and (b) some further operational concerns as discussed in the above sections.

AFME recommendations on Operational Risk

AFME would propose the following recommendations:

- Setting the Internal Loss Multiplier (ILM) to 1 - By setting the ILM to 1, as is currently the supervisory discretion that can be applied at a jurisdictional level, the limitations and volatility of capital charges caused by using rolling 10-year historical data can be neutralized.
- The recognition of insurance policies in the SA-OR - Insurance policies are a significant form of risk mitigation and should be recognized under SA-OR with **reduction capped at 20% of the initial own fund requirement.**

13 <https://www.bis.org/publ/bcbs107.pdf>

14 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876>

5. CRR3 - Market Risk: A granular implementation of the FRTB

Executive Summary

In January 2019, the Basel Committee for Banking Supervision (BCBS) released a revised version of the Fundamental Review of the Trading book (FRTB), which comprises the Basel III market risk standard. The FRTB, a CRR2 reporting requirement in the European Union, is expected to become a capital requirement as a component of the CRR3. Based on the 2019 EBA's Call for Advice (CfA) analysis¹, trading and market-making activities represent 14% of the 15.7 percentage point increase in risk weighted assets (RWAs), resulting from the finalisation of Basel III reforms, excluding the output floor. We acknowledge the updated CfA analysis² published in Dec 2020 to quantify the 2020 stress period, although this is based on data from 2019 and excludes submissions from a number of banks that according to the EBA have made conservative assumptions. An industry analyses which includes the March 2020 market turmoil suggests that the FRTB results in a higher capital impact for market risk than either of the EBA's CfA analysis.

Considering that only 5% of total RWAs of EU banks are currently allocated to these activities, the impact of FRTB is disproportionate and may further limit banks' capacity to provide markets-based financing, liquidity provision and hedging solutions, and thus impede the development of the Capital Markets Union (CMU).

As recently recognized by the Final Report of the High-Level Forum for the CMU³, the implementation of the FRTB needs to be considered in conjunction with market liquidity and market-making activities of banks - both crucially important to functioning of European financial markets. ISDA and AFME provide our key recommendations for ensuring that the standard is implemented in a proportionate way in the EU at the end of this document.

The Fundamental Review of the Trading Book: A Brief Primer

Following the global financial crisis, the BCBS initiated an overhaul of market risk capital rules with the Basel 2.5 framework, implemented quickly as a stop-gap measure, to address the most pressing deficiencies exposed by the crisis. However, the Basel Committee had a much broader review of the market risk framework in mind and initiated an overhaul of market risk capital rules in 2012, with the aim of replacing the Basel 2.5 framework with a more coherent and risk-sensitive package that also allows for the supervisors to better supervise model performance, and disallow their usage, when models underperform. This revised framework, finalized in January 2019, is commonly known as the Fundamental Review of the Trading Book, or "FRTB". The supervisory objective was to also reduce the variability of RWAs across banks and improve the governance framework for ensuring adequate risk model data quality - while still providing appropriate standards for banks that have limited market risk exposure to allow for proportionality.

The new FRTB framework will introduce significant changes to banks' market risk capital calculations, including:

- Revisions to the boundary defining which assets fall either within the scope of trading or banking book, and reducing regulatory arbitrage resulting from moves across the boundary.
- Overhaul of the Internal Model Approach (IMA) to focus on tail risk, and the introduction of variable liquidity horizons according to the instrument traded, instead of the standard 10-day liquidity horizon for all risk factors.

1 <https://eba.europa.eu/eba-updates-estimates-impact-implementation-basel-iii-and-provides-assessment-its-effect-eu-economy>

2 https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961423/Basel%20III%20reforms%20-%202019Q4%20update%20and%20Covid%20impact.pdf

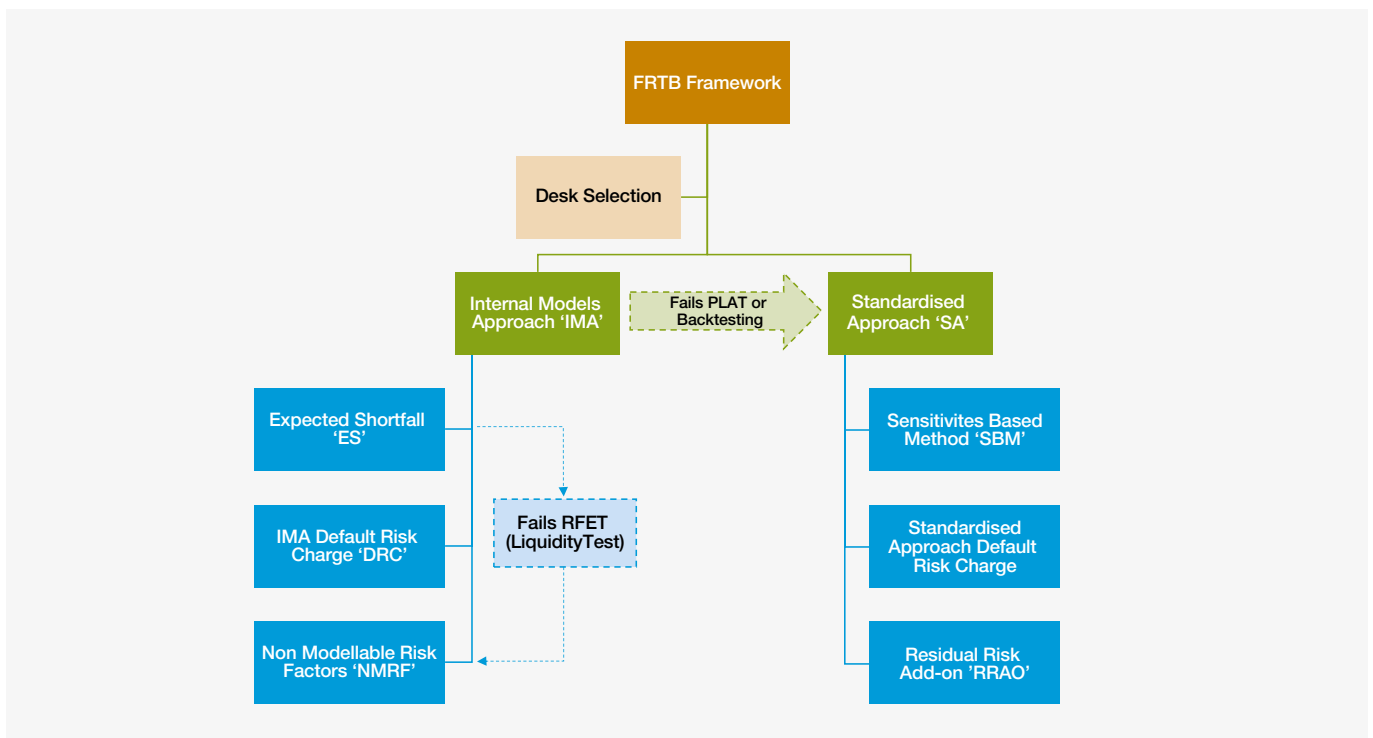
3 https://ec.europa.eu/info/news/cmu-high-level-forum-final-report_en

- Establishment of a stringent and granular trading desk-level IMA approval processes, including an assessment of the quality of data used in risk models (through a new profit and loss attribution test).
- Introduce a stressed capital add-on for risk factors failing modellability tests, known as non-modellable risk factors ('NMRFs'); and
- Ensure the Standardised Approach ('SA') is more risk-sensitive, explicitly captures default and other residual risks, and serves as a credible fallback for the IMA.

In Europe, the implementation of FRTB will follow a two-step approach. In the first instance, banks will be required first to report their market risk exposure under the Standardized Approach in 2021, followed by the IMA. In the second instance, the forthcoming CRR3 will convert the reporting into a framework for calculating capital requirements.

There are significant challenges for banks to implement the FRTB framework given that the revised market risk standard is a complete overhaul of the previous framework and how the systems have been built and set-up. Given the design of the IMA, there will be ongoing consideration given to the amount of regulatory capital they are expected to hold against market risk under the new framework. There will also be significant technological upgrades and one-off and ongoing costs resulting from changes to internal infrastructures and processes to ensure compliance with the new standards.

Figure 1: **Structure of revised Market Risk Framework**



The implementation of the FRTB will materially increase capital requirements for banks with market making activities in Europe, while elsewhere the European Commission (EC) is trying to promote market-based financing through the CMU project. The EBA's Advice published in December 2019⁴ estimated that the impact of the FRTB would be, on average, 105% higher relative to current RWA levels for the same risks. Banks with IMA approval, in particular, experience a 108% increase in RWAs under the FRTB standard. The results highlight that the cost of holding inventory as a result of market making are still relevant, even if one assumes that banks' trading desks achieve the same level of internal model approvals as under the current standard.

4 <https://eba.europa.eu/eba-updates-estimates-impact-implementation-basel-iii-and-provides-assessment-its-effect-eu-economy>

5. CRR3 - Market Risk: A granular implementation of the FRTB

In the updated EBA's advice⁵ published in December 2020, the FRTB impact is only measured through minimum required capital (MRC) not in RWAs, making a comparison between the two studies difficult. In the latest analysis, the EBA shows the impact of FRTB in both scenarios would be an increase of 0.8% of MRC vs 2.2% in the previous EBA analysis. However we believe this latest impact figure is misleading and not in line with industry studies and expectations, as the EBA estimates reflect a best case scenario that is unlikely to be attained given that some desks are likely to fail the IMA eligibility test, particularly in time of market turmoil.

It can be expected that new issues may emerge during the implementation process, which depends on the EBA developing a number of technical standards in line with its planned roadmap. The Industry acknowledges that as firms' systems and interpretations advance, they may also unearth efficiencies that reduce the RWA impact. Nevertheless, even if taking into account such potential efficiency improvements, on balance, we anticipate that the intended 22% increase in market risk (MR) RWA estimated by the BCBS will be exceeded materially⁶.

Alongside the results from the EBA impact study and the incentives created by problematic IMA components (e.g. NMRF), the earlier implementation timeline for SA reporting equally accentuates concerns with some components of the SA.

The capital impact is significant when considered against the importance of the market-making role of banks in capital markets in Europe. The intermediary role played by banks in capital markets through trading could thus be hampered by measures that increase capital requirements held against certain trading activities, limiting the capacity of banks to offer liquidity and act as market-makers. This was also recognized more recently in the Final Report of the High-Level Forum for the CMU.

Finally it is also important to note that the significance of the recent market turmoil in light of the COVID-19 pandemic has yet to be fully understood and quantified and therefore further detailed impact analysis is necessary to help clarify what the long-term impacts will be on the EU economy. In particular, this will help identify any pro-cyclicality that should be avoided in the future market risk framework.

The centrality of bank market-making in capital markets

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. 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 stocks, bonds, or other instruments at sufficient quantities, at consistent buying and selling prices. Simply put, market-makers, usually large financial institutions, make themselves available to buy and sell instruments at market price, thus ensuring that markets continue to function at all times. Without this crucial role played by banks, as well as other non-bank intermediaries, corporates and governments would find it more costly to raise capital as investors would add a higher liquidity risk premium to asset valuation. By providing liquidity, market-making thus facilitates the efficient allocation of economic resources. The prudential treatment of trading activities must thus ensure that banks continue to be able to fulfill this crucial role.

5 https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961423/Basel%20III%20reforms%20-%202019Q4%20update%20and%20Covid%20impact.pdf

6 https://www.bis.org/bcbs/publ/d457_note.pdf

Implementing FRTB in the European Union

When implementing the market risk framework in the European Union, the EC and co-legislators need to ensure that the impact of FRTB on banks' wholesale activities is not further exacerbated by an inconsistent timeline and transposition of the rules in key financial centers. To this end, aside from the more specific recommendations linked to its different components, ISDA and AFME strongly believe that a globally-consistent implementation of FRTB should be a key priority, along with the resolution of material issues resulting from this implementation identified below. An inconsistent implementation timeline could lead to market fragmentation for inherently global markets activities.

Furthermore, setting a reasonable approach for the model approval process is necessary before the start date of the framework. For example, given IMA reporting will already require model approval, it will be crucial to avoid going through an additional full-fledged model approval process once capitalisation of FRTB becomes effective. In addition, given the time gap between reporting and capitalisation, EBA guidance on how reporting numbers would impact capital planning for banks would be warranted to ensure there is a consistent approach across firms in the EU.

In terms of specific provisions in the FRTB, ISDA and AFME would like to bring to the attention of the co-legislators the following five areas:

1. The first relates to the investment in funds, or Collective Investment Undertakings (CIUs) eligible to the Trading Book. Banks often offer derivative products to their clients on performance of specific funds and hedge these products with underlying positions in the reference funds. The FRTB allows for equity investments to be included in the scope of the internal models *if* the bank is able to calculate capital requirements based on the assets underlying the fund (i.e. if the bank can "look through" to the underlying assets). Otherwise, three different approaches under the Standardized Approach (SA) are used. Two of them lead to conservative capital charges. The third one (the look-through approach under SA), which is the most risk sensitive approach, introduces computational intensity comparable to the IMA. These provisions regarding IMA and SA look through approaches result in operational complexity in relatively simple and low risk strategies and may result in activity in funds being prohibitively expensive.
2. The residual risk add-on (RRAO) is a capital charge intended to only apply to exotic risks. Its design, a flat risk weight on the gross notional of affected products, is risk insensitive and penalizes well-hedged portfolios which can result in overly high capital charges for banks, and lead to trading services becoming overly expensive. Moreover, the industry is concerned with the excessive RRAO charge for interest rate (IR) yield curve options and spread options. IR yield curve options are widely used as hedging tools against interest rate curve exposure by clients such as pension funds, life insurance companies, corporates, asset managers and the RRAO charge could increase significantly their cost of hedging.
3. Correlation Trading Portfolios (CTP): The FRTB introduces particularly punitive charges for this business line in terms of default and credit spread risks and limits recognition of hedges. This may incentivize banks to break economic hedges in order to reduce capital which should not be an aim of a regulatory capital framework. In addition, the rules still lack clarity, which might result in limited own funds requirements comparability between banks.
4. When a non-securitization instrument has multiple underlying risks, the calculation of its loss given default (LGD) is not consistent with that of an instrument with a single underlying. This may make it difficult to invest in EU markets, as the default risk for bucket/index products may incur punitive capitalization.
5. Finally, it is essential to ensure the viability of the internal model approaches. While supporting a number of methodology and supervisory measures that will lead a more robust IMA, we are increasingly concerned that the extent of these measures may challenge the viability of the IMA altogether. Certain requirements that are unique to the internal model - which due to the strictness of requirements or obvious inconsistencies across model approaches - are potentially undermining this approach as a viable option for banks. Of particular relevance are:
 - a. the Profit and Loss Attribution Test (PLAT), which requires testing on real portfolios to ensure appropriate calibration before becoming a requirement for IMA eligibility.
 - b. the Non-modellable Risk Factors (NMRF) with the prescriptive nature of the requirements potentially leading to a competitive disadvantage; and

5. CRR3 - Market Risk: A granular implementation of the FRTB

- c. The proposed floor for the probability of default (PD) in the IMA default risk charge is set at 3 basis points across all issuer types. The floor is not risk-sensitive for highest quality assets and puts disproportionately high capital requirements on bonds issued for example by high credit quality issuers, such as EU sovereigns. The floor could make market making on these high volumes but low return instruments uneconomical and could impact market liquidity in such instruments negatively. Removing - or at least reducing - the floor would therefore ensure consistency between the Trading Book and the Banking Book.

We would also propose a more appropriate calibration for Covered Bonds, reflecting their distinct characteristics and risk. We recommend that Covered Bonds should be considered (i) as a separate risk exposure class under IMA DRC just like under SA (for LGDs and Credit Spreads), and (ii) the 3 bp floor is not appropriate and should be calibrated downwards.

In the context of internal models, we also highly recommend that the interlocutors ensure that the Level 1 and 2 texts provide adequate supervisory flexibility for supervisors to exempt firms from highly procyclical model performance multipliers at times of stress, as also highlighted by the EBA's CfA. For FRTB, this flexibility is required not only just for backtesting but also for the PLAT and risk factor eligibility test (RFET).

AFME and ISDA recommendations on FRTB

We would recommend that the following changes be considered:

- For Collective Investment Undertakings (CIUs), it will be important to clarify from the BCBS rules and ensure that
 - the IMA should not include the mandatory look through requirements, instead it should be acceptable for CIUs to be included in IMA as a single risk factor using the daily liquid price of the CIU as currently permitted the ECB by paragraph 40 of the ECB guide to internal models;
 - flexibility should be introduced for the SA look-through approach so banks can use sensitivities to underlying fund's components provided by third parties (which is already allowed for the treatment of CIUs in the non-trading book).
- RRAO should address only risks not capitalized elsewhere in the framework (ex. volatility risk of volatility or variance swaps could well be captured in the SBM Vega risk charge and should not be subject to the 1% RRAO charge), it should be ensured that only real truly exotic underlying risks are subject to the 1% charge and more generally RRAO does not disproportionately charge vanilla rates products.
- Correlation Trading Portfolios (CTPs) rules remain ambiguous and require revisions to limit comparability issues between banks. In addition, CTP exposures should be able to be decomposed to constituents of the product for better recognition of economic hedging.
- The loss given default (LGD) for products with multiple underlying risks should be calculated based on the LGD %s found in BCBS MAR22.12 to ensure the CRR2 text is updated based on the latest Basel FAQ.
- Careful implementation of the key IMA requirements using real portfolios and addressing obvious inconsistencies between the IMA and SA approach before go-live of FRTB own funds requirement to ensure the viability of IMA. This includes also ensuring that adequate supervisory flexibility is provided for authorities to exempt firms from procyclical RFET, backtesting and PLAT charges at times of stress.

6. CRR3 - SA-CCR: Increasing risk sensitivity and reflecting market developments

Executive Summary

As part of the Regulation (EU) 2019/876¹ (“CRR2”), the Current Exposure Method (CEM) and the Standardized Method (SM) for the calculation of Counterparty Credit Risk (CCR)² as applied to derivatives transactions, have been replaced with a new Standardized Approach for Counterparty Credit Risk (SA-CCR). While more risk-sensitive, SA-CCR, in its current design and calibration, will lead to disproportionate increases in capital requirements for banks³ and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) who typically use non-cleared derivatives to hedge risk, and benefit less from the improvements, made through the introduction of SA-CCR, in capturing portfolio netting benefits.

The importance of SA-CCR is not only in calculating capital requirements for CCR. As of June 2021, SA-CCR will be used in many areas across the prudential framework, such as for calculating capital requirements for CVA risk, for Large Exposures framework⁴ and for the Leverage Ratio. It will affect all banks and users of derivatives and the impact will not be restricted to those that apply standardized methodologies only. This impact will become even more pronounced in CRR3, as SA-CCR will also contribute towards the calculation of the newly introduced Output Floor (OF)⁵.

Notably, analysis⁶ conducted by the Deutsches Aktieninstitut (DAI) with the support of KPMG, estimates that, under the current SA-CCR calibration, when considering the impacts of the OF, the additional hedging costs for the sample of 16 non-financial end-users could rise by between €112 and €167 million per year, depending on the average corporate rating assumption. This equates to a 200% increase in costs related to capital requirements.

In line with the urgent ask of co-legislators for the European Commission within the “Securitization Quick Fix” package (Recital 7a⁷) to review the calibration of SA-CCR by June 2021, we urge European authorities to implement the necessary changes through a CRR3 fast track proposal or to consider alternative measures that will offset the undue impact of SA-CCR.

SA-CCR: A Brief Primer

The introduction of SA-CCR, following its formulation by the BCBS⁸, was meant to address a number of deficiencies in the CEM and SM methods in the calculation of CCR – and measures the risk of a counterparty to a derivative contract defaulting. In particular, the risk-sensitive logic of the new framework was intended to address the following deficiencies in the previous framework:

1 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876>

2 Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

3 According to ISDA-GFMA estimates, the exposure calculated under SA-CCR will be significantly higher than under both IMM (1.9 – 2.5 times higher) and CEM (2-4 times higher). This is before considering the impact of the Output floor. (See: Link)

4 <https://www.bis.org/fsi/fsisummaries/largeexpos.pdf>

5 Please refer to AFME's dedicated position paper on the Output Floor.

6 https://www.dai.de/files/dai_usercontent/dokumente/positionspapiere/191213%20Position%20Paper%20Basel%20IV%20Implementation%20Deutsches%20Aktieninstitut.pdf

7 https://www.europarl.europa.eu/doceo/document/A-9-2020-0213_EN.pdf

8 https://www.bis.org/basel_framework/chapter/CRE/52.htm?inforce=20191215

6. CRR3 - SA-CCR: Increasing risk sensitivity and reflecting market developments

- Lack of differentiation between margined and non-margined derivatives transactions;
- The inability of the supervisory add-on factor (under CEM) to have captured the volatilities observed over stress periods;
- Limited recognition of netting benefits.

SA-CCR, which applies to OTC derivatives, exchange-traded derivatives, and long settlement transactions, is designed to respond to these challenges by introducing a more risk-sensitive approach in the calculation of two components: replacement cost (RC) and potential future exposure (PFE). This is handled through the recognition of excess collateral in the calculation of PFE, as well as through the introduction of a wide set of add-ons developed for the five asset classes used in the calculation of CEM (interest rate derivatives, foreign exchange derivatives, credit derivatives, equity derivatives, commodity derivatives).⁹

Significantly, the sum of the RC and PFE are then multiplied by the alpha factor, which in 2005 was calibrated at 1.4 by the BCBS.

In terms of its mathematic representation, the EAD¹⁰ (exposure at default) is thus calculated as follows, according to Article 274 of CRR2:

$$\text{EAD} = \text{alpha} \times (\text{RC} + \text{PFE})$$

Implementing SA-CCR in the European Union

The original publication of the rule, as described above, took place in 2014 at Basel level, and was introduced in the EU as part of the second iteration of the Capital Requirements Regulation (“CRR2”)¹¹.

While SA-CCR is intended to be more risk-sensitive, its current design and calibration will lead to disproportionate increases in capital requirements for banks and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) who typically use non-cleared derivatives to hedge risk and benefit less from the improvements in capturing portfolio-netting benefits.

SA-CCR does not reflect certain changes made by the Basel Committee¹² and its calibration is outdated. At the same time, the EBA’s planned review of SA-CCR is scheduled with a deadline of mid-2023, long after it is due for implementation in June 2021. As such, it is critical that the disproportionate impacts arising from the current design and calibration of SA-CCR are addressed in the meantime, particularly for end-users, in order to avoid penalizing the competitiveness of EU corporates.

Indeed, the unadjusted SA-CCR would limit the ability of end-users to hedge risks, because the increased capital requirement of SA-CCR will constrain banks’ capacity to support their demand for derivative products at an acceptable cost. This is problematic because EU corporates typically use non-cleared derivatives to hedge their commercial risks, which entail the highest capital charge in SA-CCR. Yet, corporates do not have the complex collateral management systems to support margining, and they are not required to do so by the European Market Infrastructure Regulation (EMIR). Hence, end-users would be left with no affordable alternatives to hedge their structural commercial risks, which will affect their financial strengths and competitiveness. These implications will set off in a context where the economy is looking to recover from the effects of COVID-19, and to attract investment to meet the EU’s growth objectives in the medium-long term.

9 A different methodology is followed for the calculation of the add-ons for each asset class, based on the number of “hedging sets” per asset class. For more information, please refer to the BCBS’s analysis of SA-CCR, available here: <https://www.bis.org/publ/bcbs279.pdf>

10 The EAD refers to the total value a bank is exposed to when a loan defaults.

11 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0876>

12 In particular section CRE 52.74 of the consolidated Basel III framework on the treatment of multiple margin agreements and multiple netting sets

SA-CCR is worth particular attention in the upcoming third iteration of the Capital Requirements Regulation (“CRR3”) proposal, not only due to its stand-alone impact, but also because its impact would be strongly amplified through the future constraint of the Output Floor, as well as, in the very near term, through its broad use in the prudential framework – e.g. Leverage Ratio, CVA risk, Large Exposure.

As a subject of the CRR3, and barring the welcome reviews by the EBA or through Basel, the following areas require attention:

1. Application and Calibration of the alpha factor
2. Adequate recognition of initial margin (IM)
3. Recognition of diversification benefit across hedging sets within an asset class
4. Recognition of Margining and Netting

1. Application and Calibration of the alpha factor

The alpha factor, which has the impact of increasing exposures by 40%¹³, was originally calibrated to 1.4 in 2005, at international level. It was meant to account for model risk in internal models, but is not warranted in a Standard Approach, it no longer reflects current market environment, and it is not aligned with EMIR.

Hence, the scale of the increase in exposure that the alpha factor entails for SA-CCR is unwarranted and leads to a capital requirement for banks that is not representative of the risks associated. The EU policymakers should reconsider the alpha factor to ensure it accounts for the risk the SA-CCR framework is meant to cover. Specifically:

- The alpha factor should not apply, at least for transactions with end-users. Such treatment for transactions with end-users would be consistent with BCBS-IOSCO Margin Requirements for Non-Centrally Cleared Derivatives (“UMR”)¹⁴ exemptions for end-users and with the actual risk posed by end-users. We propose this change to be made as soon as possible via a CRR3 fast-track proposal to limit the cliff effect on bank counterparty credit capital requirements and its impact on the hedging activity by end users and on the real economy. This would also be consistent with the urgent ask of co-legislators for the European Commission within the “Securitization Quick Fix” package¹⁵ (Recital 7a¹⁶) to review the calibration of SA-CCR in the context of the economic recovery from the COVID-19 crisis by 30 June 2021. A fast-track proposal would therefore allow for the respective amendments to be reflected in level 1 text as soon as possible, thereby helping the economic recovery from the COVID-19 crisis. The recital also states that due account should be taken of the international level playing field, referencing the June 2020 High Level Forum Report on Capital Market Union where it was stated that than an overly conservative SA-CCR would have a detrimental impact on the availability and cost of financial hedges to end-users, and recommended to the Commission that note be taken of the final implementation of SA-CCR in the US. Therefore, it should be noted that in its US implementation, the Federal Reserve has adapted SA-CCR methodology in order to address some of the shortcomings in the international framework, and in particular the removal of the alpha factor for derivative contracts with commercial end-users (cf. §5).

13 40% is the difference between the current calibration of alpha = 1.4 versus neutralising its impact by setting it to 1.

14 Basel Committee on Banking Supervision, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013), available at <https://www.bis.org/publ/bcbs261.pdf>.

15 https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf

16 https://www.europarl.europa.eu/doceo/document/A-9-2020-0213_EN.pdf

6. CRR3 - SA-CCR: Increasing risk sensitivity and reflecting market developments

- The alpha factor should not apply to the RC for the purposes of calculating risk-based CCR capital requirements, or the Leverage Ratio. A derivative is recorded at its mark-to-market value on the balance sheet - by its nature this value is not subject to additional model uncertainty and represents the true replacement cost. There is no justification therefore to apply a factor which increases the exposure value further and is meant to account for model risk. The RC should rather reflect the on-balance sheet exposure, consistent with the treatment of loans, overdrafts, securities or any other balance sheet exposure.
- The alpha factor as it applies to the PFE for the purposes of risk-based capital requirements should be recalibrated. The Basel II standards were implemented in the E.U. in 2008 and at that time set the alpha factor at 1.4 for the purposes of the Internal Model Method (IMM). However, certain of the rationales for this alpha factor value for the purposes of IMM do not apply to SA-CCR.

2. Adequate recognition of initial margin (IM):

To calculate the PFE component of the exposure value of a derivative in SA-CCR, banks are permitted to take into account collateral that the counterparty has posted to cover losses in the event of a default i.e. the counterparty failing to pay the amount due. This can be made up of initial margin, representing the minimum amount of collateral that needs to be posted to enter a trade, and the variation margin, which is intended to cover losses from movements in the market value of the trade.

SA-CCR recognises IM through the PFE multiplier formula, however formula results in a far more conservative recognition of IM, than done through CEM. This means that a disproportionate amount of IM needs to be posted to reduce the exposure value in SA-CCR. The lack of adequate recognition of IM results in overstated exposures and therefore unduly conservative capital requirements. Given the expected future increase in IM requirements with the phase-in of more counterparties under the uncleared margin requirements and replacement of legacy trades with new trades, this impact is only expected to grow. The conservative calibration of the SA-CCR aggregated amount (“Add-on”) should thus be adjusted significantly to improve recognition of IM in the PFE multiplier.

3. Recognition of diversification benefit within an asset class:

SA-CCR calculates the overall exposure of a portfolio of derivative on a net basis. This means that where there is a netting agreement in place, a group of transactions are viewed together, such that losses arising from one position are offset by gains in another, subject to certain limitations. One of these limitations is that netting is only permitted for derivatives in certain sub-groups with similar risks, called “hedging sets” – e.g. interest rate derivatives are sub-divided by reference currency, and foreign exchange derivatives are sub-divided by currency pair.

SA-CCR does not reflect any diversification benefit across these sub-groups (hedging sets) for interest rates and foreign exchange derivatives, i.e. the positive exposure value of one hedging set cannot be offset with a negative exposure value of another hedging set. This is overly conservative and risk insensitive, and significantly overstates the exposure value compared to internal model approaches, where some degree of diversification is assumed. A way to address this would be to incorporate correlation parameters across hedging sets which would enhance risk sensitivity without an increase in complexity.

A particular issue arises in the context of FX transactions¹⁷, SA-CCR calculates exposure values separately for each currency pair (e.g. EUR/USD), even in the case where the overall FX exposure, considering currency pairs together, is nil (FX Triangulation). As an illustration, for equal volumes in EUR/USD, USD/GBP, GBP/EUR currency pairs, SA-CCR capital charge computation adds the three exposure volumes separately, despite the fact that they offset perfectly and there is no residual risk.

¹⁷ FX Transactions refer to any transactions for the purchase, by one party, of an agreed amount in one currency against the sale by it to the other party of an agreed amount in another currency.

4. Recognition of Margin and Netting

Another key limitation in SA-CCR is that it does not sufficiently recognize margining as a form of risk mitigation, nor does it sufficiently recognize netting – both omissions leading to significantly overstated exposures. This is despite the fact that margining and netting arrangements can significantly reduce risk associated with derivatives exposures.

Margining and Netting: A Closer Look

One of the key deficiencies of the SA-CCR framework is its lack of sufficient recognition of margining and netting as risk mitigants.

Margining refers to extending a collateral, deposited with a counterparty, in order to protect against some of the credit risk that may arise from entering into a derivative contract. It is meant to cover, in case of default, the exposure linked to changes in the market value of a derivatives portfolio.

Netting refers to the practice of combining multiple financial obligations arising from different contracts into a single net obligation amount. It can thus allow for losses arising from one position to be compensated by gains in another, as long as the overall net obligation amount is met. A netting set is the group of transactions covered by a netting agreement.

A netting set may be subject to multiple margin agreements. While the netting set is subject to a legally-enforceable bilateral netting agreement, SA-CCR requires banks to divide a netting set into sub-sets to align with the margin agreements, undermining the legal agreement which allows net settlement in the event of default and reducing netting. This issue is increasingly common given new margin rules for uncleared derivatives (UMR) transactions.

Another application is the presence of settled-to-market (STM)¹⁸ and collateralized-to-market (CTM)¹⁹ trades in the same netting set. As margined and unmargined trades do not net in exposure calculations under current SA-CCR rules even when covered by the same qualifying master netting agreement (QMNA), the risk mitigating properties of such STM transactions are not appropriately reflected in a portfolio context versus margined/CTM transactions e.g. in situations where margined/CTM exposures are risk managed with STM hedge transactions.

EU standards should better reflect netting in the replacement cost and potential future exposure between all contracts within a qualifying master netting agreement (QMNA)²⁰, regardless if the contracts are CTM or STM, or part of different margin agreements or unmargined. This would also create consistency between exposure models across the CRR2 framework, as models such as the Internal Model Method (IMM) or the Current Exposure Method (CEM) recognize netting at the netting set level, rather than at the level of the margining set, and would therefore create a consistent treatment independent of model choices.

18 STM is where the trade's exposure is reset daily to zero through settlement of mark-to-market i.e. a payment is posted equal to the market value of the open position to net the exposure to zero.

19 CTM is where the variation margin is treated as reducing the exposure (credit protection). The collateral called does not necessarily equal the market value of the open position, but the collateral required will be calculated relative to the exposure.

20 Basel allows for netting under SA-CCR of transactions covered by a Qualifying Master Netting Agreement ("QMNA")

Final Report of the High-Level Forum (HLF) for the Capital Markets Union (CMU)²¹

In the Final Report of the HLF for the CMU, it was recommended that note be taken of the final implementation of SA-CCR in the US. In addition to amending the alpha factor as previously highlighted, additional items of note from the US implementation are:

- An allowance for decomposition for commodities, credit and equities indices. This would allow for each component of an index to be treated as a separate derivative contract, recognizing the benefit brought on by each different component of the index and is consistent with FRTB.
- Maintaining the option to use IMM as an alternative to SA-CCR for calculating the exposure value of derivatives in the context of Large Exposure

AFME and ISDA recommendations on SA-CCR

The Industry recommends that the following considerations should be taken into account in the context of the CRR3:

- The alpha factor as it applies to end-users should be removed altogether, and more generally should not apply to replacement cost and its application to the PFE component of the exposure calculation recalibrated. A CRR3 fast-track should be introduced to affect these changes, at a minimum removing the application to end-users to support the recovery, with any remaining items addressed through the remaining CRR3 package.
- Better recognition of initial margin (IM), to reflect its risk-reducing properties.
- Better recognition of diversification benefit across hedging sets within an asset class, in particular on FX.
- Allow netting across multiple margin agreements / credit support annexes (CSAs) and unmargined trades under one qualifying master netting agreement.
- Consider the implication of the clarifications in the US implementation of SA-CCR, allowing for decomposition of commodities and index hedges, as well as allowing the option to use of IMM as an alternative to SA-CCR in the context of Large Exposure.

Any recalibration of EU SA-CCR rules should also be pursued at Basel level, to seek alignment of the international rules with the EU approach.

²¹ https://ec.europa.eu/info/news/cmu-high-level-forum-final-report_en

This chapter has been drafted by ISDA and AFME jointly

7. CRR3 - Credit Valuation Adjustment (CVA) Risk: Risk weight granularity, index hedges and alignment with accounting CVA

Executive Summary

In July 2020, the BCBS published targeted revisions to the Credit Valuation Adjustment (CVA) framework, bringing final changes to the initial revised framework published in 2017, as part of the Basel III agreement. CVA refers to a measure of market risk incurred in the context of transactions or contracts involving counterparties (such as sovereign banks, other financial institutions, non-financial companies, etc.). In other words, as banks enter into derivatives contracts, they face the risk of incurring losses due to changes in the market value of those transactions and the deterioration of the creditworthiness of their counterparties.

Capital requirements for CVA risk are meant to require banks to hold aside capital to account for these losses. While the 2020 revisions attempted to solve some of the identified issues with the current CVA framework, further calibration is necessary to ensure that end-users, who typically use derivatives to hedge risk, are still able to access them at a reasonable cost. Particularly in the context of the recovery from the COVID-19 pandemic, it is crucial for banks to continue to support the real economy through the provision of these services and to not be constrained from doing so by an undue increase in the capital held against CVA risk.

CVA: A Brief Primer

Banks that undertake derivatives are subject to the risk of incurring mark-to-market losses because of the deterioration in the creditworthiness of their counterparties. This potential source of loss, due primarily to changes in counterparty credit spreads, but also other market risk factors, is known as CVA (Credit Valuation Adjustment) risk. CVA is thus viewed as the “price” of counterparty credit risk (CCR).

In December 2017, the BCBS published an initial revision of the CVA framework¹ to better capture CVA risk and provide better recognition of CVA hedges. Further revisions were introduced on July 8th 2020² when the BCBS released its final rule for the CVA framework to ensure, amongst other provisions, further alignment between the market risk and CVA rules, as well as address calibration issues within the framework.

This finalized standard is a significant development that is expected to have material implications for the industry, as it replaces the current CVA standardized approach and removes the ability to use internal models.

The main changes introduced by the BCBS in this framework include a re-calibrated standardized approach (SA-CVA) and basic approach (BA-CVA), adjustments in some of the previously-determined risk weights (RWs) in both these approaches, an adjustment to the scope of transactions that are subject to CVA-linked capital requirements, as well as the introduction of “index buckets”, whereby banks can calculate their capital requirements by referring to certain set credit or equity indices, instead of relying on the credit-worthiness of the underlying counterparty. Finally, the BCBS has recommended setting the mCVA multiplier, meant to account for model risk, to 1 – to address calibration issues in the framework. This also takes into account the fact that there is no advanced approach available for the calculation of the CVA capital requirements.

¹ <https://www.bis.org/bcbs/publ/d424.pdf>

² <https://www.bis.org/bcbs/publ/d507.htm>

The main changes introduced in the final revision of the BCBS CVA framework:

- a reduction of the SA-CVA multiplier (mCVA) to 1 from 1.25, originally intended to account for model risk.
- the introduction of a scalar to BA-CVA of 0.65 to ensure an appropriate relative calibration to SA-CVA.
- the recognition of hedges is improved through the introduction of index buckets, allowing banks to calculate their capital requirements by referring to certain set credit or equity indices, instead of relying on the creditworthiness of the underlying counterparty.
- a revision to the aggregation formula used to calculate the capital requirements and revisions to a number of risk weights downwards to align the requirement closer to the finalised market risk framework.
- a reduction in the gap between regulatory and accounting CVA through the revision of the floor to margin period of risk (MPOR³) as it relates to client cleared transactions (CCTs) and removing securities financing transactions (SFTs); and
- the exemption of some SFTs from CVA risk capital requirements.

These latest revisions have allowed for greater sensitivity in the determination of the CVA risk linked to specific exposures and are positive. Nonetheless, further changes to the framework are necessary to ensure that the rules are commensurate with the underlying risk.

Designing an effective and proportionate CVA Framework for the European Union

In December 2019, the European Banking Authority's (EBA) published a report⁴ showing that the impact of the 2017 CVA framework for European banks is significant:

- +558% on CVA RWA under the central scenario assuming the re-integration of the CRR exemptions.
- +140% under the alternative scenario (assuming the current CRR exemption framework is maintained).

Under the updated analysis published in December 2020⁵, the EBA shows the impact of CVA risk only through the prism of the impact on minimum required capital (MRC) and not RWAs making the comparison between the two exercises difficult.

Under their latest analysis, the EBA study shows an increase of +2.1% in MRC for CVA under the central scenario (compared to +3.9% in the previous exercise published in 2019⁶) and +0.5% under the EU specific scenario (i.e. EU exemptions maintained in CRR).

3 The MPOR is defined as the time period from the most recent exchange of collateral covering a netting set of transactions with a potentially defaulting counterparty, until the transactions are closed out and the resulting market risk is re-hedged.

4 This analysis is based on the BCBS 2017 framework and does not include the revisions introduced in July 2020. We note that its updated call for advice to the EBA on the implementation of Basel III that the Commission has asked for an updated analysis of the CVA to reflect these final adjustments.

5 https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961423/Basel%20III%20reforms%20-%202019Q4%20update%20and%20Covid%20impact.pdf

6 https://www.eba.europa.eu/sites/default/documents/files/document_library//Basel%20III%20reforms%20-%20Impact%20study%20and%20key%20recommendations%20-%20macroeconomic%20assessment%20credit%20valuation%20adjustment%20and%20market%20risk.pdf

We would note however that this latest study should not be taken at face value. The EBA notes that whilst CVA risk is a smaller contributor to the overall impact compared to previous results, it should be kept in mind that its calculation was based on a proxy for the CVA risk under the new CVA framework introduced in July 2020. A proxy calculation was necessary due to the timing of the publication of the new framework, which meant that the July 2020 final CVA risk framework was not included in 2019-Q4 templates, as the framework was published after the launch of the QIS data collection.

Furthermore, the EBA has noted that a small share of the change in CVA impact between June 2018 and December 2019 is caused by the 'pure' differences in CVA risk across time, as well as the exclusion of few large banks from the specific risk category in December 2019, due to insufficient data submissions. By contrast, the EBA has noted in the Basel III monitoring exercise based on December 2019 data⁷, that the drop in the CVA impact in December 2019 (~-1.1% compared with June 2019) is predominantly (~69% of the total reduction) attributed to the exclusion of few large banks, from the specific risk category, due to insufficient data submissions. Whilst these studies are based on different sample sizes, it suggests the exclusion of a few large banks could have impacted on the accuracy of the updated analysis and accurate impact assessment data of the new CVA framework is not available at present.

Notwithstanding the lack of availability of accurate impact assessment data of the new CVA framework, there is still likely to be a substantial increase in CVA capital after taking account of enhancements to the Final Basel 2020 standards, such as removal of the mCVA multiplier.

As the EU prepares to implement the finalised CVA framework, it will be important to monitor its impact. CVA risk represents a significant driver of risk-weighted assets (RWAs) for derivatives and capital market activities, and deficiencies in the framework have an impact on banks' ability to provide key financing, liquidity and hedging services and products to end-users. As a result, it is very important that the design and calibration issues be addressed appropriately to ensure that capital requirements are in line with real economic risk incurred by banks.

These increases in capital requirements can have a strong knock-off effect and potential cost implications for end users including pension funds, mutual funds, and commercial end users that use derivatives for hedging purposes. Any requirements that constrain the use of derivatives may affect the ability of end users to hedge their funding, currency, commercial and day-to-day risks, which would in turn weaken their balance sheets and make them less attractive as investment prospects.

In terms of more specific impacts, the industry would recommend further targeted revisions to the CVA framework on the following points:

1. Improve the calibration and granularity of risk weights (RWs) particularly for financial counterparties.
2. Improve the recognition of CVA Index hedges.
3. Misalignment between regulatory and accounting CVA

1. Improve the Calibration and granularity of risk weights (RWs) particularly for financial counterparties

In the revised CVA framework, the risk weights allocated to exposures to financial sector entities are the same, regardless of the type of financial sector entity (i.e. all financial institutions are allocated to the same "bucket"). This means that a wide set of counterparty types all pivotal to the real economy including pension funds, insurance providers, covered bonds⁸ and buy-side end-users are captured in the same bucket without any means to account for their specific risk profile.

The European Commission and co-legislators should improve the granularity of the counterparty credit spread ("CCS") risk weights. At a minimum, recognize the differentiation in CVA risk profiles between financial counterparties.

⁷ https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2020/960797/Basel%20III%20monitoring%20report%20-%20Dec%202020.pdf – see footnote 23

⁸ Counterparties within bond issuance structure buying market risk hedges *pari passu* with covered bond debt.

2. Improve the recognitions of CVA Index hedges

Credit-default-swaps (CDSs) are a type of insurance taken against the loss arising from the default of a counterparty. Banks can also use standard baskets of CDSs, called CDS indices (analogous to equity indices), which are more liquid than the over-the-counter CDSs and provide a useful tool to hedge systemic credit risk. These are especially useful for many small and mid-cap companies, as they do not have any direct “hedges” in response to counterparty credit risk– meaning that hedging has to occur at a more macro-level for the entire portfolio, using these indices as reference.

The July 2020 Basel revisions have introduced new ‘index buckets’ for these indices, namely for: (i) counterparty credit spread risk class; (ii) reference credit spread risk class; and (iii) equity risk class of the SA-CVA, in alignment with the Basel market risk framework (the Fundamental Review of the Trading Book).

The introduction of the counterparty credit spread index bucket is positive. The scope of eligible hedging instruments is limited to qualifying indices. The implied correlation between the CVA portfolio and the index bucket does not provide sufficient recognition to index hedges and does not reflect the observed historical correlation between the typical CVA portfolio and CDS index hedges.

This outcome does not incentivize prudent hedging practices and may lead to the under-hedging and inadequate protection against the real economic CVA risk. Treating the entire CVA portfolio as an index and aligning its correlation with the index bucket to a level matching the calibration of SA-TB⁹ is one approach to improve the hedge recognition.

3. Misalignment between regulatory and accounting CVA

There are significant mismatches between the regulatory CVA charges stipulated in Basel III, and the way those charges are treated from an accounting perspective, through IFRS rules. In order to ensure that CVA charge is not overstated, the CVA framework should be more closely aligned with market practices, specifically by introducing changes to the length of the Margin Period of Risk (MPoR¹⁰) – which accounts for lags in timing within which the nominal and market value of the contract can widen and by adding flexibility to the expected loss given default¹¹ (ELGD) used for specific exposures.

9 As it relates to the correlation between to Credit Default Swap (CDS) indices: Under the revised market risk approach, the calculation of the sensitivities-based method under the standardised approach for market risk sets the correlation between two sensitivities within the same index bucket at 80%.

10 See footnote 3 for a definition of MPOR.

11 Expected loss given default is the average loss anticipated for a specific exposure in the event of the counterparty to the contract defaulting, taking into account the exposure and the probability of default.

AFME and ISDA recommendations on CVA

We would recommend that the following changes be considered:

- A recognition of the different risk profiles of different financial institutions through the introduction of distinct risk weights per type of financial institutions, instead of their allocation a single bucket.
- A better recognition of indices used to hedge CVA risk, particularly in terms of their usage linked to the hedging of systemic credit risk, rather than specific sectoral or counterparty risk.
- A greater alignment of regulatory and accounting CVA. Namely, through:
 - making adjustments to the period stipulated by the MPoR. This could be done by adjusting the MPoR floor from 9+N days to 4+N days, which would make it more aligned with accounting market practices; and
 - the use of specific ELGD for secured exposures (e.g. covered bonds, infrastructure or utilities specialised lending vehicles) or entities which by nature expose derivative counterparties to lower risks than bond holders (e.g. sovereigns).

Overall, it will be important for the EBA to produce a comprehensive impact analysis of the final Basel CVA standard and to assess whether the calibration of the BCBS standard has reached a reasonable level. This would then inform the need for further changes in the EU.

8. 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 pandemic¹. 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 CMU³, 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.
- 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.

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

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	<p>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.</p> <p>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.</p>	<p>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.</p> <p>For more details, please refer to AFME’s paper on Credit Risk.</p>
Credit Risk - treatment of Securitization	Securitisation Markets and Real economy	<p>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.</p>	<p>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.</p>
Market Risk – Fundamental Review of the Trading book (FRTB)	All secondary markets (bonds, equities, derivatives)	<p>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.</p> <p>Disproportionate increases in capital requirements for certain trading activities would thus undermine the CMU project.</p>	<p>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).</p> <p>For more details, please refer to AFME’s paper on the FRTB.</p>
Counterparty Credit Risk - Standardized approach for counterparty credit risk (SA-CCR)	Derivatives markets	<p>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.</p>	<p>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.</p> <p>For more details, please refer to AFME’s papers on the recalibration of SA-CCR.</p>
Credit valuation adjustment (CVA)	Derivatives markets	<p>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.</p>	<p>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.</p> <p>For more details please refer to AFME’s paper on CVA.</p>
Leverage Ratio	Repo markets	<p>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.</p> <p>Banks’ inability to net repos and reverse repos in the Leverage Ratio has contributed to a reduction of inventories in corporate bonds.</p>	<p>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.</p>

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

The key functions of banks in capital markets

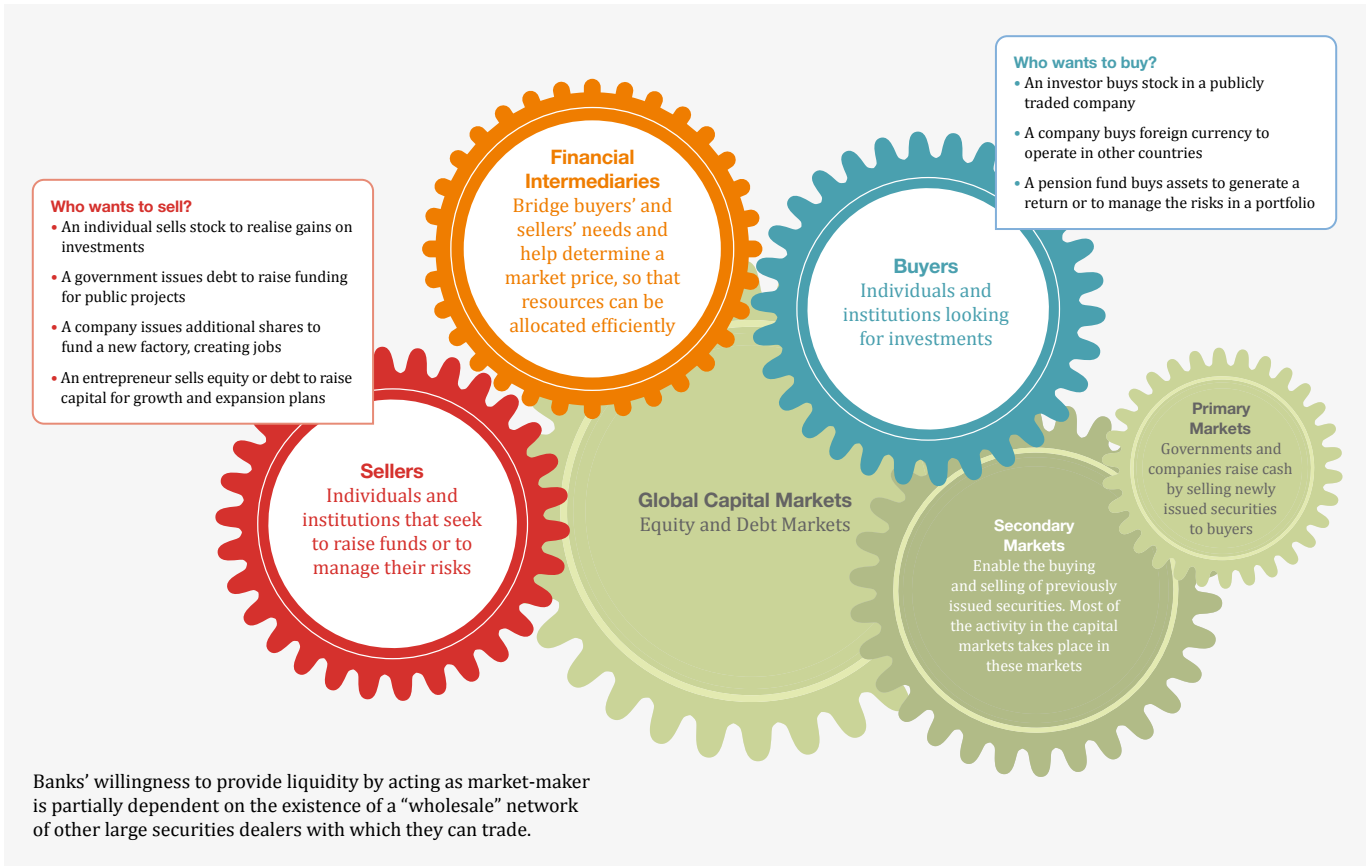
The purpose of the European financial system is to provide diverse and cost-effective credit options to real economy actors, thus facilitating the competitive, sustainable and long-term growth of the European economy as a whole. Banks, specifically, contribute to this objective through the following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



9. CRR3 - Sustainable Finance

Executive Summary

Sustainable finance has a key role to play in mobilising the necessary capital to deliver on the policy objectives under the European Green Deal, the Paris Agreement and the EU's commitment to reaching climate-neutrality by 2050. Consequently, the Commission has put sustainable finance at the core of its financial policymaking for the next five years, through the commitment to put forward a Renewed Sustainable Finance Strategy², following its previous Action Plan on Financing Sustainable Growth. In terms of prudential regulation, this commitment will be reflected by building on existing mandates to drive better consideration of ESG (Environmental, Social, and Governance) risks agreed in the second iteration of the Capital Requirements Regulation ("CRR2") and help ensure that investments support a sustainable economy, as part of the recovery from the impacts of the COVID-19 pandemic.

AFME is a strong supporter of these aims. In the context of the upcoming CRR3 proposal, we expect this to manifest in a further consideration of the prudential treatment of green and brown assets, which may be driven by some of the existing mandates already assigned to the EBA.

There are two key issues to consider which we explore in the paper:

Firstly, any differentiated prudential treatment in CRR3 will depend upon the identification of green and brown assets, which should be undertaken in a dynamic, forward-looking, and risk-oriented way. In other words, the classification of an asset under the current taxonomy should not be a proxy for its risk profile, nor lead to automatic risk weighting adjustment. For instance, AFME opposes any direct penalising policy action towards financial institutions that invest in or lend to high carbon-emitting sectors, that are on their journey to transition, as these sectors require capital in order to transform. Notably, there is a risk that the introduction of a penalizing factor could be counterproductive by leading to an abrupt slow-down in financing to those high-carbon emitting sectors, preventing them from transitioning to lower-carbon emission and further aggravating climate risks.

Secondly, the adaptation of any prudential policy related to environmental performance considerations must be balanced and requires the use of sensible and quantitative methodologies, based on experience and scientific data. Any potential specific treatment distinguishing between 'green' or 'brown' assets needs to be consistent with the principles of traditional prudential regulation and therefore grounded in the risk characteristics of such assets. It should also be agreed at an international level, as far as possible.

Sustainable Finance and Prudential Regulation: A Brief Primer

The European Commission's Action Plan on Promoting Sustainable Growth¹, following the work of the High-Level Forum on Sustainable Finance, was originally conceived in the context of the Capital Markets Union. The original Action Plan on the Capital Markets Union², released in 2015, thus served as the basis for the launch of the Sustainable Finance Agenda.

¹ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018DC0097>

² <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=&uri=CELEX:52015DC0468>

Sustainable Finance Policy in the EU: Three Goals of the Action Plan on Financing Sustainable Growth

1. Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth.
2. Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
3. Foster transparency and long-termism in financial and economic activity.

Through the evolution of the sustainable finance agenda in the European Union, its focus has in part extended to the role of banks in promoting the transition to a low-carbon economy. Much of this discussion has been centered around the notion of “a green supporting factor” and “brown penalizing factor”.

A green supporting factor refers to a “discount” applied to the capital requirements held against certain assets classified as “green”. The premise is similar to that of the SME and Infrastructure Supporting Factors which aims to encourage support for lending to such entities or on certain categories of assets. In short, it is a capital incentive for banks to increase their exposure to such assets. A brown penalizing factor would take the opposite approach, namely by functioning as a capital add-on, or higher risk weights, for exposures to assets that would exacerbate climate change, thus acting as a disincentive for banks to be exposed to those assets. In the process of agreeing CRR2, it was considered that there was not enough empirical evidence of the actual risk associated with green and brown assets to take the concepts of these “factors” forward – as any prudential treatment of green and brown assets should be explicitly risk-based. Consequently, legislators have extended mandates to the EBA to explore this question further, by collecting data on the riskiness of green and brown assets from a prudential perspective, and by developing supervisory treatment and better disclosure (please see Box 1).

Box 1 - The EBA’s Mandates on Sustainable Finance in CRR and CRD

Pillar I (Article 501c – CRR2) – June 2025: The EBA is expected to assess whether a prudential treatment of exposures linked to sustainability-related assets would be justified through assessing methodologies for determining the risk-profile of sustainability-related exposures, criteria for the assessment of physical and transition risks, and the effects of this prudential treatment on financial stability and bank lending.

Pillar II (Article 98.8 – CRD2) – June 2021: The EBA is expected to assess the inclusion of ESG risks in the supervisory review and evaluation process (SREP), by examining how NCAs should consider the development of a uniform definition of ESG risks (including physical and transition risks), the impact of ESG risks on institutions in the short, medium, and long terms, and the effectiveness of risk mitigation techniques used.

Pillar III (Article 434a – CRR2) – June 2021: The EBA is expected to develop a technical standard which will set out how financial institutions are expected to report against Article 499a of CRR2, which mandates financial institutions with publicly listed issuances to disclose information on ESG risks, physical risks and transition risks. Following the development of this standard, the EBA will further specify these disclosures as a comprehensive reporting technical standard.

The EBA’s work on sustainable finance also comprises its December 2019 Report on Undue Short-term Pressure from the Financial Sector on Corporations, examining three dimensions of short-termism: the banking perspective, the corporate perspective, and the sustainable finance perspective.

In 2019, the EBA released its Roadmap for Sustainable Finance³ based on these mandates, setting objectives for how to accelerate the inclusion of banks in the Sustainable Finance Agenda. At the same time, initiatives such as the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)⁴, launched in 2017, have released multiple reports and analysis linked to these same mandates.

As part of the Renewed Sustainable Finance Strategy, expected in Q4 2020, the Commission plans to review the question of green supporting and brown penalising factors. The Commission have considered doing so on a faster timescale than that set out in the EBA mandates in CRR2 outlined above. AFME considers that potential integration of ESG considerations into the prudential framework as part of CRR3 should be based on a premise that this would be done in a pragmatic and risk-sensitive manner, taking account of the EBA's progress in its CRR2 mandates. It is critical for any such measures agreed as part of the Renewed Sustainable Finance Strategy should be well-coordinated with existing legislation and international initiatives, where possible, given that climate change is a global phenomenon. They should also be based on a realistic and coherent implementation timeline, allowing banks the time to adjust and adopt new methodologies to align themselves with these potential requirements.

Building blocks to integrating sustainability in prudential regulation

In order to support further integration of ESG considerations into the prudential framework, as part of CRR3, in a pragmatic and risk-sensitive way, we urge legislators to take the following considerations into account.

1. Limitations of developing a classification system for use in prudential regulation

A key component of the Sustainable Finance Action Plan was the establishment of an EU classification for sustainable activities, otherwise known as the Taxonomy. The Taxonomy has since been agreed and entered into force through the introduction of the Taxonomy Regulation⁵, on 12 July 2020. In the first instance, the Taxonomy will focus on economic activities deemed to make a substantial contribution to climate change mitigation or adaptation. The Regulation also includes a further mandate to explore a “brown taxonomy” – i.e. economic activities that significantly harm the environment. Overall, the top priority for the Commission should be to finalize the Green Taxonomy and assess its effectiveness in supporting the redirection of financial flows towards sustainable activities, as well as assess if any gaps/issues exist, before deciding to develop a brown, or any other taxonomy.

Given the aim of the Taxonomy Regulation is to encourage investment in green activities and avoid “green washing”⁶, the link is often made to applying the Taxonomy in the context of prudential regulation, as a means of identifying green and brown assets, and using it to determine the prudential treatment of these assets. While we support the development of the Taxonomy as a driver of investment and important way of identifying of the kinds of underlying activities that could constitute climate-friendly investments, AFME considers there to be considerable barriers to applying the Taxonomy in the context of prudential regulation. For instance, the Taxonomy may not fully take into account the dynamic risk strategy of a corporate, whereby, all things being equal, the business model of a client which develops, adopts and implements a robust transition strategy is expected to be more resilient than that of a client which does not proactively manage its transition risk.

3 <https://eba.europa.eu/eba-pushes-early-action-sustainable-finance>

4 <https://www.ngfs.net/en>

5 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852>

6 Greenwashing is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. Greenwashing is considered an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly.

With regard to developing a brown taxonomy, while we fully support a framework which will improve reporting and disclosure around carbon-intensive sectors, including those that cannot change their business models, creating a detailed brown taxonomy or developing a form of brown “asset-tagging” would be premature and might have unintended negative consequences such as an abrupt divestment in those sectors/activities. This could ultimately hamper the needed transition and could have negative socio-economic consequences. We urge policymakers to focus rather on establishing industry-specific transition pathways towards 2050 net zero carbon emission targets, that would provide clarity about the capacity of and steps needed for real economy actors to transition towards this goal, while helping banks measure the associated risks. Moreover, any potential application of such a “brown” taxonomy to the banking prudential framework should await the completion of the EBA’s mandate on the prudential treatment of green/brown assets and potential international standards. In this context, a better understanding of the extent to which banks’ exposures to different sectors/activities are already adequately captured in banks’ models is important. This needs to be based on common scenarios and disclosures that inform risk managers how these assets will perform in a dynamic forward-looking risk-oriented way.

Last but not least, the upcoming review of the Non-Financial Reporting Directive will provide a crucial missing piece to the development of these methodologies, by ensuring companies are able to communicate the necessary non-financial information lying at the base of these future assessments⁷. Indeed, we note the conclusions of the recent report conducted by the BCBS, which show that the lack of available data is a key impediment to the prudential consideration of green and brown assets.⁸

2. The prudential treatment of green and brown assets in CRR3

We recognise the climate emergency and ambition of the EU institutions, not least to support a green recovery from the COVID-crisis. In light of this, we welcome the Commission exploring how to better incorporate ESG risks into the prudential framework, while ensuring that this is based on a coherent and consistent timeline for implementation and standardization of risk management processes, disclosure, and risk analysis. Overall, while we support adapting prudential policy to better consider environmental performance of assets and the associated risks, this should use balanced, quantitative constructs, based on observation and scientific data – driven not least by forward-looking risk-sensitivity.

In respect of the timeline, we note the EBA plans to publish a discussion paper for consultation in 2020, and then produce a final report by 2025 at the latest. We are supportive of a faster adaptation of prudential policy related to the treatment of green and brown assets - including in the context of the CRR3 proposal - if the appropriate risk methodology can be developed and the EBA mandates have sufficiently progressed. Furthermore, banks should be given adequate time to implement any changes.

Regarding the approach, aside from our concerns regarding the potential use of current Taxonomy Regulation, AFME is generally extremely cautious on how environmental performance assessments should be incorporated into assessing the risk of assets under prudential frameworks. Some of this concern is already reflected in the report of the NGFS⁹ on financial institutions’ practices with respect to introducing risk differentials between green, non-green and brown financial assets. The report found no strong conclusions on a risk differential between green and brown assets on the institutions they surveyed.

In respect of a green supporting or brown penalising factor, the NGFS report highlighted the risk of double-counting and distorting the regulatory capital requirements for assets through the introduction of green/brown factors. This report also recognised the need for a review of international standards to introduce any changes to the Pillar 1 framework. As per this report, AFME considers that any specific treatment distinguishing between ‘green’ or ‘brown’ assets be consistent with the principles of traditional prudential regulation.

7 https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf

8 <https://www.bis.org/bcbs/publ/d502.pdf>

9 https://www.banque-france.fr/sites/default/files/media/2019/04/17/ngfs_first_comprehensive_report_-_17042019_0.pdf

Indeed, in the current absence of evidence of a risk differential between green, non-green and brown assets, the EC should encourage the development – ideally at international level – of risk assessment methodologies that include a forward-looking perspective in addition to existing backward-looking analysis, to enable a more accurate calibration of regulatory capital requirements reflecting the long term risk profile of assets. In particular, the classification of an asset should not lead to automatic risk weighting adjustment, particularly given that loss severity and transition risk is going to be constantly evolving.

AFME recommendations on Sustainable Finance

AFME would recommend that:

- The European Commission and co-legislators should focus on the development of a robust, dynamic green taxonomy in the first instance, and only then carefully assess the possibilities for any further development of a brown taxonomy. Furthermore, it would not be appropriate to apply the Taxonomy Regulation as designed to the prudential framework for risk management purposes.
- Any adaptation of the prudential framework should be based on a risk-based approach and subject to common disclosure frameworks, lexicons, statistics, and forward-looking risk methodologies.

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/ About AFME

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues.

We represent the leading global and European banks and other significant capital market players.

We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society.

We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

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