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CAPITAL REQUIREMENTS

Implementing the final Basel III reforms in the EU

Financial market stability is fundamental for the European economy and its companies. For this reason, following the financial crisis, BusinessEurope supported reinforcing prudential rules and strengthening supervision. The new rules have restored confidence in financial institutions and made them more resilient. At the same time, bank lending came under pressure and there is a significant risk that as economic growth picks up banks will be less able to meet companies' funding requirements on the necessary scale.

That is why we have expressed concerns that additional tightening of prudential rules should not further increase financing problems. We also emphasised the importance of the SME Supporting Factor for the financing of smaller and medium-sized companies and argued that new capital requirements should not discourage the use of hedging instruments due to reduced availability and/or higher prices, neutralising the relief provided by the European Market Infrastructure Regulation (EMIR).

New prudential rules should therefore strike the right balance between ensuring financial stability and supporting companies' financing needs for investments and business activities, with specific attention to long term debt financing and equity investment. This requires a tailored implementation of Basel III in order to avoid that future changes to capital requirements put EU firms at a competitive disadvantage compared to their international peers (figures put forward by the European Banking Authority raise a level playing field issue with an increase of 23% of capital requirement for EU banks compared to 1.5% for US banks). The output floor should therefore only be applied to international capital requirements, excluding Pillar 2 and EU specific buffers, and as a backstop. It should also be applied at the group level of a banking group and not by entity.

Recent changes to capital requirements have increased the cost of capital in a context of low profitability of banks, which is a decisive factor for lending conditions in the market. Future changes to those rules should not significantly increase capital requirements overall, as requested by EU institutions, to support companies' need for capital for investment and trade (bank loans, equity investment, trade finance) and ensure access to risk management products at competitive terms.

BusinessEurope is worried about a number of studies (such as those carried out by the EBA, EBA and ECB, Bundesbank, Copenhagen Economics, and Deutsches Aktieninstitut on hedging activities) some of which argue that finalization of Basel III could lead to a significant increase of capital requirements for EU banks with impacts for the financing conditions of corporates, and increases of such magnitude that effects are expected to negatively impact GDP in a long transition period and even permanently.

We are thus highly concerned that financing conditions for non-financial companies will deteriorate when the EU must invest at an unprecedented level to meet the challenges of energy, climate change mitigation, economic and digital transitions, and transform its economic production model. BusinessEurope therefore urges the legislator to pay

careful attention to the EU market structure before approving any new standards in order to strike the right balance.

This includes:

- **Maintaining risk sensitivity and an adequate prudential treatment of unrated companies.** One of the most important areas of change with significant impacts are rules to restrict risk sensitivity of internal models (output-floors) as to credit risk. The output floor limits the calculation of credit risk and associated capital required through internal models to 72,5% of the standardized approach. This would, in particular, negatively impact the lending capabilities for well-performing “unrated companies” with solid business models and therefore low credit risk profiles. It would also affect loans that are well collateralized, e.g. by equipment and machinery, which could also be considered as low risk. The design of the output floor should be set with a view to minimize the impact on the European economy and the prudential treatment of unrated companies in the EU should be at least equivalent to the one applied in jurisdictions where the use of external ratings is not allowed (such as the USA). That is why the output floor should be applied at the highest level of consolidation, and only to international capital requirements as a backstop. Alternatives that provide close substitutes to formal external ratings should also be explored. Issues to be considered are the use of parent ratings, the use of existing bank ratings, and the use of certain types of national central bank creditworthiness evaluations.
- **A maintained SME Supporting Factor.** The SME Supporting Factor reduces the cost of lending to smaller and medium-sized companies. It is vital to maintain it in order to mitigate the disadvantaged position of such lending due to the combined effect of enhanced capital requirements and liquidity rules.
- **A maintained Infrastructure Supporting Factor.** The revised Capital Requirements Regulation includes a factor that reduces the cost of lending for infrastructure projects which respect specific criteria. The infrastructure Supporting Factor is not included in the Basel III framework but should be confirmed in its European transposition. Maintaining the Infrastructure Supporting Factor should go hand in hand with an appropriate prudential treatment of infrastructure projects, which are a European franchise.
- **A maintained Credit Valuation Risk Exemption and an appropriate calibration of the Standardised Approach for Counterparty Credit Risk.** In 2013, when the current rules were negotiated, the legislator recognized the specifics of the use of derivatives by non-financial companies to hedge corporate risks by exempting uncollateralised exposures from derivatives with non-financial counterparties used for hedging purposes from the own funds requirements for credit valuation risks (CVA risks). The importance of the exemption should be recognised and there should be no additional capital requirements in this context. Another significant cost increasing factor for corporate hedging activities follows from the required application of the Standardised Approach for Counterparty Credit Risk concerning various prudential calculations regarding derivatives. An overly conservative calibration of this method together with the very strict output floor will make hedging activities for non-financial companies much more expensive. This is even more



relevant as the USA has already made some announcements on that topic.

- **Creating a low risk category for specialised lending.** Project financing plays a significant role in the area of Public-Private-Partnerships projects, supply chain investments and the financing of certain export business. Proposed Basel III rules suggest much higher risk weights which might not be justifiable for all kinds of project financing. We therefore suggest exploring the introduction of a low risk category on the basis of quality criteria where this could be justified from a risk perspective.
- **Appropriate risk weights for the building sector.** Basel III introduces a specific category named *Land acquisition, development and construction* (ADC) exposures with a risk weight from 150% to 100%. In this context, the boundaries of such a category should be clarified to better determine the relevant risk weight, taking into account the specificity of the real estate leasing, and to exclude cases in which other sources of income contribute to repaying loans justifying a more favorable prudential treatment.
- **Appropriate risk weight for leasing exposures.** Leasing is a form of finance that has been proven over the years to be both low risk, sustainable, critical for future growth and for supporting companies (especially SMEs) achieving EU environmental goals. It should thus be supported. The current rules already overestimate the real risks of leasing exposures and the new Basel proposals would discourage leasing even more. Therefore, introducing a specific risk weight of 65% for corporate leasing (and of 50% for retail leasing) under the Standardised Approach would recognise the positive effect of owning the physical asset (i.e. equipment, machinery, vehicles), while also ensuring any output floor does not result in excessive limits on the internal ratings-based approach.
- **Revised treatment of certain equity exposures.** Deep and liquid equity markets are vital for supporting growth in the EU. An increase in regulatory costs, in particular in the area of venture capital equity investments, could lead to banks no longer performing the role of facilitating investment in equity markets, and consequently, no longer being able to support the European equities market. As the EU tries to promote the provision of venture capital in general, it should be considered whether a limited amount of bank exposures to equity stakes in start-ups and young companies should receive an accommodative prudential treatment.
- **Revised treatment of Unconditionally Cancellable Commitments.** From a corporate perspective, credit facilities play a significant role when it comes to financing a company's working capital. A change in the credit conversion factor (CCF) used to calculate the capital requirement of unconditionally cancellable commitments (UCCs), which are off-balance sheet exposures, is required considering that the Basel III framework identifies a specific CCF for UCCs (10%), penalizing the credit lines granted and not used. Otherwise, financing of corporate exposure entailing low risk (because the bank can unconditionally cancel its credit line at any time) becomes disproportionally expensive for banks, leading to worsened credit facility conditions for corporates.

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