

Key positions

of the Association of German Banks on the 2021 banking package

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In its banking package unveiled in October 2021, the European Commission rigorously continues to finalise the implementation of the Basel III agreement with the aim of creating a sound and appropriate framework which takes account of the special features of the banking market in Europe. We warmly welcome both these intentions.

Key European specificities

The centrepiece of European implementation is the implementation of the output floor. In addition to retaining tried and tested European measures such as the SME and infrastructure supporting factors, **Article 465** of the proposed new CRR sets out a series of transitional arrangements, whose primary purpose is to mitigate the increase in capital requirements caused by the output floor over a period of up to eight years. As well as phasing in the output floor in line with the Basel agreement, this article addresses **key specificities of the European banking landscape**.

Firstly, Article 465 introduces a preferential risk weight of 65% for **unrated companies of high credit quality** (i.e. with investment-grade status). Users of internal models approved by supervisors under the IRB approach can classify a firm as investment grade if its probability of default does not exceed 0.5%. This arrangement takes account of the fact that European companies do not normally have an external rating, making it impossible to exercise the option under the Basel standards of assigning them to a low-risk category on the basis of external ratings. The proposed measure is the best possible alternative. We assume that nothing will change in the medium to long term about the fact that very few investment-grade firms in Europe have an external rating. There are a number of (good) reasons why so many European companies decide against subjecting themselves to an external assessment by a credit rating agency. A further incentive set by the prudential framework will not change the situation. The Commission proposes that the EBA should review the use of the measure. **Precise parameters for this review should be spelled out in the level 1 text and the existing measure should be retained until an effective equivalent solution is available.** As well as taking quantitative stock of external ratings, the EBA should examine the economic, legal, institutional and cultural reasons for the low rating coverage and forecast likely developments over the next ten years. In addition, it should analyse the appropriateness of the capital requirement generated when the transitional treatment is applied.

Secondly, it is envisaged that member states can permit the assignment of a preferential risk weight to **residential property** if a number of basic conditions are met. This measure also addresses a key special feature of banking in Europe. Residential property loans are usually held by European banks for decades at a fixed interest rate. In several member states, banks can demonstrate that they have very low loss rates because the legal system works efficiently and, in the event of a default, a bank has access not only to the property through foreclosure measures but also to the income of the borrower (so-called double recourse). This combination of long-termism, fixed interest and double recourse is normally absent from the other member

countries of the Basel Committee. Europe is therefore justified in allowing special treatment in this area. The treatment is conservative, moreover, since a bank not only needs to meet the double recourse condition but must also have a very low historical loss rate of no more than 0.25% on the exposures concerned. Here, too, we are convinced that the situation will not change and that this treatment should therefore be retained permanently. Once again, it is envisaged that the EBA should conduct a review, though the specifics of this mandate are not spelled out in sufficient detail. **The EBA should be instructed to collate loss rates across Europe and systematically assess the overstatement or understatement of the risks involved.**

Thirdly, owing above all to the dependence of Europe's export industry on the US dollar and to the need to hedge exchange rate risks, the so-called alpha factor will be dropped from the calculation of **counterparty credit risk** in the standardised approach (SA-CCR) for the purpose of determining the capital charge of the output floor for users of internal models. We strongly support this measure, too. The SA-CRR was adopted by the Basel Committee in 2014 and partially calibrated before the financial crisis. There is now widespread agreement not only in the industry but also among supervisors and regulators that this calibration no longer reflects the prevailing market conditions and is far too conservative. For political reasons, however, the Basel Committee does not wish to address the issue again. The EBA has therefore rightly been given a mandate to draft a report on the basis of which the Commission may decide to adopt a delegated act to permanently lower the alpha factor. However, the SA-CCR clearly overstates the risks of derivatives for all users. **The CRR should therefore provide for the possibility of extending the neutralisation of the alpha factor to the standardised approach as a whole, and not just to the calculation of the output floor capital charge.**

Article 465 sets **final deadlines** for all the measures mentioned above. This approach may be considered a political signal. Experience since the financial crisis with comparable transitional arrangements has clearly shown, however, that setting specific dates for the initial application of new rules results in so-called front-loading. In other words, capital requirements are priced in prematurely by investors and supervisors and must be complied with in practice long before there is a legal obligation to do so. **We therefore recommend setting deadlines only for the completion of the EBA's reviews.** Given the importance of the political decisions involved, the level 1 text should require these issues to be debated by the European Commission, Council and Parliament. Article 465 in its present form will merely postpone the feared increase in capital requirements. What is more, the need for capital will rise by leaps and bounds since all the transitional arrangements will come to an end and the output floor will become fully effective.

Setting an implementation period

The proposal sets 1 January 2025 as the date of application without specifying an **implementation period** for banks. Yet the implementation of the changes will require massive IT investment and procedural adjustments, which can only be set in motion once the text of the new legislation has been finalised and for which a period of at least 24 months will be required.

Owing to the uncertainty surrounding legislative process, **a 24-month implementation period should be explicitly granted, as in previous reforms.**

Output floor

The output floor has been designed in the form of a so-called single stack approach, as recommended by the EBA. To minimise European gold-plating, however, the Commission has set requirements for European competent authorities in Articles 104a (6) and (7) and 131(5) of the proposed new CRD. To compensate for increases in capital requirements generated by the output floor, supervisors should, if necessary, reduce the **P2R, the systemic risk buffer and the buffer for other systemically important institutions (O-SIIs)**. We warmly welcome this proposal and consider it justified. We nevertheless believe the wording is much too non-binding. The objective should be to prevent the aggregation of different prudential measures (output floor plus various buffers) leading to **overcapitalisation. This should also be made clear in the text** of the legislation.

Commercial property

A cornerstone of European policymaking over the next ten years will be the transition to a sustainable economy. Official estimates see a need to invest 350 billion euros, a large part of which will be spent on the energy-efficient refurbishment or construction of commercial property. Yet the proposed new **treatment of commercial real estate** in the standardised approach for credit risk fails to take this into account. It will lead to very high capital requirements in this area without sufficient differentiation based on the actual risk involved. We therefore urge lawmakers to take a European approach to this important asset class. This could, first, take the form of a **special risk weight in the loan splitting approach** along the lines of that for residential property if a bank can demonstrate that its losses have not exceeded 0.25%. Second, **further risk weight classes should be introduced in the exposure-to-value (ETV) approach**. This would ensure that increases in value resulting from energy-efficient retrofitting would more frequently lead to a reduction in capital requirements.

ADC

In the area of property development finance (acquisition, development and construction = ADC), the Commission has adopted the Basel Committee's standards and envisages a very high risk weight of 150%. Although it is possible to apply a risk weight of 100% in exceptional cases, the scope of these exemptions is too narrow. In consequence, the associated conditions need to be adjusted to sensibly reflect the situation in Europe. We would recommend, firstly, **permitting the 100% risk weight to be applied in principle to commercial property, too**. Secondly, **sources of borrower income other than income from the property should be deemed a qualifying condition** as they are obviously effective in reducing the risk of loss to the bank.

Hard test

The so-called hard test and thus the method of calculating loss data in the property sector is a vital element in determining risk weights for property loans under the European prudential framework. **A pan-European institution should therefore regularly collect and publish comparable loss data from all the real estate portfolios of European banks on the basis of their COREP submissions.**

Trade finance

Owing to Europe's strong dependence on global trade, we see a continuing need to retain the tried and tested European approach to trade finance, which differs to that of the Basel standards. According to Annex II of the proposed new CRR, the most important trade financing instruments (performance bonds, bid bonds, warranties and standby letters of credit) will now be subject to a credit conversion factor (CCF) of 50% instead of the previous 20%. This represents an increase of 150% although analyses show that actual drawdown rates remain significantly below 20%. **A 20% CCF is therefore sufficiently conservative and should be retained.**

In addition, the use of a fixed maturity value of 2.5 years should be dropped from the foundation IRB (F-IRB) approach and **the actual effective maturity should be used** instead.

Recognition of physical collateral

Physical collateral that can already be included in F-IRB approach **should also be accepted in the standardised approach for credit risk.** There is no convincing reason why its mitigating effect on risk should not also be recognised in the standardised approach, as long as the conditions set out in the F-IRB approach are also met. Giving equal treatment to physical collateral in both approaches would have a particularly positive impact on SME financing and would also be very beneficial for sales of electric vehicles, for example.

ESG risks

The proposed new CRD introduces new requirements for ESG risks. In this context, we refer to the EBA report on management and supervision of ESG risks (EBA/REP/2021/18), which clarifies that these risks materialise through the traditional categories of financial risks (e.g. credit risk). ESG risks should not, therefore, be treated as a separate risk category but as a driver of risk within the existing regulation framework. However, given the individual requirements (e.g. to hold internal capital explicitly for ESG risks, Article 73 of the proposed CRD VI), **this principle does not appear to be anchored clearly enough in the proposed CRD.** The requirement for banking supervisory authorities to review the extent to which an institution's business model aligns with the "policy objectives of the Union or broader transition trends towards a sustainable economy" is too broad. These stipulations do not allow for a legally sound interpretation. A proposal of this nature could exceed the scope of the current mandate of banking supervision. Responsibility for the business strategy and for implementing a viable business model must

ultimately lie with the governing body of the institution, which also takes account of sustainability aspects. **This requirement should therefore be removed.**

SREP

In terms of SREP requirements, the strategies and processes for assessing and holding internal capital contained in Articles 73(1), 74(1) and 76(2) refer to risks "to which institutions are or might be exposed in the short-, medium- and long-term horizon". Although these horizons are appropriate and necessary for assessing climate risks, applying them to all risks is ineffective. We therefore propose **removing this requirement or, at least, clearly restricting it to climate risks only.**

Fit and proper

We consider the recently introduced obligation to conduct ex-ante assessments of supervisory boards under the fit and proper regulations to be neither appropriate nor feasible for many European countries. Due to existing national regulations, many institutions will have practically no influence on the recruitment process of supervisory authorities. We therefore advocate deleting Articles 91a to 91d. We also consider the supervisory assessment period of six months to be far too long. **This period should be reduced to between one and two months in order to prevent recruitment problems. The requirements for immediate replacement should also be revised.** We consider the stipulations on appointing new members to be a disproportionately high administrative burden. Equally it would be disproportionate to apply **suitability standards to incumbents of key positions that are comparable with those applied to managing directors.**

Remuneration

Article 92(2)(f) of the **remuneration** framework requires the remuneration of "senior staff in the internal control functions" to be directly overseen. In some member states, national legislation provides for two-tier governance structures, so the supervisory body or its remuneration committee has no authority to make decisions about remuneration (amounts) for employees that are not members of the board. **We therefore believe this proposal should be removed.**

Proportionality

In terms of achieving greater proportionality, the proposed new CRD is an opportunity to further reduce the administrative burden on small and non-complex institutions (SNCIs). We therefore advocate for **an exception to remuneration rules for SNCIs** and for relieving **them from disclosure requirements on ESG risks.**

EBA mandates

The banking package contains a total of 80 EBA mandates to submit reports, regulatory technical standards, implementing technical standards and guidelines. Delegating rule-setting from level 1 to level 2 legislation should be well considered and kept to an absolute minimum. Regulations

with extensive consequences for the European economy as a whole will require appropriate political decision-making processes at the highest legislative level and ought not to be decided by the authorities. Regulating on level 2 may have an additional impact on capital requirements that are not provided for or specified in the text of level 1. Furthermore, experience has shown that delegating to level 2 can lead to an unnecessary detailed and overly complex regulation which, in practice, would undermine the intention of proportionate rule-setting. We therefore advocate for a **thorough examination of all mandates with the aim of regulating political topics in level 1 legislation and significantly limiting the number of mandates overall.**