Svenska Bankföreningen
Swedish Bankers' Association

FINANCE FINLAND

FINANCE DENMARK

Response from Swedish Bankers' Association, Finance Finland and Finance Denmark to the EU Commission's "Have Your Say" consultation:

Proposal from the European Commission on a review of the CRR

Memo

February 11, 2022

A permanent risk sensitive implementation of the output floor is essential and should retain risk sensitivity for loans to unrated corporates and loans secured by real estate.

The Final Basel III standards could strengthen the resilience of the European and Nordic economies without unduly harming the economic growth if implemented in a balanced way. There is room in the Basel standards for legislators to take into account the specificities of the markets to which they are implemented.

In the proposal, the EU Commission has chosen an approach for the output floor that applies the floor also on capital requirements beyond the capital requirements agreed upon at international level. This can significantly increase the cost of bank financing for homeowners and businesses in Europe and especially the Nordic countries.

The European Commission's impact assessments estimate an overall average increase in the minimum capital requirements for European banks between 6,5 and 8 per cent. However, the increases are very unevenly distributed among regions. In general, lower-risk Nordic banks are much more affected than the EU average. For Danish IRB banks the estimated average increase in capital requirements is over 20 per cent[1] and the averages increases for Swedish and Finnish IRB banks are also expected to be high. These increases are not justified by risk concerns, and they can have significant unintended consequences, such as increased financing costs for institutions and a decline in lending to customers to the detriment of homeowners and business investment. The output floor is the main driver for these increases.

The temporary adjustment of the output floor calculation for loans to unrated corporates and loans secured by residential real estate to mitigate the effect of

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[1] Based on end 2020 figures. In 2021 the Danish FSA imposed additional requirement when applying the IRB-approach which may reduce the effect of the output floor and thereby the estimated overall increase.

the output floor, as proposed by the Commission, will only have a limited value. The focus of regulators, rating agencies, investors and the management of institutions will be on the long-term situation of the institution, assuming the toughest regulatory scenario.
A permanent more risk sensitive implementation of the output floor is therefore essential. In order to retain significant risk sensitivity a permanent adjustment to the output floor calculation should be extended to include loans secured by commercial real estate where very low loss rates can be documented.

It is necessary to recognise the regulatory measures which have taken place in the EU while the Final Basel III standards were still negotiated and during the four years after its publication. The output floor in the Final Basel III standards was drafted to address undue variability and lack of comparability of risk weights between banks. These weaknesses have, however, been addressed and mitigated already with several European regulatory measures. We specifically refer to the ECB's targeted Review of Internal models from 2016 to 2020 and the corresponding IRB Roadmap with new guidelines from the European Banking Authority, as well as new regulatory initiatives to address problems arising from a buildup of non-performing loans.

While the proposed implementation of the output floor without permanent long-term adjustments is the most important issue to address, there are other elements in the Commission's proposal where we see a need for adjustments. We have more detailed comments to the proposed legislation from the Commission in the following areas:

- The output floor
- Unrated corporates in the output floor calculation
- Loans secured by real estate in the output floor calculation
- Loans secured by real estate under the standardised approach for credit risk
- Covered bond pools and unrated institutions
- Trade finance
- Commitments
- Market risk
- CVA risk
- Equity– transitional arrangements and exposures to jointly owned service providers

Specific items

Our more detailed comments to the Commission's proposal follow below.

The output floor (CRR Articles 92 (3-67) and 465)

Legislative proposal

The European Commission has chosen the so called "single stack"-implementation of the output floor where the output floor is applied on the risk weighted assets instead of the calculated capital requirement. This means that all regulatory capital requirements and buffers will be subject to the output floor, including EU specific requirements and buffers that are not applied in other regions. In addition, the Commission has proposed adjustments to the treatment of selected exposure categories in the output floor calculation to reduce the impact of the output floor. These adjustments in the output floor calculation are, however, only temporary.

Comment

The proposed single stack implementation of the output floor will disproportionately affect lower-risk European banks. This is because the conservative and risk insensitive risk weight assumptions underlying the standardised approach for credit risk are badly suited to the European business model where corporate clients predominately use bank financing and therefore have no business need for an external rating and where low risk mortgage loans remain on the institutions balance sheet rather than being securitised or transferred to government supported agencies.

We consider that a "parallel stack" implementation of the output floor would be better suited to European conditions. In the parallel stack approach, the output floor capital requirement is calculated separately from the unfloored capital requirement and only the internationally agreed capital requirements and buffers are included in the output floor calculation. This would ensure a long-term solution that still would be compliant with the Basel standards, but which would avoid excessive increases in capital requirements for lower-risk banks in Europe.

If the European Commission's proposed "single stack" approach for implementing the output floor prevails, we consider it essential that the proposed temporary adjustments are made permanent from the outset, both for loans to unrated corporates and for mortgage loans. The underlying circumstances are of a structural nature, rather than temporary, and therefore warrant permanent solutions for these exposures.

A permanent implementation of the output floor adjustments will reduce the mismatch between risk and capital requirements for unrated corporates and mortgage exposures which the standardised approach would otherwise cause for institutions using internal models. Ideally, the proposed adjusted treatment of these exposures should also apply for banks using the standardised approach under European conditions.

A temporary model for mitigating the unwarranted effects of the output floor where a possible continuation after 2032 will depend on the conclusions reflected in the proposed reports form the EBA, will create much uncertainty about capital requirements in the longer run. Institutions would have to adapt to potential future increases in capital requirements many years before the end of the temporary period. This would affect financing costs for institutions and lending to customers to the detriment of homeowners and business investment, which would weaken economic growth and the financing of the green transition.

Unrated corporates in the calculation of the output floor (CRR Article 465 (3))

Legislative proposal

As mentioned above, the proposal provides a temporary adjustment for unrated corporates when calculating the output floor, whereby IRB institutions can use a lower risk weight of 65 per cent until the end of 2032 when lending to solid business enterprises. In addition, by the end of 2028 the EBA shall report to the European Commission on the application of the temporary adjustment and on the availability of external ratings for businesses. If appropriate, and considering the EBA report, the Commission shall submit a new legislative proposal to the European Parliament and the Council by the end of 2031.

Comment

In view of the fact, that the Commission proposes an implementation of the output floor where the floor is applied on all regulatory capital requirements and buffers and not only on the globally agreed requirements and buffers, the proposed adjustments for dealing with unrated corporates should be made permanent. This will ensure that bank financing will continue to be available for such corporates and that financing costs will not unnecessarily be increased. Furthermore, most corporates in EU do not currently have a business need to acquire an external rating. A future indirect external rating requirement will entail unnecessary additional costs for corporates, as the rating would solely be used in relation to bank financing. There is currently no evidence that an increased use of external ratings in a Nordic and European context will add value compared to the use of internal ratings based on approved internal models. The EU should thus be careful to avoid indirectly to impose costly requirements on EU corporates with no evident financial stability or societal benefit.

In relation to the mandate for the EBA report on the application of the temporary adjustments and on the availability of external ratings, we note that the report should also cover the extent to which ratings are available throughout the EU, for example for corporates in the Nordic region, and not just in the EU as a whole. Thus, if the adjustments are not initially made permanent, the EBA should also consider the importance of the business structure in, for example, the Nordic countries, which is characterized by few very large companies, and many SMEs and midsized non-SME-corporates, without the need for external ratings.

Loans secured by real estate in the output floor calculation (CRR Article 465 (5))

Legislative proposal

The adjusted transitional risk weighting of residential mortgages is subject to Member State discretion and subject to the condition that the institution has proven low loss rates that are verified by the competent authority. The adjusted treatment consists of two elements. Until end 2032 a risk weight of 10 per cent can be applied for the part of the exposure secured by property below 55 per cent of the value of the property. Until end 2029 a risk weight of 45 per cent can be applied for the part of the exposures between 55 and 80 per cent of the value of the property.

Comment

Overall, we consider that the proposed adjustments, if made permanent, could be very helpful in mitigating the harmful effects of the output floor that imposes risk weights for loans to residential real estate that are misaligned with the actual risks of real estate lending in many European countries, not least in the Nordic countries. Apart from the most important issue, that the adjustments should be made permanent, the following issues are also highly important:

- An adjustment to the risk weights in the output floor calculation should also be introduced for commercial real estate in Article 465(5), using a similar model as that for residential real estate, when institutions can document very low loss rates.

- The adjusted risk weight of 45 per cent for the part of residential mortgage loans between 55 and 80 per cent of the value of the property should continue in parallel with the adjusted treatment of the part of the loan below 55 per cent of the property value.

- To ensure the integrity of the EU financial market and a level-playing field, it is important that the same rules apply across the whole Union, so that all lending institutions that meet the 'hard test' requirements in 465 (5) can make use of it. Therefore, the proposed adjusted treatment in the output floor calculation should not be subject to a national discretion.

Loans secured by real estate in the standardised approach for credit risk (CRR Articles124-126, 129 and 22~~6~~9)
Legislative proposal
In the proposal, the treatment of loans secured by real estate is amended. New risk weights and requirements for the assignment of risk weights are introduced. Furthermore, there are altered requirements regarding the valuation of properties (use of prudently conservative valuation criteria and the ongoing monitoring of the valuation and revaluation (limiting increases in property value that can be recognised).

Comment

- The proposed loan splitting method for residential real estate only recognises the credit mitigating effect from the property on the part of the loan that is below 55 per cent of the value of the property. There is no recognition of any credit mitigating effect from the property on the part of the loan~~s~~ that exceeds 55 per cent of the value of the property. This, we believe, is overly restrictive. We would suggest applying a 45 per cent risk weight on the part of the loan above 55 per cent and below 80 per cent of the value of the property instead of the counterparty's risk weight. Such a recognition is already included in the transitional provision for residential real estate mortgage loans in Article 465 (5).

- If no adjustments to the risk weights are made under the standardised approach similar to the proposed adjustments of the risk weight on loans secured by residential real estate in the output floor calculation, then more recognition should be given to the extremely low risk loans secured by residential real estate with a property value that far exceeds the loan amount. There should be two more buckets added below 55 per cent of the property value to appropriately take into account the different levels of risk.

- It is very positive that Market Values or Mortgage Lending Values still can be used in the valuation and revaluation of property in covered bonds finance. It is highly important to keep this possibility as well as the proposed amendment in Article 129(3).

- Regarding the valuation of immovable property in the capital regulation there is from our point of view no need to amend the existing valuation principles in Article 229. It should still be possible to use Market Value or Mortgage Lending Value. We also prefer to keep the possibility to adjust the values without any limit on upward adjustments. The valuation rules in the current regulation have been working well and there is no need for amendments.

- Loans to the Finnish Housing Companies should be treated as "exposures secured by residential real estate property to associations or cooperatives of individuals that are regulated under national law and exist with the only purpose of granting its members the use of a primary residence in the property securing the loans". These exposures should be categorised as residential loans just as they are currently treated.

- Housing construction loans granted under the Finnish RS system should not be subject to the ADC classification. These exposures should have the same treatment as they currently have.

Covered bonds (CRR Articles 121, 129 and 161)

Legislative proposal

In the Commission's proposal the treatment of unrated institutions in the standardised approach for credit risk is amended. This means that unrated institutions will no longer be classified to a credit quality step that depends on the rating of the government in the member where the institution is located, but instead will be into one of three "grades".

In the new covered bonds directive (2019/2162/EU) there are detailed requirements for derivatives to qualify as "covered derivatives" in the cover pool that rank equal (pari pasu) with covered bonds issued on the cover pool.

These developments are not reflected in the provisions governing covered bonds in the proposal.

Comment

- In the regulation of covered bonds in Article 129, (1)(c) there are requirements regarding exposures to institution in the cover pool with reference to credit quality steps. It needs to be considered how the new grades for unrated institutions should be implemented in the regulation of covered bonds. It should still be possible to use exposures to high credit quality unrated institutions as an underlying asset in a cover pool.

- Furthermore, in the determination of risk weight for unrated covered bonds in Article 129 (5) it is also necessary with adjustments that consider the new "grade" classification for unrated institutions.

- To improve the functioning of the covered bond market further, Article 129 (1) could be amended to not only include covered bonds but also "covered derivatives" as eligible for the preferential treatment in paragraph 4 and 5, and, hence, a LGD of 11.25 per cent according to Article 161(1)(d). It could be possible to reference the recently amended covered bonds directive (2019/2162/EU) detailing the requirements for derivatives to qualify as "covered derivatives". This amendment would level the treatment of bonds and derivatives and better reflect the equal rights in the cover pool (i.e., ranking pari passu). It would also encourage prudent risk management in the cover pool.

Trade finance (CRR Article 111 and Annex 1)

Legislative proposal

The proposal moves performance bonds, bid bonds, warranties and standby letters of credit related to trade finance from the medium/low risk category of off-balance sheet items in Annex 1 in the CRR2 to the medium risk category for determining the credit conversion factor. This will increase the capital charge for trade finance by 150 per cent.

Comment

- If the increase in capital charge for trade finance would be fully reflected in the pricing towards customers paying e.g., 0.5 per cent on a commercial guarantee, supporting exchange of goods between corporate customers, will then increase to 1.25 per cent. For an exporting company this will mean, that on a 10mEUR commercial guarantee, the price will increase from 50,000 EUR to 125,000 EUR per year.

- Banks are today in competition with insurance companies for these types of guarantees. With an increase in the capital charge of 150 per cent banks will not be able to compete with insurance companies as these are regulated by the more favorable Solvency II regulatory framework, with which such price increases are not necessary.

- With insurance companies taking over the majority of the business in an un-level playing field, banks will not be able maintain critical mass to continue doing this kind of guaranteeing business. This is a business that is also to a large extent relying on the correspondent banking network underpinning international trade. Therefore, it is questionable, whether the current correspondent banking network will be maintained by banks.

- Trade finance business is normally short-term business with large corporates (>500mEUR turnover). Exposures to financial institutions will, according to the proposal, no longer be in scope for the advanced IRB approach (AIRB), but only the Foundation IRB approach (FIRB). The current 2.5Y fixed maturity used in FIRB will, however, be totally unfit for trade finance purposes, and would entail large, unjustified increases in the cost of banks and their customers.

It is important that these problems are addressed and solved.

Commitments to extend credit (CRR Articles 4(2) and 111)

Legislative proposal

According to the proposal, commitments to extend credit will be subject to a credit conversion factor (CCF) of 40 per cent. The proposal contains a new definition of “commitments”. According to this definition, contractual arrangements offered by the institution to extend credit that are accepted by the client are considered as “commitments”. However, the proposal contains a new provision that states that contractual arrangements offered, but not yet accepted by the client, that will be a “commitment” if accepted, shall use the CCFs according to Article 111 (2). These CCFs range from 10 per cent to 100 per cent. The criteria for determining the CCFs to be used for such arrangements is delegated to level 2 regulation.

Comment

Contractual arrangements that are not accepted by the client are not subject to capital requirement according to the Basel Standards. We fail to see any justification for proposing a treatment which goes beyond the Basel Standard in this area. Non accepted offers would normally be recallable, and in the accounting framework only irrevocable contractual arrangements to extend credit are recognised for purpose of impairment. The accounting reporting rules should remain the reference for the calculation of risk weighted assets.

Market risk - The boundary between the trading book and the banking book (CRR Articles 104 and 104a)

Legislative proposal

CRR, Article 106, regulates the possibility of hedging the risk on positions in the banking book with positions in the trading book. The proposed rules for internal hedging require that the entire market risk in the banking book position is hedged outside the trading book to prevent the trading book from taking over market risk from the banking book.

Comment

We support the tighter requirements for moving risk between the trading book and the banking book, as the current rules can be used for regulatory arbitrage, when the risk is placed where the capital load is the least. However, the proposed provisions should be adjusted to allow for effective management of asset and liability risk.

We therefore suggest that it should be made possible for banks to acquire permission to transgress the proposed restrictions on hedging between the banking book and the trading book under a defined Asset-Liability-Management (ALM) mandate.

Market risk – Treatment of default risk for government exposures and covered bonds issuers under the Internal Model Approach (IMA) (CRR Article 325y)

Legislative proposal

The standardised approach for market risk allows a zero per cent risk weight for exposures to governments and central banks in the EU that are denominated in their national currency. Under the Internal Model Approach for market risk (IMA) there is a 0.03 per cent probability of default (PD) floor, regardless of exposure class.

Comment

The 0.03 per cent PD floor under the IMA prevents a zero per cent risk weight that can be used in the credit risk framework and in the standardised approach for market risk. Similarly, the PD floor of 0.03 per cent does not acknowledge the extremely low default risk of high credit quality European covered bonds. This reduces the incentive to use advanced internal risk models and increases the risk of regulatory arbitrage.

Given the zero per cent default risk treatment for EU sovereigns in the domestic currency under the standardised approaches for market risk and as well under the credit risk framework, these exposures should not be subject to a PD floor under IMA.

Furthermore, having the same conservative floor for all issuers will penalize covered bonds issued by high credit quality issuers disproportionally. We therefore propose that the PD floor for EU covered bonds rated AA or higher is recalibrated, for example to 0.01 per cent.

Market risk - Currencies treated as domestic currencies (CRR Articles 325ae and 325bd)

Legislative proposal

For interest rates risk under the Internal Model Approach (IMA) and the standardised approach, a preferential treatment is given to banks' domestic reporting currency. Interest rate risk in a bank's domestic currency is considered to belong to the most liquid (10 day) bucket under IMA, and under the SA receives a reduction in risk weight by dividing the risk weight by the square root of 2.

Comment

It should be possible for competent authorities to allow foreign banks with a large local market presence to treat the local currency as "a domestic currency". This will improve market liquidity in smaller currency areas and improve level playing field between domestic banks and banks from other Member States operating in the market.

CVA risk – Covered bonds and ERMII currency pairs (CRR Articles 383-383w)

Legislative proposal

In the proposed new standardised approach for market risk certain risk weights and correlation factors are included that recognises EU specificities regarding EU covered bonds and correlation in interest rates and narrow currency fluctuation between Euro and currencies of member states participating in ERMII. This recognition of EU specific features is not included in the proposed implementation of the new standardised approach for CVA risk.

Comment

The new standardised approach for CVA risk (SA-CVA) is based on risk sensitivity measures, risk factor weights and risk factor correlation assumptions similar to the standardised approach for market risk. In the Basel Standard, SA-CVA risk weights, granularity of buckets and correlations are specifically calibrated according to SA-FRTB.

The EU implementation of the SA-CVA should therefore include similar adjustment to reflect EU specificities as in the market risk framework in relation to EU covered bonds and in relation to the correlation in interest rates and narrow currency fluctuation between Euro and currencies of member states participating in ERMII. This is also very important in relation to capturing the effect of hedging of CVA risk more correctly.

CVA risk - exempted counterparties (CRR Article 382(4) and (4a))

Legislative proposal

The EU exemption for corporate counterparties is retained in the Commission's proposal as the general rule, and a provision is made for institutions to include CVA risk for exempted counterparties in the capital requirement calculation where the institution uses eligible hedges to mitigate the CVA risk of those transactions.

Comment

We welcome retaining the EU exemption for corporate counterparties combined with the option to include CVA risk for exempted counterparties when the institution hedges the CVA risk. The proposed provision could be improved further, so that the discretion to include capital requirements for CVA risk for exempted counterparties is clarified to allow for including the market risk exposure components only, and not including the counterparty credit spread component, that is difficult and costly to hedge. This would be better aligned with and, hence encourage, prudent hedging policies.

Simplified approaches for market risk, CVA risk and counterparty risk (CRR Articles 325a (1), 385 and 273 (1) (2))

Legislative proposal

In the proposal, simplified approaches are available for the calculation of capital requirement for market risk as alternatives for the new standardised approach and for CVA risk as alternative for the new standardised approach and basic approach. In the current CRR regulation simplified approaches are also available for counterparty risk calculation (Simplified standardised approach for counterparty credit risk, Article 281, and the original exposure method, Article 282). According to the proposal and the current CRR regarding counterparty credit risk, only institutions with limited trading book and derivative trading activity are permitted to use these simplified approaches.

Comment

Many smaller banks may, for various reasons, have trading portfolios of a certain size in relation to their total assets or derivatives transactions to a certain extent. This means that they will be barred from applying the new simplified approaches of capital adequacy of market risk, counterparty risk and CVA risk, respectively.

Since the simplified methods are calibrated so that the capital requirement is higher when using these methods than when using the new complex standard methods for market risk and counterparty risk and the basic approach for CVA risk, we find it natural that the individual institution can choose the method that is in accordance with the institution's ambitions and resources.

Equity exposures - transitional arrangements (CRR Article 495a (3))

Legislative proposal

In the proposal, institutions may continue to assign the same risk weight that was applied as of one day before the date of entry into force of the amending regulation, to equity exposures to entities of which they have been a shareholder for six consecutive years and over which they exercise significant influence.

Comment

We strongly support the proposed grandfathering of the current treatment of historic and strategic equity investments in entities, including in insurance undertakings. However, it should be ensured that institutions, which have applied the IRB approach for credit risk upon such equity exposures, are also able to apply the same risk weight as institutions that have applied the standardised approach for credit risk upon such equity exposures. This will ensure a future level playing field between institutions regardless of the approach they currently use for the risk weighting of the comprised equity exposures.

Equity exposures to jointly owned service providers (CRR Article 4, (1) point 26, b, (ii), and Article133)

Legislative proposal

According to the proposal, non-speculative equity exposures in the banking book shall be risk weighted at 250 per cent under the standardised approach for credit risk compared to current risk weight of 100 per cent. Furthermore, the definition of a "financial institution" has been amended to include "ancillary services undertakings". This means that equity exposures in ancillary services undertakings will become subject to the rules for own funds deductions of holdings in equity instruments in financial sector entities.

Comment

The Commissions' proposal can have a significant negative effect on the business model of smaller banks that in partnership with other banks own entities which provide auxiliary services and other products for the partnership banks, for example IT-services and mortgages. This business model is used by local and regional banks in Denmark and allow smaller banks to compete on more equal terms with larger banks where these services are provided inhouse or by entities within the same banking group which would be covered by the Commission's new proposal of a risk weight of 100 per cent for such intra-group holdings. (cf. proposed amendment of article 49 (4)).

To protect this business model for smaller banks, the 100 per cent risk weighting for equity exposures to such jointly owned service providers should be maintained and an exception in the deduction rules should be allowed for capital instruments issued by ancillary services undertakings.

Contacts

Swedish Bankers' Association: Johan Hansing - johan.hansing@swedishbankers.se
Finance Finland: Veli-Matti Mattila - veli-matti.mattila@finanssiala.fi
Finance Denmark: Jakob Legaard Jakobsen - jlj@fida.dk