ESBG’s response to the Commission’s consultation on the finalisation of Basel III in the EU

Summary

- **Output floor**: The implications of the output floor on EU specific capital buffers should be carefully assessed and any undue capital increase avoided so that the output floor eventually does not affect items that were not in the scope of the international standards agreement. Moreover, we believe it should be applied at the highest level of consolidation.

- **New standardised approach for credit risk**: It lacks risk sensitivity and the new risk weights are too conservative regarding some exposure classes. More specifically:
  - **Unrated corporates**: In Europe, many of the bank’s corporate clients do not have an external rating. In the new standardized approach, these counterparts all receive a risk weight of 100%. In this respect, ESBG proposes that the EU implements the final revision of Basel III in a manner that banks may assign these corporate counterparts an “Investment Grade” classification, provided that the bank has the necessary information.
  - **Specialised lending**: ESBG calls for more risk sensitivity: 1) In the standardised approach through more granular risk weight levels; and 2) In the IRB approach, through more granular loss-given default (LGD) input floors and asset values haircuts.
  - **Acquisition-Development and Construction (ADC) lending**: it is important that the revised Basel III provision that introduces more risk sensibility to the treatment of these exposures is incorporated into EU regulation. A proper framework development is also necessary in order to distinguish between speculative and non-speculative exposures.
  - **Real estate**: the EU implementation of the revised Basel standard should secure that real estate market portfolios with historically low-defaults (commercial as well as residential) could be treated with a more risk-sensitive approach. In our view, in fact, the new standardised approach might not be granular enough and the risk weights connected to the two loan to value buckets might be too high.
  - **Equity**: we recommend maintaining the current allowance of lower risk weight of 100% (Basel proposes to increase it from 250% up to 400%) to be kept for intragroup exposures and members of an institutional protection scheme.

- Given that the package of reforms to finalise the Basel III framework is designed for internationally active banks, ESBG believes that its implementation in the regulatory framework of the EU should reflect the proportionality principle, taking into consideration the nature, scale and complexity of the activities of European credit institutions.

- Moreover, ESBG believes that the **EU special features already anchored** in the Capital Requirements Regulation and Directive (CRR II/CRD V), such as the treatment of financial equity holdings, exemption from holding capital against credit valuation adjustment (CVA) risk on corporate derivatives exposures and supporting factors for SMEs and infrastructure exposures, should be retained.

- Finally, from an international perspective, we believe that the implementation of the Basel IV standards in the EU might raise a **level playing field issue, namely with the United States**, due to the fact that European legislators will apply the new rules to all banks in the EU, and not
only to the internationally active ones. For example, the Basel IV standards are likely to increase capital requirements for lower risk-weight portfolios, such as mortgage loans. European banks generally hold larger mortgage portfolios and would therefore be more affected than US banks.

- **Corporate governance:** ESBG is of the opinion that the fit and proper assessment of key function holders should be carried out ex post. An ex ante assessment would carry additional administrative burden and significant delays in new appointments, which would leave financial institutions without important staff for longer than necessary. Ex post assessment of board members and key function holders would still be carried out as they are in a bank’s best interests. In addition, the EBA, ESMA and ECB guidelines and guide on suitability and key function holders from 2017-18 should be taken into account as there was extensive stakeholder consultation.

- **Sustainable Finance:** The phased approach considered by the EU Institutions in CRR2/CRD5 is the right way to encourage the integration of environmental governance and social (ESG)-related risks in risk management processes by financial market participants. We need to consider the steps banks and financial institutions are taking to decarbonize their portfolios and addressing the issue via the Pillar 2 first, before establishing Pillar 1 requirements are the sound way of doing so. Regarding the need of a common set of metrics (or classification system) that are specified for Environmental, Social and Governance factors, we recommend European authorities to focus first on Environmental-related risks (starting with climate to integrate step by step other environmental objectives) in their development of prudential processes. Whereas, regarding the need for data, we believe extending the scope of application of the non-financial reporting directive (NFRD) would be a first step for enhancing the quality of data available on the market. Finally, we argue that no regulatory framework should be established with respect to the inclusion of climate factors in stress testing before the market can use common scenarios and methodologies in order to stress their portfolios.

- **Reporting:** We welcome the initiative by the European Commission to simplify and harmonize the reporting and disclosure requirement, however, with reference an overall approach for Supervisory Reporting and Pillar 3 Disclosure is required to benefit both banks and external stakeholders genuinely. In addition, we believe the costs and administrative burden for the institutions should not be increased.