



EU Commission Consultation on the implementation of Basel III reforms in the EU

Confindustria response to the consultation

Confindustria welcomes the European Commission's initiative to involve all stakeholders in the implementation process for the new Basel III reforms.

In this regard, Confindustria particularly appreciates the Commission's intention to take into consideration individual European specificities, in keeping with the goal set by the G20's central bank Governors in signing the Basel III reforms of not generating significant increases in capital requirements on banks, and to ensure a level playing field among the various countries involved.

Nevertheless, it should be kept in mind that on the basis of the impact estimates published by the European Banking Authority (EBA), if the new rules are not properly transposed into European regulations, they could generate an increase in banks' minimum capital requirements amounting to about 24%, versus an estimate of 1.5% for the United States.

This is far from an insignificant impact for Europe, since it could potentially translate into a reduction in the supply of credit to families and businesses, generating significant negative repercussions on the real economy.

This is especially important in countries such as Italy, whose entrepreneurial system mostly comprises small and medium enterprises that have limited access to capital markets and rely heavily on bank credit.

It is thus important to prevent bank credit from being further penalized by the new rules. The transposition procedure for the Basel III Accord should thus include measures that facilitate the granting of credit to smaller firms, to prevent them from suffering negative shocks with restrictive effects on productivity and investments.

Additionally, there are several projections that would not favour a level playing field among the countries involved in the Accord, but instead risk further widening the gap between countries, both in a European and in an international context.

Among the various issues included in the Consultation, Confindustria would like to bring to the Commission's attention the main shortcomings identified in the text of the Agreement, with their proposed transposition in European regulations.

▪ **SME Supporting Factor**

The application of a capital reduction factor for loans to SMEs under the Basel reform is one of the novel aspects of the Accord. This is a positive achievement because the reform adopts a measure introduced into European regulations and concerning bank capital requirements, the SME Supporting Factor, thus confirming the desirability of a reduction factor for loans to smaller firms.

Nevertheless, under the Basel Accord the reduction factor only applies to unrated SMEs and to reductions applied using the standardised method, and it is smaller compared to the reduction factor currently applied under European regulations.

Proposal: the reduction factor for loans to SMEs under Regulation (EU) 876/2019 – equal to 76.19% for exposures up to 2.5 million euros and 85% for exposures above 2.5 million

euros – should be maintained. As this also applies to the exposures of banks that calculate capital requirements using internal models, it involves a scope of application that is significantly broader than the one set out under the Accord.

▪ **Prudential treatment of unrated firms**

The prudential treatment of unrated European firms is penalized compared to that of firms in jurisdictions where the use of external ratings is not allowed.

In this regard, it should be pointed out that ratings from third parties (External Credit Assessment Institutions), are allowed in Europe, while this is not the case in other countries such as the United States. This is a consequence of the financial crisis that undermined the credibility of external ratings in certain countries, which thus no longer allow them to be used to calculate the capital requirements of banks.

The result is significantly different treatment for European firms compared to American ones.

In Europe, under the Basel Accord the reduction factor is not applied to unrated firms, with the exception of SMEs, for which a reduction factor of 85% is applied.

In countries such as the United States, where ratings are not allowed, the basic reduction factor for unrated firms is equal to 100%, but a reduction factor of 65% is applied to firms classified as “investment grade”; one of the requirements for this classification is the issuance of listed financial instruments. This disposition introduces a de facto favourable treatment for firms from other jurisdictions, such as U.S. firms.

Proposal: in transposing the Basel regulations, a reduction factor of 65% should also be applied to unrated European firms classified as “investment grade”. The requirements for “investment grade” classification should also be revised. Given that in Europe, SMEs do not resort to financial and capital markets to the same extent as in other jurisdictions, especially in the United States, the requirement of issuing listed financial instruments should be removed, so that the reduction factor of 65% can also be applied to unrated European firms that are able to fulfil their financial obligations but that do not issue listed financial instruments.

▪ **Infrastructure and project finance**

In the absence of external ratings, the Basel reform applies different reduction factors to finance reform depending on the operational phase of each individual initiative.

Additionally, it does not apply a reduction factor to financing of infrastructure investments, as set out in the recently approved text for the CRR2.

Proposal: a more risk-sensitive and granular approach should be adopted that takes into account the risk mitigation factors associated with each project, and their relative impact on credit markets. Banking institutions must pay attention to the concession contract, the clauses contained, and to the cash flows that the infrastructure is able to generate.

These factors can have significant impacts on the riskiness of the investment.

Additionally, the Infrastructure Supporting Factor, a reduction factor currently applied to financing for infrastructure investments, should be maintained and strengthened in European regulations.

▪ **Construction sector**

In its standardised approach, the Basel III reform introduces a new real estate category for land acquisition, development, and construction (ADC). This category comprises exposures for the acquisition of land and for the development and construction of real estate, the reimbursement of which arises from the sale of the asset and/or the potential cash flow generated by it.

The reduction factor for these exposures amounts to 150%. Nevertheless, Basel III provides the option to reduce this factor in the presence of certain specific conditions that mitigate risk, including the existence of pre-sale or pre-leasing contracts regarding the real estate in question.

Proposal: European legislation should include the option of reducing the risk reduction factor under certain conditions. A weighting of 150%, in addition to not being justified, is able to exacerbate the crisis in the construction sector, which is one of the productive sectors that has suffered the greatest credit restriction since 2008.

To support the construction sector, it is also necessary to take into consideration:

- the possibility of additional risk mitigation related to the ability of the construction firm to autonomously reimburse the loan; in this case, the reduction factor to be applied should be that of the counterparty as opposed to the one usually applied to ADC exposures;
- other specific factors, such as those that can mitigate the construction risk, for example the build quality or the impact on environmental and social sustainability. For this reason, it is essential that the achievements of buildings with high energy efficiency, seismic safety measures, demolition and reconstruction interventions within urban regeneration programs can be rewarded.

Furthermore, the specific characteristics of real estate leasing should also be explicitly acknowledged.

▪ **Medium and large enterprises**

For large and mid-sized corporates (with consolidated revenues of over 500 million euros), the prudential treatment that applies is less favourable than the prudential treatment applied to independent large and mid-sized enterprises (with revenues of less than 500 million euros).

More specifically, if a large or mid-sized enterprise belongs to a corporate group with the above-mentioned revenues, banks cannot calculate its rating using the A-IRB approach (advanced internal-ratings based approach), unlike what they can do with regards to an independent large or mid-sized enterprise.

Proposal: The same rating calculation method should be applied across the board so as not to discriminate against large and mid-sized enterprises on the basis of whether they belong to a corporate group.

▪ **Leasing**

Within the framework of the standardised approach, the Basel Committee attributes a reduction factor of 100% to exposures arising from leasing operations for automobiles and equipment, as it does with other unrated corporate exposures.

In this regard, it should be stressed that the operation carries a lower risk for the leasing company, which maintains ownership of the asset, compared to other forms of financing.

Proposal: the transposition of the Basel Accord in Europe could be an opportunity to take this aspect into consideration, especially in light of the importance of leasing in the renewal of fixed capital, particularly for smaller enterprises.

▪ **Credit risk mitigation**

Both in the Basel III Reform and in the CRR2, the criteria for the recognition of non-financial collateral for credit risk mitigation purposes are very restrictive, and differ depending on whether the standardised approach or the approach based on internal ratings based is used.

Proposal: the new revision of the CRR for the purposes of implementing Basel III should be used as an opportunity to re-define this framework, broadening the types of non-real estate non-financial collateral that can be used for credit risk mitigation.

This would also be relevant for the purposes of the new regulations for the prudential provisioning of non-performing exposures (calendar provisioning), which establish different schedules and accrual rates depending on whether the non-performing exposure is guaranteed by risk mitigation instruments recognized by the CRR.

In general, moveable property listed in public registries could be introduced as guarantees for credit risk mitigation.

We also ask that ships be recognized as admissible guarantees. Indeed, European legislation already de facto recognizes ships as high quality guarantees within the framework of covered bonds (cf. paragraph 1 letter g) of art. 129 of the CRR.

By the same token, for the approach based on internal ratings we believe that the EBA may evaluate the existence of the conditions set out under art. 199 (6) for the eligibility of collateral other than real estate by adding ships to the list under art. 199 (8) of the CRR.

Furthermore, in order to allow SMEs to access more favorable conditions for bank credit, in implementing the Basel III reform in the CRR it would be appropriate to intervene on the prudential treatment of the exposures guaranteed by supervised financial intermediaries. In particular, this treatment should not be linked to the rating of the

Member State in which these intermediaries are based; instead it should be related to the rating assigned to the guarantor according to thresholds defined by the CRR.

- **Credit conversion factors**

The Basel III Reform introduces a new credit conversion factor – the coefficient that translates off balance sheet exposures (such as credit lines opened but not yet used) into their credit exposure equivalents – of 10% for unconditionally cancellable commitments, which are currently not subject to asset requirements.

This measure would have a negative impact on the access to operating loans for firms, especially smaller ones.

Proposal: we propose that this measure should not be transposed, given the specific conditions in many European countries where recourse to unused credit lines on the part of firms is a common practice that is essential to ensure the necessary flexibility in meeting financial needs.

- **Retail portfolio**

The Basel III reform points to the need that retail exposures must be sufficiently granular to ensure the adequate diversification of retail portfolios (which are assigned a risk weight of 75%). In this regard, the reform establishes that a single position cannot exceed 0.2% of the total value of the entire portfolio.

Proposal: the approach currently adopted by the CRR should be maintained, which does not establish fixed parameters to establish the retail nature of the exposure, leaving banks free to evaluate the adequate diversification of the portfolio bearing the exposure.

- **Investments in equity**

In the new Basel framework, equity exposures are highly penalized. It is no longer possible to use A-IRB models, and the new risk weight factors under the standardised approach are too high compared to actual position risk. The result is that capital requirements for equity exposures increase significantly, thus discouraging banks from carrying out such operations.

Proposal: the CRR's current regulations should be maintained so as not to discourage investments in equity on the part of financial institutions, which investments are useful for capitalizing firms that do not have risk levels high enough to be penalized to such an extent at the asset level.

- **CVA exemption**

The revision of the Basel III rules introduce the imposition of capital requirements for CVA risk for contracts stipulated with certain counterparty types, including non-financial enterprises.

Proposal: we ask that the current exemption from capital requirement for CVA risk currently adopted at the European level be confirmed, since the imposition of capital requirements on such transactions would imply an increase in hedging costs, thus discouraging virtuous financial risk management practices on the part of firms.

▪ **Output floor**

The Basel III reform calls for a minimum level of regulatory capital to be calculated with its own internal models (output floor), and weighted (at a level of 72.5%) to the amount of capital requirements calculated on the basis of the standardised method.

Proposal: in order to prevent the excessive reduction of risk sensitivity in bank's internal evaluation model, we ask that the output floor be applied in Europe at the consolidated level only (and not at the individual level).

▪ **Sustainable Finance**

Confindustria appreciates and endorses the goals of the European Commission's work on the issue of Sustainable Finance.

It is however important to avoid introducing excessively stringent rules for enterprises that are moving towards sustainability, so as to not penalize those virtuous processes that require time in order to be completed.

For this reason, it is essential to introduce new sustainable finance rules in a gradual manner; by the same token, it is essential to introduce incentives to the financing of sustainable investments on the part of firms.

Confindustria thus welcomes the mandate that EBA has been given to evaluate the feasibility of Green and Social Supporting Factors, although a timeframe for completion shorter than the current six years would be preferable.