BUSINESSEUROPE

POSITION PAPER

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CAPITAL REQUIREMENTS
Implementing the final Basel III reforms in the EU

Introduction

BusinessEurope welcomes the Commission's efforts to faithfully implement the international Basel III agreement while taking into account the specific features of the EU's banking sector. It is important that the amendments to the capital requirements Directive and Regulation strengthen the resilience of the banking sector without resulting in significant increases in capital requirements.

Financial market stability is fundamental for the EU economy and European companies. This includes ensuring that banks can properly finance the economic recovery and twin transition and ensuring that EU firms are not put at a competitive disadvantage compared to their international peers. Previous changes to the capital requirement rules have restored confidence in financial institutions and made them more resilient. At the same time, bank lending should not come under further pressure, and it is necessary that, as economic growth picks up, banks are able to meet companies' funding requirements. This is especially important since the green and digital transition will require significant investments by European businesses and these investments will also have to be financed by banks, both EU and non-EU banks.

For this reason, we are concerned that additional tightening of prudential rules could raise financing issues. We also emphasise the importance of the Infrastructure Supporting Factor to reduce the cost of lending for certain infrastructure projects and the SME Supporting Factor for the financing of small and medium-sized companies. We also argue that new capital requirements should not discourage the use of hedging instruments and reduce their availability, or the use of trade finance products that are key for international commerce.

SME and Infrastructure Supporting Factors

The Commission proposes to maintain the Infrastructure and SME Supporting Factors. This is necessary as, unlike in the US, banks in the EU play a key role in both infrastructure and SME financing. The EU needs to encourage investment in infrastructure projects and the Infrastructure Supporting Factor reduces the cost of lending for such projects. The SME Supporting Factor is equally important as it mitigates the adverse effects on SME lending of a previous tightening of capital requirements and liquidity rules.

Corporate hedging

The Commission proposes to maintain the Credit Value Adjustment (CVA) exemption, although banks will be required to report to supervisors as if the exemption was lifted. When the current rules were negotiated, the legislator recognised the specifics of the use of derivatives by non-financial companies to hedge market risks. As a result, uncollateralised exposures to derivatives with non-financial counterparties used for hedging purposes have been exempted from the own funds requirements for CVA risks.

AV. DE CORTENBERGH 168
BE-1000 BRUSSELS
BELGIUM
VAT BE 863 418 279

BUSINESSEUROPE a.i.s.b.l.

WWW.BUSINESSEUROPE.EU

TEL +32(0)2 237 65 11
FAX +32(0)2 231 14 45
E-MAIL: MAIN@BUSINESSEUROPE.EU
EU Transparency register 3978240953-79

This exemption is very important for corporate hedging 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 (SA-CRR) for derivatives. While we welcome the Commission's proposition to remove the alpha multiplier for banks using internal models and impacted by the output floor (the alpha multiplier artificially increases banks' exposure amounts), we regret that this would only be temporary (until the end of 2029) and that it would not apply to banks using the standardised approach (which means that it would not benefit all commercial end-users). As there is no convincing risk-based argument for such a flat-rate surcharge on corporate exposures, we strongly advise to follow the US in neutralising the alpha factor (i.e. setting it at 1) without a time limit, and to neutralize it in the standardised approach (SA-CCR) for all banks to benefit and not only for those constrained by the output floor. The twin transformation of the European economy will over time also certainly modify and increase non-financial firms' hedging needs, so there is a clear need for a long-term solution.

Output floors

BusinessEurope is especially concerned about rules to restrict the risk sensitivity of internal models for credit risk. In particular, the introduction of an "output floor" will set a non-risk-sensitive lower limit to the capital requirements that are produced by banks' internal models, at 72.5% of the requirements that would apply on the basis of the standardised approaches. It is key to maintain risk sensitivity for low-risk exposures and a prudential treatment of unrated companies that does not penalise EU banks and companies. In our view, the output floor should be applied narrowly, for example by excluding Pillar 2 and EU specific buffers and, in any case, applied at the highest level of consolidation only to allow banks to allocate capital and liquidity where it is needed.

Close to 80% of European corporates are not rated by rating agencies and often they draw most of their funding from banks that use internal models to determine their risk. However, the Basel III standardised approach to measuring credit risk is particularly severe for those unrated companies. This means that the output-floor would lead to a significant rise in EU banks' capital requirements for these exposures. The Commission proposes to temporarily limit these increases. The output floor will gradually increase from 50% in 2025 to 72,5% in 2030, and until 2032 banks will be allowed to apply a preferential risk weight of 65% to their exposures to unrated corporates that are essentially of "investment grade" quality. However, there is a strong need for a permanent solution in our view.

The EU needs predictable bank rules to finance the green and digital transition so there should be clarity before transition periods expire to ensure that companies can continue to access bank financing on competitive terms. Given the typical maturity of five to seven years for corporate lending, firms' funding decisions will be affected by the temporary nature of transition periods as soon as the next couple of years. As such, there is a clear need to move quickly to make these arrangements permanent.

Ratings

The Commission should start considering close substitutes to external ratings as soon as possible. For most companies an external rating will not be appropriate and 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.

Specialised lending

Banks play a key role in infrastructure financing in the EU, while in the US infrastructure projects are mainly financed by capital markets. As mentioned above, we are thus pleased that the Commission proposes to maintain the favourable treatment for this type of financing (Infrastructure Supporting Factor). However, it is proposed that this favourable treatment would only be temporary for non-infrastructure specialised lending such as object finance and project finance. BusinessEurope suggests making this less punitive treatment permanent and to create a stable low risk category based on quality criteria for these types of financing (infrastructure lending, object finance and project finance) to avoid any significant increases in regulatory costs in the future.

Specialised lending comprises of 3 different categories of finance which play a key role in the EU economy: project finance (e.g., sustainable infrastructure investment), object finance (e.g., a ship or an airplane) and commodity finance (e.g., finance for the import and export of agricultural goods). Project financing plays a significant role in Public-Private-Partnerships projects, supply chain investments, and the financing of export business. Collateral under these categories should be taken into account and risk weights should reflect the low risk profile of these types of financing so that the availability on competitive terms of these particularly important financing instruments is ensured.

Real estate

Unlike US banks, which offload much of their mortgage loans by selling them to state-backed entities or through securitisation, European banks largely keep them on their balance sheets until maturity. Moreover, the dual recourse to both the borrower and the property is a central element of mortgage lending in Europe, which significantly reduces losses on mortgages (as validated by the European Supervisor during these model reviews) compared to the US where non-recourse lending is more common. However, the Basel standardised approach has been devised for the US model (in which banks mainly retain high-risk residential mortgages), so it is not suited for the European model in which banks mostly retain low-risk residential mortgages. The output-floor could therefore have a big impact on European banks' capital requirements.

Consequently, BusinessEurope supports reducing capital requirements for these low-risk exposures. The transitional arrangements that are proposed for real estate exposures (until 2032) should be made permanent so that banks would be able to continue applying a lower risk weight to the part of their residential mortgage exposures that is considered secured. Such a preferential regime should also be applied to banks using the standardised approach for the calculation of capital requirements, and thus not be subject to the exercise of a national discretion.

Trade finance & Credit Lines

The leading role of European banks on trade finance is essential for the EU, ensuring the supply of key commodities and products and the autonomy of production. That is why BusinessEurope is concerned about proposed changes in the treatment of trade financing guarantees. The planned increase from 20% to 50% in Credit Conversion Factors (CCFs), which are used to determine the amount of an exposure to be riskweighted, would imply a sharp deterioration in conditions for export companies (higher prices, lower volumes).Also, it is important to note that the CCF of 50% is overly punitive and does not correspond to the actual 8% that reflects the percentage of performance bonds that are claimed by applicants already in default.

We are also concerned about the proposed treatment of off-balance sheet items (unconditionally cancellable commitments ('UCCs') which are in the SA-CR going up from 0 to 10%) considering that UCCs would include all the normal credit lines which do not normally carry any risk since banks can call the commitments off any time. We question whether these changes are necessary given the low risk-profile of these activities.

In addition, regarding the standardised approach, it is important that a short-term maturity adjustment is available that allows to assign appropriate risk weights for short-term exposures to corporates. This is particularly relevant for trade finance, amongst others, given their short-term nature.

Export finance

The CRR II requires banks to provision their non-performing loans (NPLs) after eight years, even if the loan is covered by an official Export Credit Agency (ECA) guarantee, and their guaranteed non-performing loans after four years if the loan is covered by a private credit-insurer, even if the bank does not expect any loss on these guaranteed loans.

Although we appreciate an effective European NPL framework, the proposals to provision for NPLs backed by official ECAs and private credit insurers, could impact banks' financing of export contracts with long maturities. These possible negative implications should be monitored and evaluated to avoid any significant harm to the competitiveness of some European exporters.

Strategic equity holdings

The Commission proposes a favourable treatment for strategic equity holdings, however this would not apply to all banking groups. Ensuring a "level playing field" between all banking institutions in the EU is essential to maintain an appropriate funding of the real economy in all Member States, especially at a time when the Banking Union is not yet completed and the single banking market is still not a reality. It is thus important that the favourable treatment for strategic equity holdings is extended to all categories of banks regardless of their prudential treatment.

To further provide for appropriate incentives for banks' investments in equity of non-financial companies, we suggest including a higher granularity of the framework and a better recognition of the diversification effect.

Third-country branches

EU corporates and investors also need to access to services and liquidity provided by non-EU banks. While BusinessEurope recognises the Commission's efforts to increase the supervisory quality of third-country entities and shares the objective of strategic autonomy that the Commission seeks to develop, this must not restrict access for EU corporates to capital markets or cross border investment services. It is important that the implications for the financing of EU-corporates are monitored and evaluated in an impact assessment.

Impact assessment

The total impact of the Commission's proposals on the banking sector and EU companies, both large and small, is difficult to judge as the proposal diverges in many respects from previous impact analyses by official bodies, the private sector, think tanks, etc. that were modelled on different premises. Most likely, the impact will be quite heterogeneous across Member States due to uneven effects of the proposed rules on different national banking systems.

The proposed specific adjustments for the EU would considerably reduce the short-term impact of the Basel III finalisation on banks but most of the proposed adjustments are only transitional. Banks will also certainly have to increase their own funds well beyond the estimated cumulative amounts. The capital requirements calculated by the Commission represent the additional capital that banks will need just to comply with minimum regulatory requirements. However, banks now have comfortable margins over these minimum thresholds. They will need a lot more capital if they want to maintain them.

Moreover, the impact of the finalisation of Basel III on US banks will certainly be much lower because capital markets play a larger role in the US for credit supply to corporates. In addition, the output floor will have a lower impact on US banks, notably because mortgage loans are riskier (so already associated with relatively high-risk weights) and largely removed from their balance sheets.

BusinessEurope is concerned about the uncertainty regarding the real impact on the EU economy and EU companies, especially SMEs, of the Commission's proposals. Implementing the international Basel III agreement should not put EU companies at a competitive disadvantage compared to their international peers. New prudential rules should strike the right balance between ensuring financial stability and supporting companies' financing needs for investment and business activities, with a specific attention to long term debt financing and equity investment. EU banks should be able to properly finance the economic recovery and twin transition. We thus call on all co-legislators to be thorough in their assessment of banks' additional capital needs, given how such requirements can impact the availability and price of lending in the different Member States.

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