Finance Watch response to the European Commission consultation: Implementing the final BASEL III reforms in the EU

Brussels, 3 January 2020

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 80+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are relevant to Finance Watch are reproduced here. For more about the consultation, click here.

We agree to the publication of this response.

Finance Watch – AISBL | Rue Ducale 67 b3, B-1000 Brussels | www.finance-watch.org
Tel: +32 (0)2 880 04 30 | Fax: +32 (0)2 888 63 80 | contact@finance-watch.org

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1.2.2. PD (probability of default) – increase of the input floor

Issue: The Basel III standards require for each exposure with the exception of exposures in the sovereign asset class that the PD that is used as input into the IRBA RW (internal ratings based approaches risk weight) formula and the calculation of expected loss must not be less than 0.05%. This percentage – a so called input floor – constitutes an increase compared to the previous floor of 0.03% (which is implemented in the EU in Article 160 CRR) and is meant to ensure a minimum level of conservatism in model parameters while reducing undue RWA variability.

Question 66. In your view, how does the increased floor compare with the current floor in terms of achieving the aim of increased conservatism?
Would you consider a floor that implicitly assumes that a default occurs once every 2000 years to be sufficiently prudent?
Please explain.

Moving from a PD of 0.03% to a PD of 0.05%, i.e. from a theoretical situation where a default occurs every 3333 years to every 2000 years is not statistically and, most importantly, economically significant. For obvious reasons, this sort of probability cannot be founded empirically nor extracted from any meaningful data set. This type of probability implies an underlying normal or log-normal statistical distribution that is not able to capture the economic reality of the world of defaults where 5 or 10 standard deviations events happen regularly, something impossible in theory. In other words, the underlying so-called science founding the computation of banks' capital requirements is flawed in the sense that it gives a reasonably good description of the underlying economic reality of banks' businesses when things run smoothly but is unable to capture the behaviour of financial assets or default events when things turn sour. This is a major concern given the fact that capital requirements are meant to ensure that banks will prove resilient through difficult times: the computation of banks' capital requirements is founded on a theory that does not work during times of crisis despite the fact that capital is, by construction, the lifeline that banks will need to use during times of crisis.

Confronted with this situation, regulators should have the following approach:

- Assume the fact that raising the input floor from 0.03% to 0.05% does not have to be justified by any level of so-called science, as there is no such thing in either number, but simply by the objective of reducing empirically undue RWA variability, which is a sound and legitimate objective.

- Resist the calls saying that the 66% increase in default probability between 0.03% and 0.05% is unjustified as it is too large and that the real world default probability has not gone up by that percentage. Given the fact that neither number is economically or statistically significant, the only question that counts is the level of the risk weights obtained and the reduction of its variability derived by using different PD.

- Come up with absolute levels of capital for banks that will minimize the probability of banks' default. Given the cost of financial crises and of banks' collapses for society, and given the

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fact that the weighted average cost of capital of banks is a direct function of the quality of their assets and not of their debt-equity mix, regulators should resist all attempts to lower the required levels of capital on pseudo-rational arguments linked to a low probability of default. This is, to a large extent, what the Basel III framework does and it is essential that it be finalised as planned.

1.2.9. Sovereign exposures – no substantive change

Issue: In parallel to the discussions on the finalisation of Basel III, the BCBS also conducted a separate review of the regulatory treatment of sovereign exposures. The result of this review was published in a discussion paper alongside the Basel III standards, the main conclusion being that "*the Committee has not reached a consensus*". As *to make any changes to the treatment of sovereign exposures* regards sovereign exposures under the IRBA, this has resulted in the Basel standards stating that "*the treatment of sovereign exposures is unchanged from the Basel II framework (June 2006)*". However, the BCBS recognised that a strict interpretation of this "no change" principle as regards the IRBA would have undesirable consequences, as it would create significant complexity that would neither be necessary to achieve the desired policy outcome nor prudentially justified. As a result, when the BCBS published a draft consolidated framework in April 2019, it clarified in this framework that the December 2017 agreement is to be understood to mean that sovereign exposures are "exempted" merely from the arguably most restrictive modifications of the IRBA. Specifically, both the AIRBA and the FIRBA remain available for sovereign exposures, and no input floors apply to them. On the other hand, other (more technical) changes, such as those pertaining to data requirements for PD estimation, do apply to sovereign exposures in the same way as they do to corporate exposures and exposures to institutions. Also, it should be noted that the removal of the 1.06 scaling factor also applies to sovereign exposures, and that sovereign exposures are included in the calculations of the output floor.

Question 87. Views are sought on the treatment of sovereign exposures proposed in the BCBS consolidated framework referred to above.

In your view, how would the exemption from the removal of the IRBA and from the input floors, on the one hand, and the implementation of the remaining reforms of the IRBA, on the other hand, impact the robustness and levels of RWAs for sovereign exposures treated under the IRBA?

As a civil society organisation, Finance Watch is not well placed to elaborate and provide evidence on the implications of the exemption from the removal of the IRBA and from the input floors. Substantiating an answer to this question requires being a bank.

But more generally, and more fundamentally, Finance Watch wants to emphasize that the fact that the Basel III framework does not change the treatment of sovereign exposures creates both a distortion to the proper allocation of capital in the EU and a major financial stability risk.

This situation is due to the de facto zero-risk weight attributed to sovereign exposure in the calculation of banks' capital requirements. This regulatory advantage, based on an economic

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fiction, provides banks with a reason to provide funding to sovereign issuers without analysing their credit quality and without charging the right price. This phenomenon creates in turn a major distortion in the capital allocation process as bank funding ends up not going to the right borrowers or, when it does, not at a price reflecting the underlying economic risk taken. This is a very significant economic phenomenon given the fact that banks hold between 20% and 25% of a total stock of euro area sovereign debt nearing today € 10 trillion.

The other implication of this phenomenon is its financial stability impact given the nexus it creates between sovereigns and banks. With the advantage provided by the absence of a capital charge, banks fund their home country through sovereign bond purchases as an assurance that they will be bailed-out, if need be, with the money provided. This situation, often referred to as the doom loop between sovereigns and banks, is the economic equivalent of a circular reference. At the end of the day, it feeds the support of too-big-to-fail banks by sovereigns at the expense of taxpayers and represents a major threat to financial stability in extreme cases.

6. Output floor (OF)

6.1. Material scope of application

Issue: The OF introduced by the Basel III standards intends to ensure that institutions' own funds requirements do not fall below 72.5% of the own funds requirements derived under the standardised approaches. More specifically, the floor applies to institutions' calculations of RWAs which in turn are to be used for the calculation of the applicable own funds requirements in order to reduce excessive variability of RWAs and to enhance the comparability of risk-based capital ratios. In terms of own funds requirements that need to be calculated on the basis of floored RWAs, the Basel III standards refer to the Pillar 1 requirements, the capital conservation buffer requirement, the countercyclical capital buffer requirement, as well as the buffer requirements for global systemically important and, respectively, other systemically-important institutions (G-/O-SIIs) and the total loss-absorbing capacity (TLAC) requirements. However, in addition to the abovelisted requirements, the risk-based capital framework in the EU currently also includes the systemic risk buffer (SRB) and Pillar 2 requirements (P2R).

Question 180.

In your view, how would the two approaches[1] affect the internal risk allocation across banking groups, in particular those with specific group structures or business models at subsidiary level?

Please elaborate and provide relevant evidence.

[1] *The mention to "two approaches" refers to Question 179 of the consultation which reads: "Views are sought on the relative costs and benefits of applying the OF at all levels of the banking group (i.e. individual, sub-consolidated and consolidated) or solely at the highest level of consolidation in the EU." – see also: https://ec.europa.eu/info/publications/finance-consultations-2019-basel-3_en*

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Two main reasons push in the direction of applying the OF solely at the highest level of consolidation.

First, not applying it at that level would create an opportunity for the rule to be arbitraged, as banks would have an incentive to combine risky and less risky activities in the same subsidiaries in order to mitigate the effect of the output floor. This, in turn, would have the likely consequence of diminishing the quality of risk management of the said subsidiary as activities that have normally nothing to do together would now be managed by the same risk management and general management teams.

Second, applying the output floor at subsidiary level could introduce a bias towards certain business models and would have the consequence of contributing to fragment the EU banking market when the objective today should be to promote the integration of the market.

6.3. Transitional measures

Issue: The Basel III standards foresee a 5-year transitional path for institutions to grow into and adjust to the new requirement, as well as the possibility of a "transitory cap" that temporarily prevents that RWA increase more than 25% because of the OF.

Question 182. In your view, should both of the transitional measures provided by the Basel III standards be implemented in the EU?

If not, why?

No. If anything, those two transitional measures have the effect of delaying the implementation of a much needed and positive reform. As such, they can only be justified by reasons linked to the time necessary to implement the new rules. In that respect, if the transitional 5-year path to adjust to the new requirement can be understood, even if its very progressive nature can be regretted, the "transitory cap" should not be implemented, not only because it has no economic justification, but also because it comes in addition to an already very long and gradual "transitional 5-year path". There does not seem to be any logical reason for implementing both the "transitory cap" and the "transitional 5-year path".

Question 183. Would you deem further refinements or clarifications necessary concerning the transitional measures?

If no, please elaborate on your response to question 183.

No. The transitional measures as described currently are clear enough.

6.4. Other provisions

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Question 185. In your view, which other aspects, if any, should be considered in the context of implementing the OF?

Please elaborate and rank your answers from the most important to the least important aspect.

Implementing the OF is essential for two reasons of equal importance.

1 – In a context where, everything else being equal, the Basel III framework puts a heavier administrative burden on banks of small and medium size (hence the proportionality measures taken to compensate that phenomenon to some extent) and where IRB models are used by larger banks, whilst small to medium size banks use the standardised approach, the possibility of reducing very significantly risk-weights by using IRB models distorts the playing field in favour of large banks and against small to medium size banks. This distortion of the level playing field has, in turn, consequences both on competition between banks and on financial stability. On the competition front, it gives an unfair advantage to large banks which, everything else being equal, can produce a higher return on equity on the same product priced with the same margin or, alternatively, gain market share to the detriment of smaller banks by pricing at a lower level the same product with the same risk. On financial stability, it feeds the growth of the size of large banks' balance sheets in a pro-cyclical and mechanical manner (larger banks get a better risk-weight treatment and can, everything else being equal, get even bigger with the same amount of capital) and bolsters thereby the too-big-to-fail vicious circle.

2 – By construction, IRB modelling creates a weakness in prudential measures as modelling has many well-known theoretical limits, the first of which being the fact that past behaviour of financial assets or credit exposures is a very imperfect indicator of their future behaviour. This assertion is true even when there is no intention on the part of the banks developing the IRB model to tweak the results in order to reduce their capital requirements, this latter situation being however always a possibility in the real world.

Two main arguments have been heard against the implementation of the OF: 1) It would distort the level playing field between US and EU banks given the fact that it will have a greater impact on EU banks than on US banks; 2) It would create an unbearable burden on European large banks to increase their capital in the coming years.

Regarding the level playing field between US and EU banks: if anything, the level playing field on that issue is distorted today in favour of EU banks to the detriment of US banks as the standard approach and internal models are similar with respect to consumed capital for the largest US banks using internal models due to the Collins Amendment to the Dodd–Frank Act which effectively subjects them to an output floor at 100%. Moreover, after years of discussion of a range comprised between 70% and 90%, the fact that the OF has been set at 72.5%, i.e. so close to the lowest boundary discussed, reflects clearly the willingness of European regulators to listen to the arguments of large banks, within certain limits.

Regarding the burden on banks to increase their capital, the extremely gradual schedule of implementation of the output floor (1 January 2022: 50%, 1 January 2023: 55%, 1 January 2024: 60%, 1 January 2025: 65%, 1 January 2026: 70%, 1 January 2027: 72.5%) means that most banks

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will be able to raise their level 86 of capital through retained earnings. It also has as a consequence the fact that the finalisation of the Basel III package will happen twenty years after the start of the financial crisis, which can hardly be considered as a precipitous response to the greatest financial crisis for a century.

8. Sustainable finance

Issue: In the context of the last CRR/D review, co-legislators reflected on the Paris Agreement on climate change and its impact on prudential regulation and agreed on three actions dedicated to sustainable finance:

- a mandate for the EBA to assess the inclusion of environmental, social and governance (ESG) risks in the supervisory review and evaluation process (SREP) and submit a report on its findings to the Commission, the European Parliament and to the Council; on the basis of the outcome of its report, the EBA may, if appropriate, issue guidelines regarding the uniform inclusion of ESG risks in the SREP (Article 98(8) CRD);
- a requirement for large, listed institutions to disclose ESG risks, including physical risks and transition risks (Article 449a CRR);
- a mandate for the EBA to assess on the basis of available data and the findings of the Commission High-Level Expert Group on Sustainable Finance, whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified (Article 501c CRR).

Further to this work, the Commission has launched a study on the development of tools and mechanisms for the integration of ESG risks into institutions' risk management, business strategies and investment policies as well as into prudential supervision. Final results of this study are expected for beginning of 2021.

As part of its Action Plan on Sustainable Finance, the Commission proposed a regulation for a framework for the establishment of an EU classification of environmentally sustainable economic activities (so-called "EU taxonomy") (COM(2018)353 final - 24.05.2018). In parallel, the Commission set up a technical expert group on sustainable finance (TEG) that was tasked to already advice on a taxonomy for climate change mitigation and adaptation. While the negotiations on the legislative proposal are still ongoing, the TEG has in the meantime published its report.

Question 191. In your view, which further measures, if any, could be taken to incorporate ESG risks into prudential regulation without pre-empting ongoing work as set out above? Please elaborate and provide relevant evidence to substantiate your view.

There are two dimensions to incorporating ESG risk into capital requirements: 1) diminishing capital requirements in relation to high ESG rating (low ESG risk), or 2) increasing capital requirements in relation to low ESG rating (high ESG risk).

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As a general approach to the subject, the idea of “incorporating ESG risk into capital requirements” must be considered with prudence as the very notion of “ESG risk” is far from being defined rigorously nor stabilised. In that respect, it must be noted that the methodologies used by the various ESG rating agencies do not produce coherent ESG rating results which, obviously, is a major issue if ESG rating is to be applied for calculating risk-weights and therefore capital requirements of banks. In our view, the concept of “ESG risk” is not defined with a sufficient level of precision today to be applicable to the calculation of capital requirements, whether with a view of diminishing them or increasing them.

The idea behind the approaches pushing to lighten capital requirements in relation to the so-called low ESG risk or the green nature of the project or the enterprise financed is to encourage lending to « green » projects or enterprises with sufficient green activities (probably defined in reference to the EU taxonomy), or projects with a high ESG rating supposed to reflect a low ESG risk.

The concept of a “green supporting factor” (or a "sustainable supporting factor") suffers from three main drawbacks and should therefore not be considered.

1 – There is no evidence that sound green projects or economically viable enterprises with a high ESG rating suffer from a lack of funding. In that context, what would a green or a sustainable supporting factor bring? Certainly not more of the type of funding needed, i.e. lending to green and economically viable enterprises or projects. A green supporting factor would have no effect of bridging a gap or short supply of lending to green projects for the very reason that there is no such gap. As a matter of fact, all banks are looking for green projects to finance at the moment, as they need and want to show their implication in financing the fight against climate change. The lack in the economy today is not in the availability of funding, it is in the relative paucity / scarcity of the right green industrial or infrastructure projects. Lower capital requirements for green assets will bring no additional supply of capital to the viable part of the green economy, which is obviously the only part that should be encouraged.

2 – There is neither evidence nor data showing or suggesting that “green projects” or “green enterprises” can be considered as incurring a lower level of economic risk and therefore that financing them would entail a lower level of financial risk for banks. Applying such supporting factors to lower banks capital requirements would therefore come down to moving the objective of capital requirements regulation away from financial stability. This assertion would still be valid if the criteria for defining “green” to lighten capital requirements were to be the otherwise welcome EU green taxonomy. The fact that an economic activity can be qualified as green under the EU taxonomy is not an appreciation of the economic viability of specific projects or enterprises.

3 - Applying lower risk weights to green projects or projects with a high ESG rating would have as an inevitable consequence to attract lending capacity on unsound economic projects and raise artificially the price of sound green economic project. In other words, it would distort prices and create asset bubbles that would, inevitably, be counterproductive in the short term and explode in the middle term.

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In short, a green supporting factor would bring no benefit in the short term and would not enhance green or sustainable investments but it would increase in a significant way the risk of a future financial crisis and endanger financial stability.

Approaches aiming at increasing capital requirements in relation to the so-called high ESG risk or the brown nature of the project or the enterprise financed are usually summarised under the label «brown penalising factor ». More work needs to be done to define the word “brown” precisely, in particular given the absence of a brown taxonomy, and to measure to what extent capital requirements can be a factor participating to the reduction of a brown economy.

But, in a context where central bankers recognise now that climate change is one of the major existing financial stability risks, there is no doubt that the possibility of taking into account in the calculation of capital requirements the existing brown dimension of the economy should be studied with attention.

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