Svenska Bankföreningen
Swedish Bankers' Association

FINANSRÅDET
DANISH BANKERS ASSOCIATION

Dutch Banking Association

FK | Finanssialan Keskusliitto
FC | Finansbranschens Centralförbund
FFI | Federation of Finnish Financial Services

October 2016

Basel IV – A serious threat to European banks and the ability of banks to support economic growth

Key messages:

- The proposed capital floor (output floor) threatens to overwrite the risk sensitivity of internal models.
- Floors will primarily hurt lower risk portfolios and push lending to higher risk areas.
- All possible improvements to the Basel credit risk framework regarding internal models will have no effect for most large European banks if the output floor would remain, even if calibrated at 60%.
- An output floor next to the Leverage Ratio will not bring additional comfort, while it will damage the lending capacity of European banks.

The banking associations in the Nordic countries (Sweden, Finland and Denmark) and the Dutch Banking Association all support the overall aim of the Basel Committee on Banking Supervision (BCBS) to restore confidence in internal models which many banks use for quantifying their required capital for credit risk. However, according to the proposals that are currently being discussed at the BCBS this aim is largely achieved by introducing a capital floor and parameter floors that sacrifice the risk sensitivity of the regulatory framework. The result will be very large increases in capital requirements for banks in the Nordic countries and the Netherlands, which – on average – have comparably low risk portfolios that will be hit the hardest by such floors. Such increases will neither be justified by the risks that banks are facing in these countries nor by financial stability considerations[1].

A risk sensitive approach for capital requirements ensures that sound incentives are in place for monitoring, managing and pricing of credit risk. A proposal that undermines a risk sensitive approach will create incentives for increased risk taking and, in the longer run, undermine a European banking model where good-quality credits are provided to customers and held on the balance sheet of universal banks and specialised mortgage banks. A substantial increase in capital requirements would decrease the supply of credit to the economy and severely hamper the growth and jobs agenda in Europe, and it could also have effect in the near future.

It is crucial that the financial regulation in EU succeeds in maintaining risk sensitivity at the core of the capital requirement framework. This preserves the link between regulatory capital and banks' internal credit risk management and pricing systems, and ensures that re-

[1] Impact studies in Sweden and Denmark show increases in the capital requirements up to 78% if the current proposals are implemented.

quired capital levels are aligned with risks associated with local market conditions and business choices.

Confidence in internal models is best achieved by addressing the identified problems with internal models directly, instead of bluntly removing the possibility to use internal models altogether or by overriding internal model results by introducing capital floors that cannot reflect local market conditions. Focus should instead be on maintaining a risk based approach where abundant, good quality data and robust modelling techniques are available. This could include setting up stringent criteria for minimum data requirements to determine whether a parameter or portfolio is suitable for internal modelling. Specifically we support the important work underway in this area at the European Banking Authority (EBA).

Banking models and the role of banks in financing the economy vary across the globe. In the United States, for example, financing of the economy is largely capital market based and long-term residential property risks are covered by government agencies such as Fannie Mae and Freddie Mac, which enables the US banks to operate with lighter balance sheets. Hence, a capital floor is not likely to affect US mortgage lending, while it will have a major effect on lower risk EU mortgage lending. In Europe the financial markets are characterised by bank-based finance and long-term property market financing. As a consequence, European banks are more sensitive to a regime shift towards a less risk based approach for credit risk, and could be forced to change their business models and to decrease their direct lending to corporates and households and to shift towards a role as intermediaries.

As the European banking system finances around 75% of the economy against only 25% in the United States, there is a risk that the proposals from the BCBS will have a much larger impact on the real economy in Europe than in the United States.

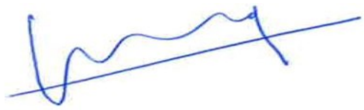
According to the BCBS, the final calibration and design of the proposals, including the output floor, will be subject to a comprehensive quantitative impact study and will be affected by the Committee’s aim to not significantly increase overall capital requirements. However, we fear that adjustments aimed at avoiding significant increases in capital requirements from an overall, global perspective, will still result in very substantial increases in capital requirements for banks operating in Europe, and especially in the Nordic countries and the Netherlands, even if the output floor is calibrated at 60%.

A large number of financial regulations have been introduced in recent years. The combination of existing regulations and proposed new requirements on capital, liquidity and bail-in instruments entails a great risk of regulatory failure and unintended consequences. We recommend the EU Commission to carefully assess the overall impact of all the recently implemented regulatory initiatives, before the proposed new Basel standards are transposed into EU legislation.

We urge the regulators at the international level to ensure that the proposals for reforming the capital requirements for credit risk are modified so they do not unjustly penalise the European banking model and especially markets in low risk environments. Should the final revised Basel standards not be fit for purpose for the European market we call the European regulators to consider measures to limit the harmful impact of international standards in Europe by carefully applying modifications to the standards for banks operating in the European market and make adjustments that take European regional aspects into account.

In the Appendix we list the issues that should most urgently be addressed and reflected in the final international standards on credit risk that are currently being discussed in the BCBS.

For more detailed comments on the proposals and motivations for the issues we have listed in the annex we refer to our responses to the BCBS consultations and our joint position paper in 2015[2].



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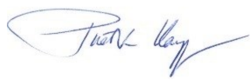

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2 Links to the joint position paper from 2015 and responses to the BCBS consultations:
http://www.finansraadet.dk/Politik/Documents/Høringssvar/2015/150715_HS_Joint%20Comments%20to%20Basel%20Proposal_540876%20(2).pdf
https://www.bis.org/bcbs/publ/comments/d306/daba.pdf
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APPENDIX

The revised Standardised Approach (SA) for credit risk

The revised Standardised Approach for credit risk is important for the large number of EU banks that do not use internal ratings-based models (IRB approaches). However, from a broader economic perspective, its main importance stems from the fact that it serves as the base on which the proposed output floor is calibrated for banks using the IRB approaches. In addition, it serves as a fall back for capital requirement calculation for portfolios where restrictions on the use of the IRB approach are proposed by the BCBS.

Therefore, it is very important that the risk weighting applied under the revised Standardised Approach reflects the underlying risks in a credible manner, including cases where local market conditions have profound effects on the riskiness of loans.

The calibration of the risk-weights under the proposed revised Standardised Approach (SA), is however, not reflective of the low loss and impairment levels of loans which are due to the institutional framework characterising the housing and labor markets in the Nordic countries and in the Netherlands (e.g. level of creditor protection, efficiency of foreclosure processes, social security systems). This will especially affect real estate and other low default exposures in an unduly negative way.

Residential real estate (including income producing residential real estate)

- Allow for local calibration to lower risk weight if local market conditions and loss rates can be documented to support such lower risk weights
- If local calibration is not deemed feasible, risk weights for real estate exposures should be significantly re-calibrated to better reflect the risk of such exposures in jurisdictions where structural factors underpin low loss rates. Under this approach competent authorities should increase risk weights if the risk weights are not supported by local market conditions.
- The proposal from the BCBS on the revised SA suggests using a top LTV (loan-to-value) bucket approach, i.e. placing the entire exposure in the top category with the highest risk weight. From a risk perspective, when LTVs are used as a proxy for LGDs, the so-called continuous LTV should be used under which an exposure is split across different LTV buckets.
- LTVs should be calculated on the basis of current debt outstanding as well as the current property value (and not using the original property value measured at the time of loan origination). The present proposal creates an incentive for customers to change credit institution when property values increase as this would enable them to obtain a lower risk weighting on a new loan.

Risk weights for Corporates

- Unrated corporate exposures are risk weighted by 100%. In Europe this would apply to the vast majority of corporate exposures. In jurisdictions that do not allow the use of external ratings a risk weight of 75 % cap be assigned to "investment grade" corporate exposures. It is imperative to put in place a solution that assigns a 75% risk weight to exposures to unrated corporates that comply with the conditions set for the category of investment grade in the Standardised Credit Risk Assessment Approach (SCRA)

Off-balance sheet items

- The proposed credit conversion factor for uncommitted credit lines for corporates is set at 70%. In the existing framework the credit conversion factor is set at 0%. If not retained at 0%, the credit conversion factor should be reduced substantially.

Proposed restrictions on the use of the IRB approaches

Corporates and institutions

- For corporates, all approaches should potentially be applicable, subject to supervisory approval, for each of the predefined segments based on size (very large, large, smaller) of the corporate exposure class. The appropriate approach for each segment should be determined based on available loss data, risk management experience and modelling techniques for exposures in the particular segment.
- For institutions, the supervisory authorities should also be allowed to approve the use of IRB approach (at least F-IRB) if the available loss data, risk management experience and modelling techniques are satisfactory.

Specialised Lending

- Specialised Lending, such as project financing, object financing and trade financing, provides lending to clients, where the lending transaction is structured to minimise the risks for the banks and costs for the client. The Basel proposal, as it stands, no longer recognizes in full the credit mitigating effect of such structures. This will substantially increase the cost and hence reduce the attractiveness of this type of financing.
- The Advanced IRB Approach should be available where models are based on good quality data, solid risk management experience and a proven track record.
- The Slotting Approach should be available where the conditions for using internal models are not met, but should be amended (more buckets, lower risk weights and additional tenor bucket shorter than 1 year).

Parameter floors

- Parameter floors should only be activated if the competent authority determines that the internal models are underperforming.
- Parameter floors should be applied at portfolio level and not at exposure level.
- There should be guidelines on assumptions that can be used when key risk parameters are estimated. This would help limit the variability of capital requirements for credit risk.

Output floor

- As the leverage ratio is already being introduced as a backstop, we do not see any reason for the proposed output floor as another back stop measure. The output floor and the leverage ratio are two methods with the same aim and would therefore together be an example of overregulation.

- The existing, temporary, capital floor based on Basel I capital requirements functions as a back stop measure in a similar way as the new leverage ratio. However, the proposed output floor is designed so that Pillar 2 capital requirements as well as the capital buffers that were introduced with Basel III sit on top of the output floor, thus raising the capital back stop for most European IRB-banks to become the binding, non-risk based, capital requirement. If the proposal to introduce the new output floor is cancelled it will not lead to a capital freefall in Europe compared to the existing capital levels. Hence, it will not weaken the European banks.