BASEL OUTPUT FLOOR

TOWARDS A FAITHFUL TRANSPOSITION TAKING INTO ACCOUNT THE EU BANKING SECTOR'S SPECIFICITIES

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EXECUTIVE SUMMARY

The parallel stacks approach - applying the output floor to the Basel Minimum Requirements and implementing the result as an additional, stand-alone capital requirement - is compliant with Basel Accord. Thus, there is no reason for the EU not to use it as faithful transposition of the Accord, while respecting the mandate received from the Council and the Parliament, in line with the G20 direction, so as to avoid a significant increase of overall capital requirements.

The alternative of calculating and applying the output floor also to the Additional European Requirements would go further than required under Basel III, and would constitute an unwarranted, disproportionate gold-plating exercise.

Applying the output floor to the Additional Requirements would not effectively contribute to limiting excessive variability between RWAs calculated under the IRB or under the Standardised Approach, and would not ensure better comparability between the capital ratios of institutions applying internal models, since these requirements inherently differ from one institution to another.

Moreover, the application of the output floor to the Additional European Requirements would not fully achieve the general objectives set by European rules and the Final Basel III Accord, i.e. the preservation of banking resilience, harmonisation and the absence of a significant increase in overall capital requirements.

In order to transpose the output floor as an effective backstop mechanism, in compliance with the Final Basel III Accord, EU policy-makers should therefore rely on the parallel stacks approach, i.e. provide for a new minimum capital regulatory requirement based on floored RWAs which would only apply to the Basel requirements, and require a Pillar 3 publication of floored RWAs for institutions using internal models. Additional European capital requirements and ratios would be based on un-floored RWAs, subject to the relevant disclosure obligations.

The proposed parallel stacks approach is a pragmatic and legally-sound approach which supports and contributes to the consensus and the mandate granted to the Commission by the EU co-legislators that there should be no significant increase in capital requirements as a result of this reform.

INTRODUCTION

1. In accordance with the Basel III Accord[1], which has been implemented in European law notably by Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (the "**CRR**"), European banks are subject to regulatory capital requirements designed to ensure their resilience, i.e. their capacity to absorb any unexpected losses, particularly in situations of stress.

2. The regulatory capital requirements set by the Basel III Accord (the "**Basel Minimum Requirements**") and implemented by European regulations consist in i) a solvency ratio corresponding to the capital of the reporting institutions, expressed as a percentage of the total amount of their risk exposure - the latter corresponds primarily to the amount of assets weighted according to the risks to which the institutions are exposed ("risk-weighted assets" or "**RWAs**")[2] and ii) additional capital buffers: namely, (a) a mandatory capital conservation buffer of 2.5% of RWAs, (b) a countercyclical buffer of 0 to 2.5% of RWAs, and (c) a buffer (of 1 to 3.5%) applicable to institutions of so-called global systemic importance (the “Global systemically important banks” or “**G-SIBs**”).

3. These requirements, which correspond to the minimum amount of capital required within a credit institution according to its risk level, are calculated as a percentage of the RWAs' amount.[3]

4. Subject to supervisory approvals, credit institutions may use two approaches to calculate their RWAs. For example, in the area of credit risk, the calculation methods are:

   (i) the "standardised approach", based on the type and category of exposure. The RWAs are the product of the exposure value at default and a fixed weighting as defined by regulation (the "**Standardised Approach**"); and
   (ii) the "internal ratings-based approach" ("**IRB**"): the weighting is not fixed but calculated by the credit institution. The credit institution has to develop its own models to estimate the probabilities of default and, subject to supervisory approval, losses given default and exposures at default of the various exposures (the "**Internal Approach**").

5. To fulfill the mandate received from the G20 to reduce excessive variability of risk-weighted assets and to enhance the comparability of risk-weighted capital ratios, the Basel Committee on Banking Supervision (the "**Basel Committee**") decided in the final version of the Basel III Accord (the “**Final Basel III Accord**”), to introduce a floor requirement that is applied to RWAs of banks using an Internal Approach.[4]

6. Thus, the Final Basel III Accord provides for reporting institutions to calculate their Basel Minimum Requirements on the basis of an amount of RWAs equal to the greater of (i) the amount of RWAs calculated using the methods for which the credit institution has received prior authorization from

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[1] BCBS, Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (document revised in June 2011).

[2] The solvency ratio is composed as follows: (a) a Common Equity Tier 1 capital (CET1) ratio of at least 4.5% of RWAs, (b) a Tier 1 capital ratio (CET1 and Additional Tier 1 capital (AT1)) of at least 6% of RWAs, (c) and a total equity ratio (Tier 1 and Tier 2 capital) of at least 8% of RWAs.

[3] This amount is equal to the balance sheet value of assets (or a calculated equivalent for off balance sheet commitments and certain other items) multiplied by weighting factors intended to reflect the risks to which credit institutions are exposed.

[4] The Final Basel III Accord, *Basel III: Finalising post-crisis reforms*, 7 December 2017, p. 137.

the regulator and (ii) 72.5% of the amount of RWAs calculated using the Standardised Approach only (the “**Floored RWAs**”).

7. This output floor mechanism has the effect of limiting to 27.5% the difference in terms of RWAs that credit institutions using an Internal Approach could have over those using the Standardised Approach.

8. In addition to the Basel Minimum Requirements, Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (the "**CRD IV Directive**") modified by Directive (EU) 2019/878 of 20 May 2019 (the “**CRD V Directive**”) provides for additional regulatory capital requirements (the "**Additional Requirements**"). The Additional Requirements consist of:

   (i) additional capital requirements set by supervisors for each reporting institution, proportionate to the institution's particular risk profile (“**Pillar 2**”)[5];
   (ii) an additional capital buffer for systemic risk (systemic risk buffer, "**SRB**")[6]; and
   (iii) an additional capital buffer for Other Systemically Important Institutions ("**O-SIIs**")[7].

9. The question is raised of how the output floor should be transposed and implemented in the European Union, and specifically, whether in this context the output floor mechanism could apply only to the Basel Minimum Requirements as set out in European regulations, without encompassing the Additional Requirements.

10. The aim of this Memorandum is to demonstrate that such an approach - applying the output floor only to the Basel Minimum Requirements and implementing the result as an additional, stand-alone capital requirement (the "**parallel stacks approach**") - would be a compliant transposition of Basel, both consistent with European prudential regulation (**1.**) and compliant with the Final Basel III Accord (**2.**).

1. CONSISTENCY WITH EUROPEAN PRUDENTIAL REGULATION

1.1 Objectives and mechanics of the output floor

11. In its Final Basel III Accord, the Basel Committee states that "*to reduce excessive variability of risk-weighted assets and to enhance the comparability of risk-weighted capital ratios, banks will be subject to a floor requirement that is applied to risk-weighted assets. The output floor will ensure that banks’ capital requirements do not fall below a certain percentage of capital requirements derived under standardised approaches*".[8]

12. The European Commission echoes the objectives of the Basel Committee by stating that "*similar to the original "Basel II" floor[6], the revised floor is intended to provide a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approaches. This is meant to help maintain a level playing field between banks using internal*

[5] Article 104a of CRD V.

[6] Article 133 of CRD IV.

[7] Article 131(5) of CRD IV.

[8] BCBS, Basel III : Finalising post-crisis reforms, December 2017, p. 137.

models and those on the standardised approaches. It also expected to support the credibility of banks' risk-weighted calculations, and to improve comparability via the related disclosures".[9]

13. Thus, the output floor objective is two-fold. **The first and primary objective is to limit the *excessive* variability of RWAs** among credit institutions. In other words, the output floor aims at avoiding a too great difference between RWAs calculated by institutions according to the IRB compared to RWAs calculated by institutions according to the Standardised Approach.[10] It is not meant however to suppress variability altogether.

14. As literally stated in the Final Basel III Accord, the floor applies to RWAs; the effects of the floor further materialise when the relevant capital requirements - i.e. those listed under paragraphs 2 and 3 of the Output floor section of the Final Basel Accord - are calculated.

15. The Final Basel III Accord requires therefore that at most, the benefits in terms of RWA-reduction would reach 27.5% of the RWAs calculated under the Standardised Approach.

16. The second objective is to **improve the comparability of the risk-weighted capital ratios among credit institutions**. It is assumed that by applying a floor to the effects of IRB on RWAs, RWAs - and therefore the capital ratios of institutions applying IRB - will be more comparable with each other.[11] This objective is achieved via the related disclosures foreseen in the Final Basel III Accord.

17. That said, the Final Basel III Accord does not foresee specific percentages or amounts for the reduction of minimum capital requirements.

18. Concretely, the output floor establishes **'backstop' mechanics applied at the level of the RWAs**, distinguishing between institutions using IRB and those using the Standardised Approach, in order to address excessive variability of RWAs, and relies on disclosures to achieve greater comparability of risk-weighted capital ratios.

1.2 An Approach in line with the prudential objectives of the output floor

19. Whereas the minimum requirements as provided for under Basel and transposed in CRD, the Additional Requirements imposed under the EU prudential framework are individualised and tailored to take into account the specifics of each institution (where relevant). In that respect, it is important to consider the characteristics of the EU-specific capital requirements.

20. *Firstly*, the Additional Requirements are laid down in a directive (CRD IV) and not in a regulation (CRR), in contrast to the Basel Minimum Requirements. The regulation has indeed a general application and it is binding in its entirety and directly applicable in all Member States of the

[9] European Commission, Consultation document Exploratory consultation on the finalization of Basel III, 2018.

[10] "*The first objective (on excessive risk-weight variability), in general, would address perceptions that risk weights calculated by institutions using internal models may in some cases deviate too much from those under the standardised approach*" (EBA, Policy advice on the Basel III reforms: output floor, 2 August 2019, paragraph 2, p. 8).

[11] "*The second objective (comparability of risk-weighted ratios) is based on the understanding that, by applying a floor to the effects of internal models on RWAs, the RWAs — and consequently the capital ratios of institutions applying internal models — will be more mutually comparable*" (EBA, Policy advice on the Basel III reforms: output floor, 2 August 2019, paragraph 2, p. 8).

European Union.[12] It does not require any national transposition measures.[13] The regulation ensures maximum harmonisation, i.e. Member States may not impose requirements that are more stringent, or conversely less stringent, than those provided for in the regulation for the matters that it governs.

21. Conversely, the harmonisation contained in the directive has less direct and uniform effects : the directive is subject to transposition by Member States which for some provisions are free to adapt the rules contained in this directive to their national specificities and to provide for stricter national rules for operators under their jurisdiction (principle of unilateral imperative). For some of its provisions, CRD ensure only minimal harmonization.

22. Through maximum harmonisation, credit institutions are subject to the same definition and prudential rules, regardless of their country of establishment in the Union. As recalled by the Commission, mostly thanks to the regulation it avoids any risk of divergence between Member States[14] and thus prevents distortions of competition between European credit institutions.

23. *Secondly*, the Additional Requirements are not uniform requirements applied to all banks. Indeed, Pillar 2 corresponds to additional capital requirements that are set at the discretion of competent supervisors. Beyond the minimum capital requirements imposed by the CRR (called "**Pillar 1**"), supervisors may within the framework of the supervisory review and evaluation process (the "**SREP**"), impose additional capital requirements (Pillar 2 Requirements, "**P2R**"), which are binding, and, if necessary, issue additional capital recommendations (Pillar 2 Guidance, "**P2G**"), which are formally non-binding.

24. Both national and EU supervisors have significant discretionary power when determining Pillar 2, since they are to set it in relation to the specific situation of an institution. Thus, the capital requirements under Pillar 2 vary from one institution to another as they depend on the particular risk profile of each institution.

25. The same observation applies to the SRB[15] which, as specified in Article 133 of the CRD IV, may be introduced by Member States for the financial sector or for one or more subsets of that sector. Since its introduction into EU legislation in 2014, only 14 Member States[16] have implemented the SRB. For instance, to date, according to the *Banque de France*, the level of structural systemic risk does not require the implementation of an SRB in France.[17]

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[12] Cf. Article 288 of the Treaty on the Functioning of the European Union ("**TFEU**").

[13] The Regulation is general in scope, binding in its entirety, and no transposition measures by the Member States are required or even tolerated (ECJ, 10 October 1973, *Variola*, 34/73, ECR, p. 981, points 10 and 11).

[14] European Commission, CRD IV/CRR – Frequently Asked Questions, 21 March 2013, p. 6: "***While the Member States will have to transpose the directive into national law, the regulation is directly applicable, which means that it creates law that takes immediate effect in all Member States in the same way as a national instrument, without any further action on the part of the national authorities. This removes the major sources of national divergences (different interpretations, gold-plating***)").

[15] The SRB aims at preventing or mitigating "non-cyclical long-term" systemic risks that could disrupt the financial system and have serious repercussions on the real economy of a given Member State.

[16] Austria, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Hungary, Netherlands, Poland, Romania, Slovakia and Sweden, Finland and the UK.

[17] Bulletin de la Banque de France, *Coussin pour le risque systémique : à quoi servirait cet instrument?*, janvier-février 2020, p. 1.

26. Moreover, the application of the SRB is in itself very flexible. Not only its rate is not capped and fully adjustable depending on the subset of the financial sector,[18] but it can be applied to varying perimeters of institutions (solo or consolidated basis), and while distinguishing among exposures (domestic, EU non-domestic, third countries).

27. For example, the SRB has been applied either to all exposures of some banks (Austria, Croatia, Czech Republic, Denmark, Hungary, Netherlands, Romania and Sweden) or only to domestic exposures of all banks (Bulgaria, Estonia and Poland). For two of these countries (Croatia and Hungary), the SRB was used to address real estate sector risks, based on common or correlated exposures in this sector.[19]

28. This lack of uniformity also exists for the additional capital buffer applicable to O-SIIs. Article 131 (5) as amended by CRD V specifically states that "*The competent authority or the designated authority may require each O-SII, on a consolidated, sub-consolidated or individual basis, as applicable, to maintain an O-SII buffer of up to 3 % of the total risk exposure amount calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013, taking into account the criteria for the identification of the O-SII. That buffer shall consist of Common Equity Tier 1 capital*". Thus, there is full discretion in applying - or not, and to which extent - this capital buffer to institutions qualified as O-SIIs based on national criteria.

29. Therefore, applying the output floor to the Basel Minimum Requirements only, without the Additional Requirements, permits to reach the objectives of greater comparability of RWAs and reduction of excessive variability of RWAs. Applying the output floor also to the Additional Requirements would go beyond the provisions of the Final Basel III Accord and be inconsistent with the principles of individualisation and tailoring on which the Additional Requirements are based.

1.3 Consistency with the general objectives of European prudential regulations and with Better Regulation

30. It is also important to assess the consistency and alignment of the parallel stacks approach, and the alternative, with the objectives of European prudential rules, both at a macro level and at a micro level.

31. In that respect, the transposition of the output floor in European law must i) take into account the potential impact(s) in terms of EU prudential regulation (banking resilience, avoiding any significant increase of overall capital requirements), ii) comply with the proportionality principle, and iii) be assessed in conformity with the Better Regulation principles.

1.3.1 Banking resilience and harmonisation

32. In order to preserve financial stability,[20] European prudential rules have two main objectives creating a harmonised risked based approach by:

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[18] *Ibid*., p. 3.

[19] *Ibid*., p. 4.

[20] "*The most important recommendations advocated in the de Larosière report and later implemented in the Union were the establishment of a single rule book and a European framework for macro prudential supervision where both elements in combination were aimed at ensuring financial stability*", Recitals 3 and 14 of the CRR Regulation.

(i) Strengthening banking resilience by ensuring that institutions have sufficient own funds to absorb unexpected losses arising from the occurrence of risks (credit risk, market risk, operational risk, etc.) to which their activities expose them, but which are not covered by their profits; and

(ii) Ensuring European harmonisation.[21]

33. The parallel stacks approach would support banking resilience and harmonisation, whereas the application of the output floor to the Additional Requirements would undermine these objectives.

34. *Firstly*, applying the output floor to the Additional Requirements would further reduce the risk sensitivity of the calculation of capital requirements since it limits the influence of risk-sensitive Internal Approaches on the required level of own funds even more strictly than the parallel stacks approach. Thus, it greatly reduces the incentive for banks to use risk-sensitive approaches, and arguably goes further than the Basel mandate of addressing *excessive* variability.

35. It would also run counter the intention of European co-legislators which recall in the CRR that "*it is essential to <u>take account of the diversity of institutions in the Union</u> by providing alternative approaches to the calculation of capital requirements for credit risk incorporating different levels of risk-sensitivity and requiring different degrees of sophistication. Use of external ratings and institutions' own estimates of individual credit risk parameters represents a significant enhancement in the risk sensitivity and prudential soundness of the credit risk rules. Institutions should be <u>encouraged to move towards the more risk-sensitive approaches</u>"*.[22] (our emphasis)

36. In its consultation paper on the European transposition of the Final Basel III Accord, the European Commission also acknowledges and stresses the importance of preserving risk-sensitivity by stating that "*This* [Final Basel III] *agreement is the result of a strategic review of those international reforms, which was conducted by the BCBS with a view to improving <u>the balance between simplicity, comparability and risk-sensitivity</u>*".[23] (our emphasis)

37. Thus, in order to improve the balance between comparability and risk-sensitivity and ensure that the risk sensitivity of capital requirements is preserved to a proportionate extent, it is necessary that EU-specific buffers or requirements are not subject to the output floor set by the Final Basel III Accord.

38. *Secondly*, the objective of European harmonisation would also be compromised. In fact, and as demonstrated above,[24] unlike the Basel Minimum Requirements, Additional Requirements differ from one credit institution to another and therefore from one Member State to another.

39. Consequently, taking into account the Additional Requirements for the implementation of the output floor would not allow to reach the objectives set by the European prudential regulations, unlike the parallel stacks approach.

[21] Recital 2 of the CRR.

[22] Cf. Recital 42 of the CRR.

[23] European Commission, Consultation document *Exploratory consultation on the finalization of Basel III*, 2018.

[24] See above, paragraphs 20 to 22.

1.3.2 Avoiding a significant increase of overall capital requirements

40. Importantly, the European Parliament Resolution of 23 November 2016, "*[s]tresses that the current revision* [Basel III] *should respect the principle stated by the Group of Governors and Heads of Supervision (GHOS) of not significantly increasing overall capital requirements, while at the same time strengthening the overall financial position of European banks*". (our emphasis) Such a resolution, voted by elected Members of the European Parliament, has legal force.[25]

41. This legal force is illustrated also by the fact the European Commission was under the obligation to respond to this resolution. In its follow-up response to the Parliament resolution, the European Commission stated "*the revised standards would have to respect a number of key principles. They would need to be sufficiently risk sensitive, should not lead to a significant increase in overall capital requirements for European banks, and should preserve an international level playing field*".[26] (our emphasis)

42. The ECOFIN Council also noted in its 12 July 2016 conclusions "*that the reform package would not be expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions of the world*". (our emphasis)

43. EU institutions have taken a clear stance: the transposition of the Final Basel III Accord into European law must strike a balance, ensuring the resilience of banking institutions while not subjecting them to a significant increase in their capital requirements. An increase far too significant would have a negative impact on economic growth through a reduction in the supply of credit.

44. As illustrated below, taking into account Additional Requirements besides the Basel Minimum Requirements would inevitably result in a significant increase in the capital requirements of European banks.

45. Therefore, the parallel stacks approach is necessary in order to avoid a significant increase of overall capital requirements and abide by the principles endorsed by all three EU institutions, including the European Commission.

46. This requirement is not only relevant due to the statements of the EU institutions; it is a reflection of a more general principle, that of proportionality.

1.3.3 The principle of proportionality

47. The methods for calculating and applying the output floor, and assessing the consequences of the future requirements in terms of capital requirements, must indeed comply with the principle of proportionality laid down by the Treaties.

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[25] See Article 263 of the Treaty on the Functioning of the European Union ("**TFEU**"), and for instance the action brought on 17 October 2018 in Case C-650/18, *Hungary v. European Parliament*, against a European Parliament Resolution. As an act of the European Parliament, it may be subject to legal challenge before the Court of Justice of the European Union, where such act is intended to produce legal effects vis-à-vis third parties.

[26] EC Follow up to the European Parliament resolution of 23 November 2016 on the finalisation of Basel III (2016/2959 (RSP)), SP(2017)148.

48. In accordance with this principle, any change in the current legislation should be appropriate to attain the objective pursued and must not go further than is necessary to attain it, i.e. the objective of reinforcing prudential supervision through harmonisation in the application of the Final Basel III Accord.

49. Specifically, the CRR provides that prudential regulation must be applied "*in a manner commensurate with the nature, scale and complexity of the risks associated with an institution's business model and activities*"[27]. This requirement of proportionality, which guides all EU decisions, applies in particular to all legislative acts.[28]

50. As shown above, applying the output floor to only the Basel Minimum Requirements would be legally sound and proportionate. First, it would be compliant with the mechanism foreseen by Basel and would guarantee that the level of capital of credit institutions using the Internal Approach does not fall below a certain level in relation to the level retained in the Standardised Approach.

51. In turn, it would fulfil the objectives of the output floor mechanism as set out in European regulations, i.e. (i) limit the variability of RWAs, and therefore of capital requirements between credit institutions; (ii) improve the comparability of these requirements between credit institutions. In contrast, the inclusion of Additional Requirements would be disproportionate as this would lead to going beyond what is necessary to achieve these objectives.

52. Furthermore, the Additional Requirements, in particular the Pillar 2 Requirements, have a similar prudential objective to using Floored RWAs. Indeed, the P2R is intended to cover "*risks that are underestimated or insufficiently covered by Pillar 1*". The P2G indicates *"to banks the adequate level of capital to be maintained in order to have sufficient capital as a buffer to withstand stressed situations*".[29]

53. In the same sense, the output floor ensures that the level of capital requirements of banks using Internal Approaches does not fall below a certain level. Consequently, applying the output floor to the Additional Requirements would result in a dual requirement on European credit institutions, which is contrary to the principle of proportionality.

54. Finally, by using the parallel stacks approach, the minimum total capital requirement applicable to a credit institution will always be at least equal to the minimum total capital requirement imposed by the Basel Accords,[30] since this approach retains the maximum of two quantities, at least one of which results from the application of the Floored RWAs.

1.3.4 An impact assessment conforming to the Better Regulation principles

55. To ensure compliance with the objectives listed above - and in particular that of avoiding a significant increase of overall capital requirements - the impact assessment of the Commission will be essential, and should therefore be based on the best available evidence drawn from an appropriate range of methods.

[27] Recital 46 of the CRR Regulation.

[28] Cf. Article 5 TEU.

[29] ECB, ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus, 12 March 2020 .

[30] On these requirements, see paragraph 2 above.

56. So far, the response of the European Banking Authority (the "**EBA**") to the Commission Call for Advice[31] on the impact and implementation of the finalised Basel III standards provides an incomplete view of the consequences stemming from the output floor, which would be a source of concern should it be the base of the Commission's impact assessment.

57. The EU Better Regulation Guidelines (the "**Guidelines**") state that "*the aim is not to respect procedural requirements per se but to* *<u>ensure that the Commission is equipped with relevant and timely information on which to base its decisions</u>*". (our emphasis)

58. The impact analysis should focus on assessing those (intended and unintended) impacts that are expected to be more significant. The greater the likely impact, the more thorough the assessment should be and the greater the efforts to collect data and quantify impacts.[32]

59. Moreover, the key impacts should be **screened objectively**,[33] and a **well-justified choice** should be made on the most significant impacts to be retained for more detailed analysis.

60. However, the impact and quantitative assessment undertaken by the EBA is not relying on an objective and well-justified screening of the capital requirements impact. Indeed, according to the EBA, capital shortfalls (CET1, Tier1 and total capital shortfall amounts) resulting from the implementation of the output floor are calculated excluding the "*institutions that currently have sufficient own funds to meet the increases in the* [minimum required capital]".[34]

61. Such an approach is contrary to the Better Regulation principles: it underestimates the number of institutions affected by the output floor, and it underestimates the real impact of the output floor since it relies on an inappropriate baseline scenario of the banks' capital.

62. This is also counterintuitive given the constant regulatory and supervisory drive, since the 2008 financial crisis, for institutions to hold more and higher quality capital; and a counterproductive signal to institutions which are capitalised well above the minimum requirements.

63. In turn, this raises the crucial question of how balanced and sound the evaluation of the competitiveness impact of the future legislative proposal of the Commission will be. If the capital requirements' impact of the output floor is underestimated, then the cost of regulatory compliance and its impact on EU banks' competitiveness would also be incomplete and inaccurate.

64. A 'full picture' is needed in order to ensure that there is no significant increase in overall capital requirements, that the overall financial position of European banks is strengthened (as called for by the Parliament), and that a true international level playing field is maintained (as called for the Commission).

65. The Better Regulation principles are very important in order to obtain the "*rigorous evidence base*" needed to inform the EU decision-making process.[35] They are all the more essential in the present case so as to ensure a high-quality, evidence-based impact assessment which ensure that policy-

[31] Call for advice to the EBA for the purposes of revising the own fund requirements for credit, operational, market and credit valuation adjustment risk, Ref. Ares(2018)237410 - 4 May 2018.

[32] Better Regulation Tool #13, *How to undertake a proportionate Impact Assessment*.

[33] Better Regulation Tool #19, *Identification-screening of impacts*.

[34] Call for advice to the EBA for the purposes of revising the own fund requirements for credit, operational, market and credit valuation adjustment risk, Ref. Ares(2018)237410 - 4 May 2018, paragraph 88.

[35] Better Regulation TOOL #1, *Principles, procedures & exceptions*.

making regarding the calculation and application of the output floor complies with the principle of proportionality.

2. AN APPROACH COMPLIANT WITH THE FINAL BASEL III ACCORD

2.1 Final Basel III Accord and the choice of only Basel Minimum Requirements

66. The parallel stacks approach is conform to the Final Basel III Accord, which clearly retains only the Basel Minimum Requirements as the basis for the output floor. The Basel Committee specified that « *the risk-weighted asset that banks must use to determine compliance with the requirements set out in paragraphs 2 to 3 above must be calculated as the maximum of (…)*"[36]. (our emphasis)

67. Paragraphs 2 and 3 refer only the Basel Minimum Requirements. In that respect, relying solely on the latter would be compliant with the Final Basel III Accord and consistent with this reading. Thus, applying the output floor to Additional Requirements would expand the scope as defined by the Final Basel III Accord, and result in the "gold-plating" of Basel.

68. Contrary to the EBA statement in its Policy advice on the Output floor,[37] it cannot be derived from the statements of the Basel Committee that the revised framework of Basel III suggests a wide application of floored RWAs. In no respect does the Final Basel III Accord indicates that the output floor is to be applied to all requirements and ratios; and the jurisdiction-specific capital layers (i.e. SRB and P2R requirements in the EU) are never mentioned or referred to in the output floor Basel provisions.

69. Furthermore, there is no prohibition in the Final Basel III Accord to compare two total minimum capital requirements. The Basel Accord only requires compliance with the regulatory capital requirements as set out in those texts, including where relevant based on a set of floored RWAs.

2.2 Compliance with the general objectives set by the Final Basel III Accord

70. Compliance with the Basel minimum capital requirements is fully consistent with three general objectives of the Final Basel III Accord.

71. Strengthening banking resilience: in particular by maintaining the risk sensitivity of the regulatory framework; as previously demonstrated, this can be achieved by retaining only the Basel Minimum Requirements for the capital requirements based on the floored RWAs.[38]

72. Ensuring international level playing field and thus avoid excessive distortions of competition with countries implementing the Basel III Accord but that are not part of the European Union, particularly between European and American banks.

73. According to the studies conducted by the Basel Committee and the EBA, the minimum capital requirements applicable to American and European credit institutions, determined according to approach which takes into account all the capital requirements (both the Minimum Requirements and Additional Requirements), would be affected as follows:

[36] Final Basel III Accord, paragraph 4, p. 137.

[37] EBA-Op-2019-09c, 2 August 2019, paragraphs 6 and 3.

[38] See paragraphs 34 and 35 of this Memorandum.

(i) for American credit institutions, a 1.5% increase in applicable minimum capital requirements (i.e. Basel requirements) was anticipated as of 30 June 2018[39] and a 0.4% decrease in applicable minimum capital requirements was finally anticipated as of 31 December 2018;[40]

(ii) for European credit institutions, an increase of more than 24% in the applicable minimum capital requirements (i.e. Basel and additional European requirements) was anticipated as of 30 June 2018.[41]

74. The output floor mechanism would typically affect credit institutions that rely on internal models to calculate their RWAs and, consequently, the capital they must hold. As highlighted by the SSM, internal models play a much smaller role in the United States of America than in the European Union; the largest American banks are allowed to use internal models, but only if the resulting demand for capital is higher than under the Standardised Approach.[42]

75. <u>Avoiding a significant increase in capital requirements</u>: Capital requirements, which aim at strengthening the stability of credit institutions and of the financial system, should be the result of arbitration between prudential considerations on the one hand, and expected impact on the banks' capacity to support and finance the economy on the other.

76. In that respect, both the G20 and the Basel Committee have acknowledged the limits of a constant increase in capital requirements. The consideration of avoiding any adverse impact on the economy due to capital requirements increase has driven the Committee in the Basel III reform, which "*conducted a comprehensive and rigorous assessment of the impact of these revisions on the banking system and the wider macro economy. <u>As a result of this assessment</u>, the Committee focused on <u>not significantly increasing overall capital requirements</u>*".[43] (our emphasis)

77. During the Basel Accord negotiations, the G20 also acknowledged the risk for the ability of banks to finance the economy, in case of further increase in capital requirements. The G20 Finance Ministers press release stated that they "*support the work by the Basel Committee to refine elements of Basel III framework to ensure its coherence and maximize its effectiveness <u>without further significantly increasing overall capital requirements across the banking sector</u>*"[44].

78. The spirit of the Basel reform is to reach a coherent outcome whereby current overall capital requirements are not increased in a significant manner, which could explain why the Basel Committee has chosen in its Final Basel III Accord to only refer for the output floor to the Basel Minimum Requirements, to the exclusion of any other additional requirement.

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[39] BCBS, Basel III: Monitoring Report, March 2019, table 4, p. 30.

[40] BCBS, Basel III: Monitoring Report, October 2019, table 4, p. 32.

[41] EBA, Basel III Reforms: Impact study and key recommendations.

[42] Cf. Speech by A. Enria, *Basel III -journey or destination?*, 12 November 2019.

[43] Cf. The Final Basel III Accord, *Basel III: Finalising post-crisis reforms*, 7 December 2017, point 7.

[44] Press release of the G20 Finance Ministers and Central Bank Governors, February 2016.

CONCLUSION

79. In light of the above, the parallel stacks approach - applying the output floor to the Basel Minimum Requirements and implementing the result as an additional, stand-alone capital requirement - is compliant with Basel Accord. Thus, there is no reason for the EU not to use it as faithful transposition of the Accord, while respecting the mandate received from the Council and the Parliament to avoid a significant increase of overall capital requirements.

80. This approach would indeed ensure that banks' capital requirements are subject to a backstop, thanks to Floored RWAs working as safety net and thus reducing excessive variability of RWAs. It would also be consistent with European prudential regulations and the objectives of avoiding a significant increase in capital requirements.

81. The alternative of calculating and applying the output floor also to the Additional Requirements would go further than required under Basel III, and would constitute an unwarranted, disproportionate gold-plating exercise.

82. Applying the output floor to the Additional Requirements would not effectively contribute to limiting the excessive variability between RWAs calculated under the IRB or under the Standardised Approach, and would not ensure better comparability between the capital ratios of institutions applying internal models since these requirements inherently differ from one institution to another.

83. Moreover, the application of the output floor to the Additional Requirements would not fully achieve the general objectives set by European rules and the Final Basel III Accord, i.e. the preservation of banking resilience, harmonisation and the absence of a significant increase in overall capital requirements.

84. In order to transpose the output floor as an effective backstop mechanism, in compliance with the Final Basel III Accord, EU policy-makers should therefore rely on the parallel stacks approach, provide for a new minimum capital regulatory requirement based on floored RWAs which would only apply to the Basel requirements, and require a Pillar 3 publication of floored RWAs for institutions using internal models.

85. Additional European capital requirements (including Pillar 2) and solvency (including distance to MDA trigger) or resolution ratios (MREL) would be based on un-floored RWAs (also subject to relevant disclosure obligations).

86. The proposed parallel stacks approach is not a mere theoretical perspective, but rather a pragmatic and legally-sound approach which best reconciles the objectives of the output floor and Basel reform with the EU legal requirements and the needs of European banks, supporting the consensus and mandate granted to the Commission by the EU co-legislators that there should be no significant increase in capital requirements as a result of this reform.

87. Basel Accords have to be implemented in a way which is compatible with EU law, EU mandate and EU interest. The parallel stacks approach is compliant with Basel Accord and such transposition is even more needed as EU banks are mobilised to finance EU resilience and recovery.

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