EUROPEAN BANKING AUTHORITY

BANKING STAKEHOLDER GROUP

Working Group 1A - Capital and Liquidity

# BSG Workshop on the Finalisation of Basel III - 26 January 2022 - Report


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# 1. Introduction

This report follows a workshop on the finalisation of the Basel III framework in the European Union, organised on January 26th, 2022 by the Capital and Liquidity Working Group (WG 1A) of the EBA Banking Stakeholder Group (BSG).

The workshop provided a forum for stakeholders to exchange views on, and discuss the European Commission's legislative proposals which had been presented by the European Commission on October 27, 2021 for amendments to the Capital Requirements Regulation and Directive (CRR/CRD).

The workshop was open to BSG members, EBA staff, representatives of national competent authorities and of relevant EU institutions, as well as a limited number of academic experts and stakeholder representatives from consumer and corporate associations (invitation-only). The total audience throughout the course of the event was 50 to 60 participants.

The present report is a summary of the workshop discussion, which will be made available to the EBA, national competent authorities and participating stakeholders. It will also be published on the EBA BSG website.

The purpose of this report is not to formulate specific opinions and recommendations to the EBA but to provide a balanced and comprehensive overview of the views and concerns of all relevant stakeholder constituencies, in order to contribute to the ongoing discussions on the banking package among co-legislators.

Classification : Internal

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## 2. Workshop Agenda

**Welcome and Opening address**

José Manuel Campa, EBA chairperson
Rym Ayadi, EBA-BSG chair
Eduardo Avila Zaragoza, EBA-BSG vice-chair
Véronique Ormezzano, co-head of BSG Capital and Liquidity Working Group

**Session 1: Presentation and discussion of the legislative package**

Presentations by:

Sean Berrigan, European Commission, Director General DG-FISMA
Olli Castrén, EBA, Presentation of the EBA impact study

Panel discussion and Q&A with BSG members:

Moderator: Christian M. Stiefmueller, co-head of BSG Capital and Liquidity Working Group

Panellists: Andrea Enria, ECB, chair of the Supervisory Board
Martin Merlin European Commission, Director Banking, Insurance & Financial Crime
François-Louis Michaud, EBA, Executive Director

**Session 2: The perspective of the banking sector and financial stability**

Panel discussion and Q&A with BSG members:

Moderator: Concetta Brescia Morra, co-coordinator of BSG Resolution Working Group

Panellists: Dierk Brandenburg, Scope Ratings
Elena Carletti, Academic expert
Gonzalo Gasos, European Banking Federation
Martin Hellwig, Academic expert

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**Session 3: The perspective of bank clients and potential effects on bank lending to EU corporate and retail clients**

Panel discussion and Q&A with BSG members

Moderator: Johanna Orth, BSG

Panellists: Gerhard Huemer, SME United
Klaus Günter Deutsch, Federation of German Industry (BDI)
Dorothea Schäfer, Academic expert

**Closing remarks**

Véronique Ormezzano, BSG
Rym Ayadi, BSG Chair

# 3. Presentation and discussion of the legislative package

## 3.1 Presentation of the legislative package

**Sean Berrigan, Director-General, DG FISMA**, began his presentation[1] of the Commission's legislative proposal with a reminder of the financial crisis of 2008-09. He said that the crisis had shown weaknesses in the system and caused a severe contraction of credit and liquidity. Between 2010 and 2017, the Basel Committee had responded by agreeing on comprehensive prudential reforms. The 2021 Banking Package contains the final Basel III standards and a number of other, non-Basel III related measures that address sustainability risk and third country branches, among others. The introduction of this package had been postponed due to the Covid-19 emergency. The package, Berrigan said, would address shortcomings in the prudential framework, ensure that banks are capable to act as sustainable source of finance, contribute to a level playing field between EU-headquartered banks and those operating from third countries, and enable further progress in completing the Banking Union.

He noted that extensive preparatory work, including Calls for Advice, reports and studies by the EBA, public consultations, stakeholder conferences, and exchanges with expert groups, had gone into the drafting of this package and added that the Commission would be working with the co-legislators to ensure its speedy implementation. The overriding objective, Berrigan said, is to (a) improve the overall balance between simplicity, comparability and risk-sensitivity of the framework and (b) restore confidence in risk-based capital requirements and improve the solidity of banks' balance sheets, in particular by addressing deficiencies of internal models and enhancing the risk-sensitivity and robustness of standardised approaches. To this end, the Commission had to balance several political objectives:

- Implement Basel III agreement faithfully,
- Take into account European specificities
- Avoid a significant increase in capital requirements on EU banks
- Prevent competitive disadvantages
- Reduce compliance cost
- Balance the concerns of home and host member states

Overall, Sean Berrigan explained, the proposed implementation would translate into an increase in capital requirements for EU banks of less than 10%, on average, at the end

[1] See slide presentation in appendix 1

of the transitional period (2030). The impact in the short term would be even lower and concentrated on the largest banks.

He then provided an overview of the main Basel III-related elements of the package:

- Implementation of the output floor, subject to transitional arrangements
- Revision of the credit risk framework, with EU-specific adjustments for unrated corporates and low-risk residential mortgages (transitional), specialised lending (project and object finance), and equity exposures
- Implementation of new standards on market risk (FRTB), with certain elements postponed pending further international developments
- Implementation of the CVA risk framework, with EU specific adjustments
- Implementation of the new operational risk framework, making use of certain discretionary options available under the Basel standards

Sean Berrigan then went into more detail regarding the implementation of the output floor, which he highlighted as one of the key measures of the Basel III reforms. In terms of benefits, the output floor should, in particular, reduce excessive variability of banks' capital requirements calculated with internal models and level the playing field between banks using internal models and those applying the standardised approach. On the other hand, however, it was also the main driver behind the estimated increase in banks' capital requirements. The Commission's proposal, he said, was designed to faithfully implement the Basel III standards without significant capital increases. This would be achieved by (a) implementing the output floor for all capital requirements ('single stack') at the highest (EU) consolidated level only, but with a re-distribution mechanism for subsidiaries in host member states; and (b) requiring supervisors to avoid double-counting of risks and review the calibration of supervisory (Pillar 2) requirements to ensure their continued appropriateness.

Finally, Sean Berrigan briefly reviewed some other important elements of the proposed package:

- In connection with the Sustainable Finance strategy, new Pillar 2 and larger scope for Pillar 3 requirements would be introduced to address Environmental, Social and Governance (ESG) risks
- Further improvements would be made to supervisory framework, including changes to the 'fit and proper' assessment of senior bank managers, enhanced supervisory powers to assess transactions that affect the prudential profile of banks, changes to the disciplinary framework, provisions to facilitate the shared use of supervisory data and create a centralised data hub at EBA to reduce cost of compliance, and a minimum harmonising framework for third country branches
- Lastly, the proposal comprises specific aspects related to bank resolution, namely provisions to operationalise 'daisy chains' for both regulatory capital and MREL

purposes and adjustments to the TLAC/MREL framework for 'multiple points of resolution' (MPE) strategies

In concluding, Sean Berrigan restated the Commission's commitment to finalising the reforms that were started 10 years ago. This package should send a clear signal that the EU remains faithful to the international agreements. It was important to provide banks with legal certainty and enough time to implement the new rules, which was why the Commission proposed to postpone the entry date. This would soften the impact of the reforms by spreading it out over time.

## 3.2 Presentation of the EBA Quantitative Impact Study

The second speaker, **Olli Castrén, Head of Unit, EBA,** presented a comprehensive overview[2] of the EBA's extensive preparatory work on the implementation of the final Basel III standard, with a particular emphasis on the various Quantitative Impact Studies (QIS) it has conducted over several years, and which had largely informed the Commission's work on the legislative proposal.

Oli Castrén first provided a chronology of the main milestones of the Basel III implementation process in Europe and the principal analytical studies and reports produced by the EBA under its various mandates beginning with the Commission's Call for Advice (CfA) in May 2018. He noted that the EBA would continue to assess the impact of the Basel III reforms after the adoption of the new framework as part of the Basel monitoring exercise, using the Basel Committee's methodology, which differs from the one employed by the EBA in its CfA analyses.

He then presented, as a point of reference, the results of the EBA's December 2020 QIS, based on 31 December 2019 data, for a sample of 99 banks. This 'EU-specific' scenario took into account certain deviations from the Basel III standards envisaged and specified by the Commission. The total estimated capital shortfall for the sample was ca. EUR 33 bn. Oli Castrén then proceeded to trace the evolution of the EBA's estimates, first between the first impact study in August 2019 (based on June 2018 data) and the December 2020 exercise (December 2019 data), and then between December 2020 (December 2019 data) and September 2021 (December 2020 data). The first comparison showed the total estimated capital shortfall decline from more than EUR 70 bn to EUR 33 bn (-53%). The second comparison showed another significant decline (-20%) between the December 2020 and September 2021 estimates. Oli Castrén attributed this significant reduction within a relatively short period of time. primarily to fast and timely adjustments being made by the banking sector. He also elaborated in more detail on the main features and objectives of the new, more risk-sensitive

[2] See slide presentation in appendix 2

standardised approach and discussed the impact of the output floor at different levels of consolidation. According to the EBA's assessment, 4 of 5 banking groups in the sample experienced higher output floor-related shortfalls at the consolidated level than individually.

Oli Castrén closed his remarks with an comparison of the EU-specific amendments included in the Commission's legislative proposal with those reflected in the EBA's QIS analysis. Future: EU specific scenario takes into account large deviation included in the EC proposal. He observed that a number of elements, in particular transitional arrangements, were not included in the EBA's last impact assessments. The EBA was currently discussing how to incorporate them in its analysis going forward.

### 3.3 Panel discussion

**Christian M. Stiefmueller (Moderator)** opened the discussion by noting that the ECB had advised, in the run-up to the publication of the Banking Package, that the final instalment of the Basel III standards should implemented in the EU without material deviations. In the Commission's proposal, key elements of the Package, such as the output floor, would not be fully phased in until 2030, two years later than the extended deadline agreed with the Basel Committee while some Basel III standards would be disapplied altogether and replaced with EU-specific amendments, with reviews scheduled by 2028. Was the EU on track to achieve a balanced, Basel III-compliant outcome?

**Andrea Enria, Chairman of the Supervisory Board of the European Central Bank**, welcomed the opportunity to have a candid discussion of the Basel package. He commended the Commission on delivering a 'masterpiece' in terms of balancing different, and potentially contradictory political objectives in its proposal. There were some points that he would take issue with from a purely prudential and supervisory perspective. Overall, however, the Package contained a number of very good points, such as further harmonisation of the prudential and supervisory framework for the assessment of bank directors ("fit and proper"), the expansion of its scope to cover ESG risks, and the regulation of third-country branches.

Regarding Basel III, Andrea Enria noted that he would have preferred a speedier implementation in the EU, without postponement. He went on to emphasise, however, that a delay was still better than settling for a watered-down version of the rules. He expressed his support for the Commission's choice to apply the output floor using the 'single-stack approach', strictly in line with the Basel framework. This had been the core, and the most controversial point in all the debate at the international level. At the same time, he noted that the Commission had proposed a long list of new temporary or

permanent deviations from the path of the standards in order to soften the impact of the output floor, on the grounds that the parties to the Basel negotiations had committed not to impose upon banks ”any material increases in capital requirements”. Andrea Enria emphasised the importance for the EU to adhere to the commitments it took on in Basel and pointed out that the ’mantra’ of ‘no material increase in capital requirements’ was being misinterpreted. The Basel package was not meant to raise the bar for everybody, it was aimed at restoring reliability and consistency in the use of internal models. Responding to the criticism that the package was not fit for the European market he remarked that the relevant studies conducted by the EBA and the ECB were also put on the table at the Basel Committee and their analysis of the impact on European banks was taken into account. The Basel Committee’s objective of ’no significant increase in capital requirements’ was to be interpreted at the global level. Now, however, individual jurisdictions – including the EU and its member states – seemed to take the view that the new standards should not have a significant impact at their level, and banks would take the same view at the level of the individual entity. He reiterated that this was a distributional package, the impact would necessarily be larger for some banks than for others, and the impact would be distributed differently across jurisdictions. He agreed that the impact in the EU could be harsher than in other jurisdictions noting that, in several member states, the original Basel II standards on the output floor had never been implemented in a compliant way in the past. Some banks had enjoyed a competitive advantage for a long period of time and had to catch up now. He reiterated his concern about the proposed deviations, which could become a reputational issue, among other things, not only for the signatories of the agreement but also for the banks themselves.

Andrea Enria observed that the EU had strong and well capitalized banks, with many banks considering returning excess capital to their shareholders, which was a very positive sign and would enhance market valuations. On that evidence it would appear that they were well placed to play by the global rule book and did not need any specific special treatment. He rejected the argument that complying with the Basel standards would reduce banks’ capacity to lend to the real economy. In its own analysis, the ECB had come to the opposite conclusion: there would be a minor one-off impact on the economy in the first two years, but this would be more than compensated by a massively positive impact on growth in the longer term. He warned that even if some deviations were small on their own, or temporary, they could collectively – like small cracks in the dyke – make the whole package significantly weaker. He thought that the Basel Committee has come a long way in addressing EU concerns, such as its calls for a more risk-sensitive standardised approach, and recognising EU specificities, such as covered bonds. specialised lending and loan splitting. He concluded that, on the whole, it would be better to stick to the to the global rule book and avoid deviations.

Following up on Andrea Enria's comments that the commitment to 'not significantly increase capital requirements' was not directed at individual banks or individual member states, the Commission's representative, **Martin Merlin, Director of Banking and Insurance at DG FISMA**, gave an explanation of the Commission's proposed EU-specific amendments. He concurred with Andrea Enria's observation that this commitment had been given at the global level and agreed that a number of specificities of the EU economy and the EU banking sector had already been taken into account by the Basel Committee. He noted, however, that the Basel III still remained a hard-fought and complex compromise, which did not sufficiently take into account certain aspects of the European economy and the way in which it is financed. He pointed out again that the Commission's goal was to converge with the Basel agreement, even if that process were to take longer. The Commission, Martin Merlin added, wants to end up in the right place, as close as possible to the Basel agreement. This was especially true in relation to the output floor: the Commission expects the EU to be fully compliant at the end of the process.

Martin Merlin went on to elaborate on some of the proposed adjustments. On a general note, the Commission had made the conscious decision not to re-open matters on which agreement had been reached recently by the co-legislators, especially as part of the CRR II/CRD V negotiations, e.g. on the SME and infrastructure supporting factors. The Commission, he said, was of the view that it was important to apply a different treatment for high-quality object finance and project finance under the standardised approach and to have the option to lower the calibration of risk weights under the internal model-based approach, if appropriate. Merlin emphasised the importance of specialised lending and noted that the treatment of these exposures under Basel III may not be sufficiently granular and risk-sensitive. With reference to real estate exposures, he noted that the Commission suggested to maintain the previously agreed practice of allowing upward adjustments of property valuations post-origination, subject to regular monitoring. Given the importance of bank lending for the property sector in the EU it was better to maintain this approach. In order to reduce the post-crisis debt overhang, Martin Merlin said, it was also important to inject more equity into the European economy and, in the Commission's view, banks had a role to play in this respect. Long-term and strategic equity holdings of EU banks should not be treated as speculative Investments and should benefit from lower risk weights. This approach would lend support to other private and public initiatives providing long-term equity to EU corporates. He then addressed the proposed transitional arrangements for the treatment of low-risk mortgages and exposures to unrated corporates under the IRB approach. He acknowledged the concerns and emphasised that the proposed adjustments were merely temporary. The Commission's goal was to achieve full compliance with the Basel III treatment of low-risk mortgages and unrated corporates by 2032 but the transitional measures were necessary to avoid cliff-edge effects. He noted that the situation of unrated EU corporates, in particular, was very different from

other main jurisdictions, for example, the United States. Before moving to a full implementation of the Basel III agreement the EU would have to develop credit ratings for mid-sized companies. Summing up, Martin Merlin reiterated that the Commission's proposal is very targeted and focused on those EU-specific adjustments that were deemed necessary to smooth the introduction of the Basel III package.

**François-Louis Michaud, Executive Director of the EBA**, provided the EBA's perspective on the Commission's proposal and, in particular, the EU-specific amendments from a supervisor's point of view. He reminded the audience that the EBA is a participant in the discussions of the Basel Committee and had provided numerous, and detailed recommendations on the proposed package in its responses to the Commission's Call for Advice. The EBA, he said, supports the improved Basel III framework and calls for its full implementation in the EU, without material deviations. If the co-legislators decide that exemptions are necessary the EBA would strongly recommend that they should be viewed as temporary solutions only. He mentioned the Covid-19 pandemic as an example to highlight the importance of having a robust regulatory framework in place, which enables the banking sector to absorb this kind of shock.

Commenting on specific aspects of the legislative package, François-Louis Michaud pointed out the Commission's proposed implementation of the revised standardised approach included an extension of the concept of a 'high-quality project' from the area of 'project finance' to the broader field of 'object finance', providing banks with a degree of discretionary latitude that was at odds with the spirit of the actual standard. Moreover, the decision to keep the 'infrastructure supporting factor' was likely to result in unnecessary complexity of the rules and potential inconsistencies in their application. There was a need to do more work, François-Louis Michaud said, and the EBA was ready to prepare the relevant analysis under the mandates envisaged in the proposal. The EBA had fewer concerns about the use of advanced statistical and other mathematical methods for the revaluation of mortgage collateral as long as those methods were properly validated internally and approved by the competent authorities. Regarding the introduction of minimum haircut floors for securities financing transactions (SFTs), he expressed EBA's support for the Commission's proposal not to apply the relevant Basel III standard at this stage. He reminded the audience that the EBA, in its response to the relevant Call for Advice, EBA had pointed out a number of practical implementation issues and the risk of regulatory arbitrage and had questioned whether these provisions would actually achieve their objective, which was to reduce or limit the build-up of leverage outside the banking sector. The EBA, and the ESRB, had suggested that stricter rules for SFTs might be introduced more easily and effectively in market regulation. Given that ESMA was responsible for administering the SFT Regulation (SFTR), EBA would be comfortable with that mandate being assigned to ESMA, possibly in cooperation with EBA. François-Louis Michaud then addressed the treatment of equity holdings. He noted that the so-called ~Danish compromise~ had an important political

dimension that goes beyond the technical assessment. He cautioned, however, that the Commission's proposal, which leaves the risk weight applied to equity holdings at 100%, would create inconsistencies in the framework and reiterated the EBA's suggestion, expressed in its response to the Call for Advice, to adopt the risk weights specified by the Basel Committee in the last iteration of the standard. There was no technical reason, he added, for applying a preferential treatment to these exposures compared to any other equity exposures. Finally, on the subject of operational risk, François-Louis Michaud noted that the Commission's decision to exclude internal losses from the calculation (by setting the internal loss multiplier, ILM, to 0) permanently would considerably reduce the risk-sensitivity of the approach. He suggested that a bank-specific ILM could be phased in overtime, similarly to the output floor. To conclude, François-Louis Michaud expressed his hope that any exemptions, even if warranted and justified by EU specificities, would be transitional only.

Continuing on the theme of transitional arrangements and review clauses, Andrea Enria reiterated his view that the proposed transitional treatment of residential real estate and unrated corporates, in particular, if it were to be maintained permanently, would constitute a material deviation from – even a circumvention of – the international standards. He insisted that these arrangements, if they were adopted, should only ever be considered as transitional, even though there were efforts to make them permanent. He returned to the question whether these transitional provisions were really needed to soften the impact. Regarding residential real estate, he reminded the audience that the ECB, in its Financial Stability Review, had only recently identified the residential real estate sector as a source of financial stability risk for the Euro area. Average residential real estate prices were growing at a rate well above their long-term average, at more than six percent. Some member states were experiencing double-digit growth rates and considering the use of macro-prudential tools. Andrea Enria questioned if there really was a need to soften the impact if the sector was already overheating. On the treatment of equity exposures, and especially intragroup holdings, he that the proposed calibration of the risk weights was simply too low and not adequately covering the underlying risk. This was, in his view, not a matter of European specificities. The ECB had already given its opinion on the so-called 'Danish compromise' at the time and it critical of this arrangement. Andrea Enria voiced his concern that the Commission had tried to anticipate all the potential trade-offs in its initial assessment, even before entering into negotiations with the Council and Parliament. There was a risk, in his view, that prudential standards agreed at the international level could become even more diluted.

**Christian Stiefmueller** then drew the panel's attention to the fact that the impact of the final Basel III instalment, in terms of incremental capital requirements, was expected to be concentrated in a very small number of large institutions, mainly G-SIIs and some O-SIIs. If the Commission proposed measures to mitigate this impact, would they not also negate the positive side-effect of narrowing the competitive advantage these large

institutions derive from using internal model-based approaches vis à vis their – usually smaller – competitors who apply the standardised approach?

In his response, **François-Louis Michaud** emphasised the importance to focus, first and foremost, on the preserving the risk sensitivity of the prudential framework. He acknowledged that there were also distribution effects but emphasised that improving the risk sensitivity was the main priority the reforms. The introduction of a more risk sensitive standardised approach, combined with stricter limits on the use of the internal models-based approach and the output floor, should result in rebalancing the framework. Studies by the EBA do indeed indicate that the output floor is the single most important driver of incremental capital requirements and the bulk of that impact is borne by a few large institutions. François-Louis Michaud noted that this was a likely outcome but not a deliberate policy objective. The reforms were meant to affect all institutions.

François-Louis Michaud described how estimates of the impact of the Basel III reforms on banks' capital requirements had evolved – and decreased – significantly over time as a result of further refinements of the impact analysis and estimates. What seemed to be awful in the first place, he said, will not be so difficult to digest at the end of the day. He pointed out that banks' positions should not be seen as static. Institutions are, and should be capable of adjusting their activities to market conditions. In this sense. the reforms would also contribute to the transformation of the banking sector. Instead of focusing on the loss of certain benefits, e.g. from optimising capital requirements through internal modelling – something that had gone too far anyway in the view of many analysts and market participants – banks should take this as an opportunity to assess their franchise and rebalance their activities, where needed. To conclude, Michaud called upon large banks, in particular, not the convey the impression to the market that they cannot afford to absorb the impact of the reforms or are not capable of adjusting their strategies to adapt.

Moving on to the topic of Environmental, Social and Governance (ESG) risks, **Christian Stiefmueller** noted that the Commission's proposal appeared to rely mostly on Pillar 3 measures, such as stricter, and more comprehensive mandatory disclosures, with the possible addition of bank-specific Pillar 2 add-ons based on stress testing. He made reference to the ongoing discussion about the feasibility of introducing additional Pillar 1 in the EU and in other jurisdictions, such as the UK.

On behalf of the Commission, **Martin Merlin** agreed that ESG risk was indeed an important dimension and noted that the package should be seen as another step towards implementing the EU's Sustainable Finance strategy. He mentioned the proposed introduction of specific requirements and incentives for banks to manage ESG risks in a systematic and consistent manner and the expansion of existing Pillar 3 disclosure requirements to all banks. The proposal would also give supervisors the necessary tools to assess ESG risks in the context of the SREP process and impose

specific requirements, where appropriate. Finally, he said, the proposal would also confirm that the Systemic Risk Buffer could also be used to address risks related to climate change. Regarding the discussion in the UK, in particular, Martin Merlin was skeptical that the PRA would recommend imposing Pillar 1 requirements. He pointed out that regulators in the UK as well as in the EU were mindful of the fact that any Pillar 1 measures would have to be based on very robust evidence. He added that the Commission was open, in principle, to considering potential measures going beyond Pillar 2 and Pillar 3, but had to be sure that they are based on solid evidence and analysis. EBA has been tasked to anticipate the report on the treatment of exposures involving environmental and social risks for 2023 and the Commission will take that report into consideration when deciding if there is a case for additional Pillar 1 prudential measures. Martin Merlin added that any such measures would have to be designed in a way that remains fully compatible with a risk-based prudential framework. The concept of applying specific risk factors, such as a ’green supporting factor’, which is being supported by some, may be difficult to reconcile with well grounded risk-based, risk-sensitive approach.

Referencing a recent research publication in the ECB’s macroprudential bulletin **Christian Stiefmueller** asked Enria whether he agreed that the current prudential framework was not sufficiently reflective of ESG risks.

**Andrea Enria** concurred largely with the position set out by Merlin. He advised against ’jumping the gun’ and imposing an overly simplified, binary solution, e.g. involving ‘green supporting factors’ or ‘brown penalising factors’, and acknowledged that there was work to be done, also at the international level and by the Basel Committee. The EU should not be portrayed as lagging behind in this area – to the contrary, the EU was a global leader. The EU, he said, had had been among the first jurisdictions setting out supervisory expectations on climate risk and asking banks to provide self-assessments and remedial plans to promote convergence towards these expectations. The EU was also preparing to conduct its first, bottom-up climate stress test in the course of this year. He expressed his view that the EU was moving ahead, and making significant progress in this area.

From the EBA’s perspective, **François-Louis Michaud** agreed with the views expressed by the other panelists and noted that the EBA was very actively involved in the process of establishing the necessary empirical basis, in particular, the EBA’s 2021 pilot exercise on climate stress testing, which helped to identify data gaps. He added that regulators were still very far from having full and reliable data and called on banks and other stakeholders to concentrate their efforts on making that data available, not only to assess and mitigate risks but also to educate customers and address information asymmetries in the market. François-Louis Michaud encouraged banks and supervisors to communicate openly, between themselves as well as with customers and market participants, on what they know and on what they don't know yet, especially during the

transition phase. It was important, he said, to reduce uncertainty and manage expectations among stakeholders. He underlined the need to manage the transition in and orderly fashion and cautioned against rushing through measures that could damage the economy and may jeopardise financial stability. He was very comfortable, he said, with the level of attention supervisors pay to this area but called for more realism from stakeholders about what could be done at this point in time.

### 5.4 Q&A with participants

**Audience question:** In view of current, very 'frothy' conditions in the markets for residential mortgages in several member states, would it not be sensible to actually speed up the transition, and shorten the phase-in period, instead of applying the proposed transitional arrangements?

**Andrea Enria** agreed, in principle, that there is no need for a transition. He pointed out that conditions in the residential real estate market, for instance, are a cyclical phenomenon, and risks related to these exposures should be addressed with properly calibrated microprudential tools, in the first instance, and with macroprudential tools, when considered necessary. There was no inherently transitional element that needed to be addressed. Generally, Andrea Enria agreed with the reasoning that informs the Commission's proposal, which provides a discretionary option, not an obligation, for member states to apply the preferential transitional treatment of low-risk residential mortgages. It is appropriate, in his view, to leave such a decision to the member states individually. There was a question, however, as to whether it would be for national competent authorities or for governments to decide. If it were member state-governments there could be a risk, in his view, that different countries choose different treatments, which could result in a heterogeneous mixture of micro- and macroprudential tools.

**François-Louis Michaud,** while supporting Andrea Enria's comments in principle, reiterated his view that a transition period for banks was appropriate. He argued that banks had to reassess and adjust their business models. He did not think, he said, that there was a need to to speed up things. At the same time, re noted that a number of jurisdictions around the world were making rapid progress, with ideas and implementation plans being announced and shared with market participants. It was important for the EU, in his view, to keep up the momentum and finalise the implementation of the Basel framework quickly.

**Martin Merlin** referred back to his earlier statement, reiterating that the proposed preferential treatment of low-risk residential mortgages was only an option given to member states. Looking at the discussions the Commission had had with member states on that matter in recent months he expected very few member states to actually make

use of that option, which should go a long way towards reassuring those who are concerned about the risk of overheating real estate markets.

**Audience question:** If the standardised approach is becoming more risk-sensitive, whereas the IRB was going to be become less risk-sensitive, could this actually affect the business selection by banks in a negative way?

**Andrea Enria** noted that an important amount of technical work had been done by the Basel Committee, with the support of outstanding work by the EBA, European supervisors and national authorities to achieve a balance, which included making the standardised approach more risk-sensitive and placing some constraints on the internal model. On a broader note, he pointed to a lesson he had dawn from the adoption of the first Basel III package: jurisdictions where the new rules were implemented fast, such as the US, which front-loaded the adoption of the new capital requirements, were also much faster in restoring the banking sector to a condition where it could resume lending and support the economy. He concluded that the idea that long transition periods were better, for banks and for the real economy, was misguided.

**François-Louis Michaud** spoke about how the EBA would be monitoring the impact of the new framework, which would be done regularly are part of the Basel quantitative impact assessments (QIS). He conceded that this exercise may not fully reflect all EU specificities but, on the whole, the direction of travel would be very similar. The EBA would closely monitor developments but he was confident that the increase in risk sensitivity would render the system more efficient, from an economic point of view, and provide good outcomes for both banks and the economy. The EBA was not overly concerned, he said, about redistribution effects or credit crunches.

**Audience question:** The proposal provides for any incremental capital requirement resulting from the application of output floor to be calculated at the highest level of consolidation, with a resitribution mechanism to address home-host issues. Is this rather complex way of redistributing capital the best approach and have alternatives, such as waivers – including cross-border waivers – been considered?

**Martin Merlin** noted that the Commission had been advocating for some time in favour of allowing banks to manage capital and liquidity more easily across borders. The use of the waivers was discussed with the co-legislators fairly recently, he said, but there did not seem to be sufficient political appetite to be ambitious in this respect. The Commission did not consider it appropriate to raise this issue again in this package but is hoping that it would be picked up as part of the Banking Union discussion. Merlin went on to explain that, when the decision was made to apply the output floor at the consolidated level only, the Commission felt that it should be accompanied by a

mitigating measure, and the redistribution mechanism was designed to provide this balance.

**Andrea Enria** added that the ECB had been quite vocal in asking for these requirements to be applied the consolidated level only. With European banking supervision covering 21 out of the 27 member states, ideally, the requirements should be set at the consolidated level and banks should be responsible for ensuring that capital is distributed across the group in an appropriate manner, also across subsidiaries. This should be subject to review by the supervisors, of course, and they would conduct an assessment on a bank-by-bank basis. This would be a more effective approach of applying the output floor and would avoid trapping capital at the parent level. He expressed confidence that there would be enough time for the banks to prepare for the adoption of these new rules.

## 4. The perspective of the banking sector and financial stability

***Concetta Brescia Morra***

The Basel III agreement was intended to react to the global financial crisis. Nevertheless, the last step in the implementation of this comprehensive agreement takes place more than 10 years after the peak of the crisis. The reform in its entirety was clearly conceived in a different context. We would therefore like to have an overall assessment of Basel III from you. In particular, it will be of a great interest to understand if the measures that will come into force with the legislative package under discussion are the most suitable to address the risks and vulnerabilities of the banking market in a macroeconomic scenario still characterized by great uncertainty due to Covid19 crisis.

***Dierk Brandenburg***

The overall assessment of the package is positive, banks operating under global standards is a unique strength, found in few industries. It creates transparency in what would otherwise be a very opaque sector to analysis and allows for global benchmarking. My arguments not only apply to the RWA floor, but also to other measures such as the Leverage Ratio or the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

One positive aspect is that the Europe is moving ahead because any further discussion would be a distraction given that few investors have concerns over European banks' capital level at this point of the cycle. Experience of Covid crisis has shown that banks can withstand sizeable economic shocks while keep lending. So both regulators and

banks are acting from a position of strength. However, the risk profile of banks has evolved since the Great Financial Crisis. Asset markets have recovered strongly and are a key support to banks' risk profile in terms of asset quality and revenue generation. At the same time there has been a proliferation of non-traditional risks linked to technology, especially in payment systems, money laundering, cyber and new market entrants, sometime from outside of sector. Technology is the key ESG risk for banks ahead of climate. EU banks also face a unique operating environment in the EU, where the Banking Union is not complete and there remain residual risks around the sovereign exposures on their books. The latter is not reflected.

***Gonzalo Gasos***

The finalisation of Basel III was conceived 6-7 years ago, and it will take another 3 years until implementation. A lot of time has passed and, more importantly, a lot of things have happened that have taught us important lessons. The banking and financial landscape is substantially different to the time when Basel III was thought. In 2015, the original Basel III package was in the first stages of implementation, but now it is fully loaded and well established. The benefits and the success are evident: the capital ratio has more than doubled; the loss-absorbency of capital instruments has been significantly improved and is adequate; liquidity risk, a specific historical deficiency of European banks before and during the Great Financial Crisis, is now under control, as well reflected in the EBA dashboard; there is a fully-fledged Recovery and Resolution framework, including loss-absorbency requirements not only for the few G-SIBs as in other jurisdictions, but Europe has applied its own version of MREL to the whole banking sector.

In the meantime, and in addition to the regulatory reform, Europe has established and consolidated a Single Supervisor and a Single Resolution Board covering the majority of the banking assets in the region, which permits a quick, uniform and effective reaction to unexpected crises, and the EBA has completed the Single Rulebook, including a thorough analysis of all internal risk models and set the terms of an ambitious repair program, coupled with a detailed revision of each internal model by the SSM in a 5-year TRIM project detecting all potential deficiencies, increasing capital requirements accordingly and setting out remedial actions.

Apart from those facts, during this time we have also experienced a real-life stress test. At the outbreak of the pandemic in March 2020, the EBF put forward a series of proposals to tackle the consequences with a combined response including monetary policy, supervisory flexibility and the regulatory quick fix. Many of the EBF recommendations were taken on board, in particular the implementation of a moratoria program across Europe, the extension of the TLTRO facilities in time and scope, covering a wider range of counterparties including SMEs, or the revision of some elements of the regulatory framework.

But let me remind that all that would not have been sufficient if the banking system had not recapitalised itself substantially during the previous decade. The crisis caught our banking system with a capital ratio of 15% on average and a short-term liquidity ratio of more than 150%. To put things in perspective, the level of capital and liquidity now is more than double than at the time of the previous crisis of 2008. And we have seen the difference: in 2008 banks were part of the problem. In 2020 banks have been part of the solution.

Against this background and also drawing from the lessons learnt in the last 2 years, the Banking Package will have to strike a balance between concurrent objectives: complying with the spirit of the Basel reform; doing it without significantly increasing capital requirements as requested by the G20 in order to find a balance in the trade-off between capital and growth. Covid-19 has been a reality check when supervisors and governors, mindful of the need to keep up lending, suggested decreasing temporarily the level of capital; taking into account European specificities and respecting proportionality.

But I would like to add other relevant underlying objectives: flexibility to overcome the rigidness of the regulation that became apparent during the Covid crisis; simplicity to reduce the current regulatory complexity; Market integration in the EU and all the more, within the Banking Union, limiting and reducing measures conducive to fragmentation; certainty to improve the current regulatory uncertainty that makes difficult to decipher what the actual requirement will be for every bank in the future.

***Elena Carletti***

I would like to take a step back of what has happened in the past 10 years also considering that in the meantime there has been another crisis. Banks are much more capitalised than 10 years ago (figures from EBA reports on capital and leverage ratios clearly show the improvements). The first package of Basel 3 has boosted capital levels. Then banks have been able to withstand the bad weather, even if thanks also to the Authorities facilitations during the pandemic. Notwithstanding this positive result we should compare the EU banking sector to that of other jurisdictions. When thinking in the global perspective, it is evident that in Europe capital has increased but not the level of profitability. How much do we have to worry about this problem? One could think that banks are greedy and thus we should not care about profitability. On the contrary, I consider profitability as an important source of organic capital generation. Recently also the SSM and the EBA have devoted more attention to the issue of bank profitability. For this reason, I am of the view that the regulatory framework should not penalise further EU banks, in particular try not to harm profitability of the EU banking sector.

***Martin Hellwig***

The question posed by the chair involves several invalid presumptions. First, the Basel III reform was not conceived as a temporary measure but as a long-term correction of flaws in Basel II that the Global Financial Crisis had laid open. One feature about the

context that is always the same involves the incentives of bankers to engage in risks that endanger the financial system and the overall economy, especially when these dangers may force governments and central banks to spend taxpayer resources for bailing banks out. Basel III had actually been negotiated quickly and under the influence of an industry unwilling to acknowledge its responsibility for the Global Financial Crisis. Martin Wolf of the Financial Times commented that “tripling almost nothing still does not give one very much.”

Subsequently, regulators and supervisors came to realize that in 2010, they had been too timid. In particular, they came to realize the extent to which the model-based approach can be manipulated to downplay risks. This realization provided the impetus for the additional reforms that the Basel Committee on Banking Supervision (BCBS) has negotiated in order to fill important gaps in the 2010 Basel III Accord. The negotiations and subsequent agreement involved the representatives of the Member States of the European Union.

Given the agreement reached in the Basel negotiations, the task of the European Union is to implement this agreement in its legislation. This is – or should be – the purpose of the legislative package under discussion. Therefore the question is not be whether these measures “are the most suitable to address the risks and vulnerabilities” of European banking systems but whether the European Union is willing to be a loyal participant in the Basel system or not.

As Andrea Enria has emphasized, the Basel Accord sets minimum requirements that national and European legislation and supervision must meet if their banks are to enjoy the benefits of the home country principle. If national or European legislators choose to water these requirements down, they risk retaliation from other jurisdictions – just as the UK risks retaliation from the EU if it breaches the Northern Ireland Protocol to the Brexit agreement. The bank lobbyists who clamour for such watering down should take into account that they risk increased ringfencing in other jurisdictions, in particular the United States.

Turning to the assessment of Basel III and the current situation that the Chair has asked for, I first note that Basel III was timid and only eliminated the worst abuses. Bankers vaunt their current equity levels, but typical leverage ratios of large European banks have only been increased to the levels of 1998 – and those were already at historical lows. The point is even more striking when we take account of the implicit equity that comes from the ability to recoup losses by earning significant profits (“charter value”). This implicit equity has declined dramatically over the past five decades. Lack of profits is a major reason why banks have found it so difficult to rebuild equity since the Global Financial Crisis. Low profitability is a consequence of intense competition. Over the past five decades, intensity of competition has been heightened by entry of non-banks (“shadow banks”), technical and institutional change enhancing the scalability of operations, and the lack of exit due to government bailouts.

Industry participant at this workshop vaunt the industry's high equity levels and robustness in the Covid Crisis. In this context, they overlook a few things. First, the Covid Crisis began as crisis in the real economy rather than the financial sector. Second, government bailouts neutralized much of the damage to the real economy. Without these bailouts, banks would have seen dramatic increases in non-performing loans and borrower insolvencies. I doubt that they would have looked so good then. Third, some of the fallout from the Covid Crisis may still be coming to hit the banks. Government measures protecting the real economy involved relaxations of rules for debt service and a finding of nonperformance; they also involved significant additional lending to firms hit by the lockdowns. We have no transparency about the amount of debt overhang of the real economy when the Covid Crisis is over so some problems may still be ahead. Governments will be tempted to ask banks to participate in debt relief.

Concerning risks ahead of us, the return of inflation should alert us to the possibility that interest rates may soon rise from their current historical lows. When this happens, there will be substantial pressure on institutions involved in real estate finance. If mortgage loans have been made under variable-rate contracts, the question will be whether borrowers can pay the additional debt service. If mortgage loans have been made under fixed-rate contracts, the question is whether the lenders have taken out insurance, i.e. engaged in interest rate swaps or not; if they have not, the question is how well the can bear the increase in the costs of funding those mortgage loans. If they have, the question is how good the counterparties are.

The Bundesbank's annual financial stability reports have suggested that the past few years have seen the development of real-estate bubbles. They have also shown that the lengths of periods over which mortgage interest rate are fixed have gone from an average of ten years to an average of over fifteen years. I imagine that, if a large bank writes such a contract, they will engage in proper risk matching through derivatives, but I have doubts that this would also be true for small local banks.

The many financial crises of the early 1990s, as well as the subprime crisis in the US and further crises in Spain and Ireland, were all related to real estate finance, interest rate increases and real estate downturns. Given the historical experiences and given the current situation, I find it highly appropriate that the "completion of Basel III" includes a reform of equity requirements for real-estate loans.

***Concetta Brescia Morra***

In adopting the Basel standards, the Commission has chosen to respect European specificities (on this point is clear that the Commission proposal embedded already a political compromise that can be further adjusted before the Parliament) and avoid a significant increase in capital requirements. This has resulted in the maintenance of some preferential treatments already provided for by European legislation (support for small and medium-sized enterprises and for infrastructure financing, exemption of

certain exposures from the "credit value adjustment" requirements). What do you think of this choice? Are there any other specific features of the European banking market to consider?

***Elena Carletti***

Rules are applied to the universe of banks and it is therefore important to take account of specificities. Guiding principles are necessary and the level playing field should be guaranteed both across small and large institutions and across jurisdictions. The maintenance of some preferential treatments should have not been a political decision. To achieve a true level playing field the package should reduce national discretions.

Moreover, the rules that provide for specific exceptions should be assessed individually. I would like to consider some of them in particular. The first is the more granularity in the discipline of Residential and Commercial Real Estate markets exposures. I read this choice negatively. We have seen heated markets. The heat of the market has not changed. In this context the choice to have a RRE specific discipline is difficult to justify. The second is the countercyclical capital buffer (CCyb). I recall that CCyb requirements are decided at a national level and we have seen several countries have decided to increase CCyB requirements. Third, the treatment of unrated companies. We need to have more information on these companies before removing the favourable treatment. The treatment of unrated companies will become important in light of ESG considerations. It will be complicated for unrated companies to comply with the ESG requirements. Then a delay in removing the favourable treatment could be good to help the transition. Fourth, concerning the discipline of investments in equity holdings; Basel 3 increases the requirements for equity holdings, but a favourable treatment has been provided for intra-group equity investments. The rationale for this choice is not clear. Furthermore, a departure from Basel 3 is represented by the treatment of insurance subsidiary according the so-called “Danish compromise”. This choice is correct only if we think that risk in insurance companies has decreased.

***Martin Hellwig***

On the matter of “European specificities”, we should be clear that this a euphemism for what in fact will be a breach of the Basel Accord.

I appreciate the political weight attached to SME lending, which is hardly less than the political weight attached to real estate finance. Any notion that SME lending is particularly safe – or that real estate lending is particularly safe – is unrealistic. The banking crises of the late 1980s and early 1990s (US, UK, Switzerland, Sweden, Norway, Denmark, Finland, Japan, Crédit Lyonnais) all involved nonperforming business loans and real estate loans, for business loans quite often SME loans.

Given the political weight attached to SME lending and to real estate lending, political authorities are always tempted to impose on banks to be forthcoming on these loans. Relaxing equity requirements for these loans is on way of doing this. However, the risks

are there even politicians and bankers chose to negate them. Once the risks realize, there is a significant chance that taxpayers must pay the bill. It would be preferable to have taxpayers participate explicitly, e.g., by providing government subsidies to these loans. Supporting SME and real estate lending through laxer regulation is somewhat dishonest to taxpayers who will not be able to allocate proper responsibility for the damage they must pay. Of course, once the political process treats the matter of explicit subsidies, it will be much more controversial.

***Gonzalo Gazos***

The Commission's proposal takes into account certain European specificities, many of which were already in the current legislative framework. However, there remains uncertainty about the stability of those decisions. And this is an increasingly important aspect. I have talked before about the solidity of the regulatory reform, but we don't have to be complacent and address the deficiencies. A blatant weakness of the European banking regulation is the high degree of uncertainty in front of analysts and investors. This does not help with the market valuation of our private banks.

At this point, when the capital ratios are quite high, reducing regulatory uncertainty could be more important than the level of the minimum requirement itself. Every bank should have a clear prospect of its capital requirement for the following years, all things being equal. But there is a high probability of significant variations due to discretionary measures by multiple authorities upon external decisions that can neither be controlled by the bank nor anticipated at all. In these conditions, it is very difficult to prepare a financial plan for the next years with any degree of certainty.

With this in mind, it is good to take on board European specificities, but it is necessary to make them permanent and to give a sense of stability. For example, the CVA exemptions have been maintained, but still CVA has to be reported as if it weren't exempted and the EBA is mandated to develop standards of measurement. Therefore, the democratic decision taken years ago is challenged and, in front of investors, looks unstable.

Another example is the temporary character of the solution to the case of unrated corporates. Medium and long-term financing will last longer than the envisaged transitional timelines, so how can you incorporate this into financial planning? The transition period should last until a credible solution, like a credit rating mechanism covering the majority of clients, is in place.

Finally, let me illustrate an opportunity to contribute to all the previous objectives. The alpha factor in the Standardised Approach for Counterparty Credit Risk, which has a material impact. An investor is analysing the capital requirement for a US bank and a European bank:

In the US, the alpha factor has been set at 1 for commercial end-users applied across the whole prudential framework and on a permanent basis. That is certainty. In Europe, the Commission, in principle, has set the alpha factor at 1, but only for the purposes of calculating the output floor on credit risk, not for banks using standardised approach neither for the calculation of the leverage ratio. And the permanence is subject to discretionary decisions upon an EBA report. That is uncertainty.

If the alpha factor is set at 1 for all banks with no further conditions, as in the US, we would be contributing to all objectives: simplicity, certainty, reducing the impact and applying proportionality. The Commission has made an effort to strike a balance between the implementation of the spirit of the Basel standard and the G20 mandate to do it without significantly increasing capital requirements. And the result is around 9% by 2030. However, we have to consider the assumptions made and what the impact will be on a permanent basis. More importantly, we have to consider an add-on of uncertain decisions which is very difficult to anticipate but it will not be negligible. In the banking package, the EBA has been given around 80 mandates to elaborate standards and write reports, some of which may have a substantial impact depending on the outcome and the use that the Commission will make of them. There are many examples across the text: additional value adjustments, specialised lending, risk parameters, CCFs, alpha factor, etc.

If the total impact is to remain non-significant as foreseen by the G20 in its multilateral agreement, there should be a clear mandate to the EBA to develop those standards without increasing capital requirements.

***Dierk Brandenburg***

The banking sector is perceived as well capitalised at present and we would not expect there to be an impact from the package on the system. However, capital is cyclical and we can’t assess how this will play out in the 25-30 period.

Main question is not whether banks can generate enough capital to meet the requirements but how they can generate sufficient earnings to maintain that level of capital. So the real question is how banks will develop their business models.

There will be impact on certain asset classes, notably unrated corporates and the market will have to develop solutions, e.g. for external ratings for mid-sized corporates and if necessary provide sufficient equity for corporates to achieve those ratings.

***Concetta Brescia Morra***

The Commission explicitly stresses that the reform “should ensure proportionality and aim to further reduce compliance costs, in particular for smaller banks, without loosening prudential standards”. Do you consider that the progress made in favour of a greater proportionality of the measures contained in the CRD5 / CRR2 package (for example with the introduction of the definition of "small and not complex" entity to which simplified rules on supervisory reporting apply) sufficient? Are there other

aspects of the Basil III reform that need to be better calibrated to reduce compliance costs for smaller institutions? Is “one size fits all” the only argument to consider when it comes to proportionality?

***Gonzalo Gasos***

CRR2 and CRD5 represented a step forward in terms of proportionality. For the first time, we have a clear definition of “small and non-complex institution” and simplified versions of the newer and more complex metrics like the NSFR or the IRRBB. The work undertaken by the EBA has been also appreciated in terms of the exemptions granted to SNCIs for the reporting of various classifications of concentration and liquidity metrics, the very granular data on asset encumbrance or the reduction in the number of templates to about half. These changes will be implemented in 2023 so they will be effective by the time the new CRR3 enters into force.

Regarding opportunities to increase proportionality in the banking package, let me suggest some easy and smart choices:

The EBA is coordinating an ambitious project for a European integrated reporting system (statistical, resolution and prudential data) that will reduce reporting costs, if it follows the EBF principle to define once, report once and share information between authorities to avoid duplicated or overlapping data requests. This project will reduce reporting costs for all banks but, of course, it will benefit smaller banks the most for a simple reason of economies of scale. If compliance costs are bigger for smaller banks, then any reduction in compliance costs will benefit smaller banks the most. The development of RegTech solutions promoted by the EBA and other authorities will also be mostly beneficial for smaller banks.

Second easy opportunity: I talked before about the alpha factor in SA-CCR, which will be set at 1 for the calculation of the output floor only benefitting IRB banks. Europe should apply the alpha factor equal 1 for all banks including the small ones that use the standardised approach. Another big opportunity to favour smaller banks. The Commission has given recognition to the lower risk of European mortgage loans that have dual recourse to the property and the borrower, which explains the extremely low loss rate in the best quality tranches. But the transitional arrangement for low-risk exposures secured by mortgages on residential property applicable upon discretion of the Member State, has been proposed only for the purposes of calculation of the output floor. Given the soundness of the arguments, it should apply to all low-risk exposures including those of smaller banks using standardised approach that meet those requirements and directly in all Member States; also, the transitional arrangement should be made permanent as long as the dual recourse feature persists. This way, the recognition of low-risk residential mortgage would cover smaller banks too.

***Dierk Brandenburg***

Cost of regulation is a major issue for banks that it disproportionately affects smaller banks. Such cost come on top of banking levies and low interest rates and this has been visible in cost to income ratios and also cost-to-asset ratios.

Market already demands higher capital levels from smaller banks due to their lower diversification. So no need to double down on regulatory requirements and supervisory flexibility is required.

Smaller banks are a diverse group. Can be "cookie cutter" non-complex versions of large banks but can also be innovative market entrants that help the sector to adapt to changing client needs and provide competition. Regulators have an interest in ensuring that new banks can enter the market. BoE for example very focused on ensuring that new business models can develop. Burden is already high on these banks because they need to fund their expansion and usually focus on a narrow set of risks, at least initially.

***Elena Carletti***

The apparatus of resources required to manage "risk management and compliance" in a bank is substantial. It is a fixed cost of regulation. I agree with Dierk that it is fair to have new entrants as long as they can stand on their feet and can be resolved, if needed. It is difficult to raise MREL instruments. Looking at the Italian market, largely composed of small and medium banks that are difficult to resolve we should admit that large banks pay unfairly the bill.

I agree with the principle of proportionality, but small institutions should be able to manage themselves and not require government support.

***Martin Hellwig***

"Proportionality" is a weasel word that can be used arbitrarily, without any consistent approach to the underlying problems.

The underlying problems involve risk taking by banks and the prospect that financial stability may be endangered and/or taxpayer bailouts required. Elena Carletti has just pointed out that in Italy the small banks tend to be more problematic than large banks. In Germany, the reverse is true. The only part of the German banking system that I would consider to be fairly safe is made up of the small savings banks and cooperative banks that are active in retail, with strong competitive positions. In contrast, the large banks, private as well as public, operate in intensely competitive environments, with a fair amount of overbanking, with artificial barriers to exit, so that is where I see the systemic risks. From a German perspective I therefore see some reasons for making life easier for small banks, but Elena's observation makes me cautious as to whether we should really go by size.

This being said, I have a lot of sympathy for the executive of a small bank who finds it difficult to cope with information and reporting requirements from the authorities that are tailored to the large, internationally active banks. The problem should perhaps be addressed by allowing bankers a choice between say the acceptance of a high equity

requirement, in the form of a high leverage ratio, without any additional conditions and the acceptance of the current regime.

In terms of risks to financial stability, the real distinction is not large versus small or complex versus simple but micro risks versus macro risks. Savings and loans institutions in the United States were small and simple, but they succumbed to the macro shocks from high interest rates in the early 1980s and again the late 1980s. Although each of them was small, the aggregate mattered and contributed significantly to the recessions in 1981 and 1990, as well as costing taxpayers some $ 154 billion (after the accounts were finally made). We must stop looking at positions one by one and at banks one by one and get an idea of what the macro risks are.

For all its emphasis on risk sensitivity, the current regulatory framework does not adequately consider the implications of macro risks and their correlations with micro risks. Banks' risk models "believe" in hedging, but sometimes the macro risks that one has hedged come back in the form of counterparty credit risks. Right now, if a bank has made a mortgage loan at 1.5% interest rate, fixed for twenty years, and if this bank has used a swap to hedge the interest rate risk, what do we know about the ability of counterparties to step in when interest rate go up? At these time horizons, somehow the case of Metallgesellschaft comes to mind.

Given the inability to handle the macro risks and the correlations properly, I very much fear that banks claiming that they have no risks at all (Dexia or Hypo Real Estate) will become insolvent from risks from correlations that had not appeared on their radar screens. Given this fear, I consider the output floor to be a very good idea, except that it is too low.

***Concetta Brescia Morra***
Please may the other panelists answer to the issue raised by Martin on macroprudential measures?

***Dierk Brandenburg***
Usability of buffers remains an issue, however, the distance to MDA buffer requirements is an important metric for market participants. Main worry is not default, but risk of regulatory intervention. Implicit cross default assumption if equity and AT1 dividends are suspended. What can be done about it? Variability of buffers and the counter cyclical Buffer. Higher buffers in the good times is a good option, but pre-covid we have seen it takes time to bring those adjustments to the system. It is a slow process. Regulators have acted quickly. That has created a precedent and people will expect this to happen again it should have needed.

***Elena Carletti***
We should think how we can make this buffer usable; if we reduce NPL we have high enough buffers. To make the buffers usable the easy answer is making them higher now. We need certainty on when banks will have to refill the buffers. Market discipline is more important than regulatory requirements.

***Martin Hellwig***

Macroprudential measures are not well designed. In theory, the idea is fine, impose higher equity requirements in a boom, slowing down the boom, release the extra buffers in a recession or a crisis, slowing down the downward pressures. The reality however has little to do with the theory. Most Member States do not have the courage to impose countercyclical buffers in time. For example, Germany decided in 2019 to impose the countercyclical buffer effective as of mid-2020. The decision was late by at least a year. Even without Covid, it would have become effective at the worst moment, when contractionary fallout from the global economy might have caused a recession. Because of Covid, of course, it was rescinded in March 2020, before it ever took effect. As we are exiting the Covid Crisis and waiting for interest rate increases that will put the financial system under stress, it would be appropriate to impose the countercyclical buffer again, but politics of intervention goes the other way. In summary, we have no appropriate rules for when to impose these buffers and when to relax them.

***Gonzalo Gasos***

As regards the O-SII buffer, which is contemplated in the Basel framework, we have to be conscious of the fact that, using that discretion, Europe has applied it to a wider scope of banks and to a higher level than other jurisdictions, therefore it represents a material part of the total capital stack in Europe. We would encourage legislators to also freeze the effect of the output floor add-on on the O-SII buffer and to scrutinise its purpose in the context of the upcoming macroprudential review.

In conclusion, the safeguards of the Commission are well-thought, but it would have been simpler to have a clear proposition to apply the output floor only to the global requirements. We are afraid that the problem is not the amount of capital required but the retention of that capital at local level. That is a problem of a different nature which has to be analysed in the context of the macroprudential review and the debate about the integration and consolidation of the European banking system.

***Martin Hellwig***

I have great sympathy for this question. At one point, a discussant in a seminar asked me: Why not have a high leverage ratio and then forget about countercyclical buffers? The discussant was not convinced that we can get the dynamics of macroprudential regulation right. However the first part of his question must not be forgotten: With a low leverage ratio, for example the 3% of Basel III, the procyclical effects of equity regulation are enormous: If equity is 3% of total assets, a 1% loss on assets wipes out one third of the equity. To re-establish the 3% ratio, the bank must either replenish the equity (difficult in a crisis) or sell one third of its assets. The deleveraging multiplier is huge. If equity is 20% of total assets, a 1% loss on assets wipes out 5% of the equity, so 5% deleveraging is enough to re-establish the 20% ration. Procyclical deleveraging is

much larger when there is little equity. Countercyclical buffer properly handled may reduce this procyclicality somewhat.

In actual practice though, the need for the buffers may be political rather than economic. When CRD IV/CRR were introduced, quite a number of Member States were displeased about the fact that the Single Rule Book took away their power over banking regulation. Some of these were states that had experienced banking crises and that thought the Basel III rules and their implementation in the CRR were too soft. So they fought for national discretion in macroprudential regulation and got what they wanted as macroprudential regulation was put into Pillar 2. In some Member States therefore, macroprudential regulation is simply an add-on to capital requirements, imposed because they consider the standard Pillar 1 requirement to be too lenient. Any attempt to fiddle with macroprudential regulation must address this political issue.

***Christian M. Stiefmueller***
Why is it that all the proposed EU adjustments seem to benefit primarily a small group of large banks?

***Martin Hellwig***
In the case of Germany, the answer is simple. Because of the Landesbanken and because of some 'national-champion' illusions, politics are twisted towards large banks. The output floor is particularly relevant for Deutsche Bank, Commerzbank and the Landesbanken. Commerzbank and the Landesbanken also received the biggest bailouts. Deutsche avoided direct bailouts but benefited a lot from bailouts of other banks (AIG in the US, HRE in Germany). The Landesbanken are parafiscal institutions of the regional governments; that makes them untouchable. This being said, the local savings banks are also affected by the treatment of real estate finance and SME lending, and they are also highly politically connected.

## 5. The perspective of bank clients and potential effects on bank lending to EU corporate and retail clients

**Johanna Orth (Moderator)** gave the floor first to **Gerhard Huemer, SME United**, who set the scene by saying that there are 23 million SMEs in the EU; 39% of those are micro-enterprises that, according to the Basel Accord definitions, fall under the Retail SME exposure class (loans below 1 M€). One should also not forget that many SME's are clients to smaller banks and therefore do not even benefit from the retail SME treatment due to the granularity criterion.

Neither these, nor the remaining, larger, SMEs are active in capital markets and all rely on bank financing. Furthermore, now is the recovery phase after the C19 crisis and SMEs need to strengthen their equity basis.

Generally, the Commission's proposal is welcome since it is not strictly following Basel in all details and addresses some EU specificities for SMEs and corporates. The proposal facilitates the interests of SME's: treatment of long-term equity investments. The Commission has made efforts to take into account specificities of the EU market – therefore there is less for the co-legislators to improve.

The introduction of the output floor to IRB banks might restrict lending to corporates and lead to higher costs for corporates. The output floor might become an issue after the transition period when some corporate exposures, similarly as leasing of mobile assets, will get 100% risk-weight in the output floor calculation.

Therefore, the ten-year transitional period gives time to solve concrete structural problems and increase availability of information (e.g. information needed for external rating purposes). For instance, rating coverage would be beneficial not only for the output floor issue, but also for the capital market union goals.

**Dorothea Schäfer, Academic expert**, took as a step back by reiterating that the idea of the Basel Agreement is to ensure that banks have sufficient capital to survive bad times. IRB models gave incentives to underestimate risks and minimize capital requirements. Basel III and the output floor limits this discretion, which mitigates the issue between IRB and SA and establishes a more adequate level playing field. Now, banks using the IRB approach still have lower risk weights than those using SA. Economically this would make sense only if all low-risk clients are in IRB banks, and all high-risk clients are in SA banks. Clearly, that could not be the case. Having a good capital position is a necessary condition to lend to SMEs or other client segments.

**Johanna Orth** raised the point that IRB model shortcomings have been addressed by other policies such as the TRIM exercise by the ECB and the IRB overhaul by the EBA. These measures are effective in ensuring robust IRB models while retaining risk sensitivity in the capital requirement calculation, while the output floor significantly decreases risk sensitivity for clients of those banks for which the floor is a binding restriction.

**Klaus Günter Deutsch, Federation of German Industries**, stated that the business community is concerned about the Basel proposal and its impact on corporate lending. While he recognizes that the Commission's proposal tries to implement the Basel III agreement faithfully and to include EU specificities, there are some issues remaining.

The post-pandemic phase will require substantial investments from EU corporates. These investments lead to a need for higher levels of lending to corporates. Normally, two thirds of lending come from the banking sector. Thus, EU corporations are highly

dependent on bank financing and a substantial part of that is lending by IRB banks. The output floor is therefore troublesome. It is especially so in some countries where the risk generally is lower and less so in those where risks are recognized as relatively large. So, lending in some countries will be constrained more than in others.

Another concern is availability of hedging instruments – for commodities, currencies etc if the alpha factor would become unfavourable. Trade instruments are also possibly ones that have too much risk weight compared to the underlying risks.

Also, in 2025 there is a risk that credit supply would be reduced due expectations of regulatory uncertainties in 2029. The notion that the EU can wait with establishing a comprehensive solution for these corporates until 2030 is wrong. In the financial markets there is an anticipatory effect. To reduce these uncertainties, we need to clarify the rulebook already now.

**Gerhard Huemer** raised the point that the Basel proposal (the output floor) is obviously a deviation from the risk-based approach, but there are ways to mitigate the impact of it. For instance, can banks support the efforts to increase coverage of external ratings somehow? Also, more differentiation in the SA could be a potential direction, for example, addressing the 100% risk weight for the leases of mobile assets.

There are differences as to how the output floor impacts EU corporates in different member states. E.g. in Germany, SMEs depend on smaller SA banks, which are not subject to the output floor, but that is not the case in the Dutch market. All SME's in the Dutch market are essentially financed by three banks, and all will be hit by deviations from IRB based risk weights (in the form of the output floor, if it becomes binding).

**Johanna Orth:** Turning to Ms. Schäfer, do you think the EU should move more towards the US model, where a larger part of the corporates find financing in the capital market and where many more corporates get themselves an external rating to be able to issue corporate debt instruments?

**Dorothea Schäfer** argued that the EU should not copy the US market. Not all SMEs should get external credit rating - it's expensive for them. There is 100% RW for unrated corporates, but at least for the SME segment there is a supporting factor that does not depend on credit rating. She advocates for a simple leverage ratio and one could argue that the output floor is more like a compromise leverage ratio.

**Johanna Orth** asked what panellists think the EU should do to help the mid-sized corporates that do not qualify for SME supporting factor but are too small to be active in global capital markets?

**Klaus Günter Deutsch** explained that there are essentially four buckets of corporates in Europe: small retail and SMEs under the SME supporting factor, that are not affected by the reform package; large SMEs and mid-cap firms that are mature but not yet capital market oriented. These should get incentives to acquire external ratings, but one should

keep in mind that 80% of corporates do not have an external rating. They are hit by the proposed output floor rules. The alternative is moving towards becoming a more capital markets-oriented company – the fixed cost of acquiring rating is high for those. For these large SMEs and mid-sized corporations that are affected by the reform package, it is not clear how to help them in cases where the risk weight increases for them significantly. The last bucket is the large corporations that already are active in the global capital market.

Early in the process, the policymakers, central banks and supervisors have to think about how to address the issue for unrated corporates. We cannot assume that in 10 years there will be external rating coverage. Probably, local solutions are the way forward, it is not necessarily so that an EU-wide approach should be sought. In addition, he notes that EU corporates will have to transition to a more sustainable economy and other new financial markets regulatory policies, such as the implementation of the final Basel III agreement, should not be disconnected from those efforts.

**Gerhard Huemer** also notes that majority of SMEs are ‘micro’ and do not benefit from the SME supporting factor but from the retail portfolio treatment instead. Then there are SMEs and mid-size corporations. Generally, it appears that German institutions do not want to think about rating alternatives. However, it would seem that the Swedish side is more open.

**Dorothea Schäfer** reiterated that she does not believe that all corporates need ratings, that it is the banks’ job to assess creditworthiness. She acknowledges the Global Financial Crisis and the lessons learned from that. Own risk assessments by banks translate into low capital requirements, but the output floor mitigates that issue. Also, more capital is generally better for banks and thus risk insensitivity is not that large of an issue. The question of “good” bank clients subsidizing the “bad” ones was a debate when the Basel II was launched and served as an argument to introduce the IRB approach. The IRB approach did not perform well. Banks that use the Internal Risk Based Approach and assessed their risk weights themselves, came up with rather too low risk-weighted assets and thus substantially reduced their necessary own funds. This was a source of bank instability in the financial crisis 2008/2009, she noted.

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Summary of Q&A session with panellists and audience divided by sub-topic:

**Topic 1: Risk-sensitivity of capital requirements and pros and cons with the output floor**

Several persons in the audience asked questions about risk sensitivity of capital requirements vs. financial stability. One BSG member asked Huemer whether the output floor is a really 'deviation from the risk-based approach'? Is it not rather a corrective to systematic biases we have observed in the current implementation of a risk-based approach? **Gerhard Huemer** replied, that yes, the floor is a corrective, but still, it leads to a less risked based approach and less risk based capital requirements.

One BSG member pointed out the fact that research and analyses have shown that internal models, while in most cases they are fairly good at determining risk, in the cases where they are not, the models both overestimate and underestimate the actual risk. I.e. the model goes both ways. She also stated the importance to be clear of what the effect will be in the jurisdictions where the output floor is binding: corporates with good credit quality will pay more for their loans. And less creditworthy corporates will pay less.

**Topic 2: Impact on retail clients (mortgages) in the EU**

Panellists were asked to elaborate their views on impact for real estate mortgage lending, especially against the backdrop that Andrea Enria mentioned risks that are building up in real estate/residential mortgages. One BSG member asked whether we could be confident that it is sensible for either customers or lenders to reduce the requirements in that area?

Another BSG member replied, that to clarify, there is no reduction of the risk weights on real estate mortgages. There is a significant increase, and the discussion is about whether this increase should be limited. The Loan to Value (as used in the revised SA, which is the basis for the output floor calculation) is the right metric in the absence of a dual recourse system, i.e. in the US. When there is a dual recourse, debt service to income is a more appropriate indicator. Another BSG member pointed out that not only for residential real estate, but also for commercial real estate, it would be good to achieve a more adequate risk sensitivity of the framework.

Another BSG member pointed out, that for households it is very important to combine provisions regarding LTV, DSTI and maturities. This is commonly done in macroprudential approaches.

**Summing up**

BSG members representing consumer organizations expressed concern about mortgage transitional arrangements and the development in the housing market (overheating), which in general adversely affects the clients. All panellists broadly agreed but there was disagreement if just having more required capital in banks is the solution.

## 6. Conclusion

To conclude, the BSG Chair thanked all speakers and panelists for the timely rich discussion on the finalization of the Basel III framework.

She concluded with the following:

1- The banking package is timely, necessary and considered as a masterpiece to achieve a resilient EU banking sector that would respond forcefully to fund the real economy – while is compliant to the internationally agreed Basel accord (to maximize international consistency). It will be cornerstone to further strengthen the banking union.

2- It is essential that the package is not watered down in the legislative process while trying to factor in the EU specificities and insisting on deviations (eg. Output floor). She emphasised that the output floor is necessary condition to be compliant to international standards – and to correct the variability of the outputs of the internal models and the potential of underestimation of risks profile that backed by adequate level of capital - She further proposed to go beyond to enlarge the application of the output floor to all IRB and SA banks -

Not watering the legislative proposal down will enhance the reliability and consistency of risk treatment and hence the reputation of EU banks and EU banking system and above all – to maintain their capacity to lend to the economy with no disruption and need to require public intervention.

3- The specificities must be carefully studied not to risk having a cost of implicit support factors (for example to SMEs and other similar exposures) higher than direct subsidies when things would go bad. Such an approach would obviously enhance transparency and accountability to the public particularly accounting for the major government support during the pandemic

4- Other aspects that were highlighted such as the treatment of sovereign risk, the technological/digital related risk and others risks such as money laundering and conduct risk, these risks can threaten the stability and resilience of the banking sector and might be further factored in the overall risk assessment.

5- Also important considerations are – the macro risks related to the potential increase of interest rates (speed and levels) and the debt overhang and sudden surge of NPLs.

The question is – is there convincing evidence that shows EU banking are prepared for this? Based on their current capitalization level?

6- Moreover, to ensure all actors are prepared, appropriate transition is needed in terms of timing and phasing out, we must consider that the pandemic has increased this delay… The transition must be seen as temporary and the preparation phase should not be lingering not to increase the level of uncertainty that might reduce confidence from market perspective.

7- Banks, regulators and supervisors are expected to work hand in hand to ensure the package is implemented with appropriate calibration and will reach its intended objective, particularly when the evidence shows no tangible negative impacts on funding the real economy and a positive effect is granted in the long term. For the EU, the proportionality principle must be achieved not to penalize the small and medium institutions and institutions with specific business model. A focus on size and type of banks is needed. The most important issue is not to use theoretical proportionality principles as a tool to manipulate the real risk profiles.

8- An aspect addressed is putting EU banks in an international perspective and to ensure EU banks remain profitable but certainly not at the expense of sound risk assessment. And also considering the existing excess capacity that must be dealt with, preferably by the market itself.

9- An essential consideration, in view of the impressive government support of banks during the pandemic to support the real economy, more transparency on social cost is needed to enhance accountability and to contribute to the rebalancing of the overall picture.

10- a specific issue was discussed – relate to the use of buffers -- on the one hand there was a questioning of their relevance and use and on the other hand, the procedure of increasing/decreasing/replenishment and when to do so -- is not clear and little transparent – a proposal is to increase the leverage ratio across the board instead of having these unclear buffers--- and eventually to engage further on enhancing and refining macro-prud measures to deal with systemic risks

To close her remarks – Basel III finalization is a delicate balancing act and all actors are responsible to ensure the rules are neither watered down nor penalizing the EU economy – moving in a post covid-19 recovery and sustainable transition.

Finally, she thanked the EBA coordinating team – the BSG members who contributed to the organization of this workshop – special thanks to the WGs coordinators dealing with financial stability and resolution.

BSG will continue its work to provide its balanced advice to the EBA and will make its advice publicly accessible to all.

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# Appendices: Slides used by presenters

Appendix 1: Presentation by Sean Berrigan

Appendix 2: Presentation by Olli Castrèn