



European Banking Industry Committee

European Banking Federation (EBF) • European Savings Banks Group (ESBG) • European Association of Cooperative Banks (EACB)
European Mortgage Federation (EMF) • European Federation of Building Societies (EFBS)
European Federation of Finance House Associations (Eurofinas)/European Federation of Leasing Company Associations (Leaseurope)
European Association of Public Banks (EAPB)

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EBIC high-level paper: Views on the transposition of Basel III into the European Union through the review of the Capital Requirements Directive (CRD)

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The European Banking Industry Committee brings together European banking associations with a mandate to provide advice, assure a comprehensive consultation of market participants and ensure a representative industry view throughout the process of drafting, adopting, implementing and enforcing EU-financial legislation and thereby provide input for the European institutions and their relevant sectorial committees. It is amongst the declared aims of EBIC to advise the Commission on relevant legislative banking and cross-sectorial initiatives and any developments at Community level affecting the banking and financial services activities associated with the establishment of a European Single Market for financial services.

EBIC has been established by the main banking industry federations: the European Banking Federation (EBF), the European Savings Banks Group (ESBG), the European Association of Cooperative banks (EACB), the European Mortgage Federation (EMF), the European Federation of Building Societies (EFBS), the European Federation of Finance House Associations (Eurofinas)/ the European Federation of Leasing Company Associations (Leaseurope), and the European Association of Public Banks (EAPB).

I) Introduction:

The European Commission is currently developing a legislative proposal for the transposition of the newly finalised Basel III framework in the European Union via a revision of the Capital Requirements Directive ('CRD'). It has been announced that this legislative proposal will be tabled by no later than the end of the summer.

In this paper, the European Banking Industry Committee (EBIC), as the representative of the European Union's banking sector, lists its most important concerns as regards the adequacy of some parts of Basel III for the wider European banking sector. EBIC urges the European Commission to take these remarks into due account in order to ensure the best possible transposition of Basel III in the EU.

II) Over-arching concerns:

In general, EBIC supports Basel III, which addresses several weaknesses observed during the crisis. However, due account needs to be taken of the important specificities of the European banking sector, such as the variety of business models operating under different legal forms; the fact that the European corporate sector is predominantly financed through bank lending and mortgage lending predominantly kept on balance sheets rather than in SPVs; and, finally, the absence of government-sponsored and government-guaranteed institutions, to which banks in some other jurisdictions are in a position to sell their mortgages to alleviate their capital and liquidity requirements.

In addition it has to be kept in mind that Basel III was developed for internationally active banks. Yet its EU transposition will be applied to all EU credit institutions, i.e. large and small, international and regional, and retail and universal banking models with different ownership and organisational structures.

To EBIC, it is also essential that Basel III should be implemented globally, and that EU regulators should remain mindful of developments in other jurisdictions when deciding on the transposition details at EU level, so as to preserve the competitiveness of Europe's banking sector, abroad but also at home, where a level playing field between European banks must be an overriding priority. Of similar importance, for the success of Basel III in increasing financial stability, is that regulators consistently and coherently reduce the scope for shadow-banking activities to which risk taking may otherwise migrate.

Furthermore, EBIC regrets that there has been no further opportunity (since February 2010) to comment on, or express the wider views of stakeholders, through a general consultation on the review of the CRD. This is particularly regrettable due to the lack of transparency surrounding the process of the Impact Assessment launched regarding CRD IV. EBIC calls on the Commission to take the cumulative impact of all the various legislative measures currently on the table (the review of the Deposit Guarantee Schemes Directive, initiatives for an EU crisis management and resolution framework and so on) into account alongside the review of the CRD.

Also, EBIC generally supports the creation of a harmonised single rule book. However, EBIC reiterates that the creation of a single rule book should encompass and allow for differentiation according to national or product circumstances, when this is necessary.

Another of our concerns is regarding the format of the legislative package. If the Commission is indeed determined to cover important parts of the Basel III transposition in the form of a Regulation, directly applicable to all EU credit institutions, EBIC urges for great caution. Here it is essential that all relevant national

specificities are sufficiently taken into account. Furthermore EBIC does not see any alternative to an appropriate industry consultation in this regard.

Finally, EBIC stresses that the European Commission should not re-open issues which have already been agreed upon in the CRD and its two previous reviews (CRD II&III), particularly in relation to complex and sensitive areas.

III) Specific Remarks:

1) CAPITAL REQUIREMENTS:

i) Neutrality of Common Equity (CE) Tier 1 eligibility as regards an institution's legal form:

It is of paramount importance that for the transposition of Basel III into the European Union, a strict and neutral definition of Common Equity (CE) Tier 1 capital requirements is provided, which does not discriminate according to an institution's legal form. Thus, the Basel Committee's fourteen criteria for eligibility of capital instruments as CE Tier 1, for instruments other than 'common shares', should be the benchmark for all EU institutions. This substance-based approach should apply regardless of an institution's legal form.

ii) Recognition of minority interests:

The Basel Committee takes an overly strict approach as regards the recognition of minority interests for consolidated capital. Here it is problematic that the Basel approach is highly asymmetrical, as it allows only partial recognition of the subsidiary's capital (in the numerator), but still fully includes the subsidiary's risk weighted assets (in the denominator). Also, CE Tier 1 recognition is limited to capital issued by consolidated subsidiaries which themselves are banks.

This approach is not compatible with the structures of many European banking groups, in particular if these have entered into a contractual or statutory liability arrangement, and thus puts an unwarranted burden on well diversified groups.

Therefore, EBIC strongly advocates a balance in the treatment of common equity attributable to minority shareholders by reducing the consolidated risk weighted assets proportionate to the reduction of excess capital from common equity.

Furthermore, the Basel Committee extended the limited recognition of capital that is issued by consolidated subsidiaries to all components of capital. Even Additional Tier 1 and Tier 2 of 100 % owned subsidiaries would be affected. This tightening of eligibility criteria was introduced without prior consultation of the final framework. The capital issued by third parties fully absorbs losses at group level through the control relationship between parent and subsidiary. A limited recognition would limit the capitalisation of subsidiaries significantly and is inappropriate from a prudential point of view. EBIC therefore strongly advocates for restricting the limited recognition only to CE Tier 1.

iii) Grandfathering (Basel III vs. CRD II):

It is of paramount importance that sufficient grandfathering and transition periods are put in place in order to adjust to the increased equity requirements. Basel III sets an ambitious timetable for the phasing out of capital instruments which are no longer eligible according to the new definitions and only capital instruments issued before 12 September 2010 can be grandfathered. In EBIC's view, this provision is unsound in legal terms. The

reference date for the grandfathering period should be no earlier than the day of publication of the Commission's legislative proposal. Furthermore EBIC reiterates that when implementing Basel III in the EU, the transitional periods defined in the CRD II should be maintained as otherwise, the legitimate expectations which CRD II has created amongst market participants will be impeded upon.

iv) Deferred Tax Assets:

Regarding deferred tax assets (DTAs), it must be ensured that regardless of the applied accounting standard and national tax law, DTAs may be netted with deferred tax liabilities (DTLs) if the DTAs and DTLs relate to taxes levied by the same taxation authority, as otherwise substantial competition distortions in relation to the respective accounting standard and tax law could occur when calculating regulatory capital. Since there are already differences in treatment of DTAs between national GAAP and IFRS, coherence at the EU level should be sought after. In IFRS, DTAs may be netted with DTLs only for a very restricted number of positions. Furthermore, EBIC has concerns that there will be a substantial imbalance in comparison to the US, since US-GAAP allows for netting if the DTAs and DTLs related to taxes, which are levied by the same tax authority.

v) Holdings in other credit and financial institutions:

The existing methods (Article 59 and Article 60 of Directive 2006/48/EC) concerning deductions of holdings in insurance companies for banking groups that are subject to the Financial Conglomerate Directive should be maintained.

Furthermore the deduction of holdings in other credit and financial institutions that are outside the scope of regulatory consolidation should be applied to direct holdings only. A 'look-through-approach' for indirect holdings would lead to a substantial practical burden without significant improvements on the regulatory side.

vi) Capital Requirements and Residential Mortgage Credit:

The Commission is suggesting the introduction of an EU-wide common loan-to-value ratio and stricter capital requirements for a loan to value of 80%. This means that the average mortgage credit becomes significantly more expensive for European consumers. This is due to the fact that credit institutions would be forced to pass on the additional charges to consumers. EBIC urges the Commission to note that a provision of this kind would considerably constrain the lending activities of credit institutions and would endanger certain business models which play an important role for providing housing throughout the European Union. Due to the differences in mortgage markets in Europe it should be left up to the relevant authorities to determine the adequate LTV for the preferential risk weight in their national residential mortgage market.

In addition European mortgage markets are dissimilar and predominantly local. Differences pertain to state guarantees, mortgage execution possibilities and legal procedures, mortgage markets predominantly floating or fixed interest rate based compensation for early redemption etc. The impact of a standard, fully harmonised approach will therefore impact in different ways the individual EU Member States and, therefore, not achieve a level playing field.

vii) Counter-cyclical buffers:

In EBIC's view, more clarity is required in relation to the applicability of these additional counter-cyclical buffers, as an additional capital buffer will result in making capital management, which is continuously expanding, even more complicated. Furthermore EBIC would like to reiterate that it remains unclear in how far

the counter-cyclical buffer will interact with any other additional capital buffer imposed by supervisors for other reasons and as a Pillar II measure, and ultimately calls on the Commission to provide clarity in this respect also.

Consequently EBIC believes that it is crucial to have sufficient building-up periods for the counter-cyclical buffer; at least 12 months should be guaranteed, however this is still a rather ‘tight’ timetable and ultimately there should be the option of additional upward flexibility. EBIC disagrees with the proposal to adopt a Pillar I type approach in respect of counter-cyclical buffering, and therefore believes that the best option will be to leave the buffer determination to the local supervisor under a Pillar II approach, implying non-disclosure and not necessarily following the credit-to-GDP gap measure.

Furthermore, in EBIC’s view, it is generally necessary to think about the introduction of a materiality limit.

2) LIQUIDITY:

i) **Liquidity Coverage Ratio (LCR)**

Basel III takes the approach that, in order to withstand sudden liquidity stress (i.e. net cash outflows calibrated for all banks for the same hypothetical scenario), banks need to hold a sufficient stock of high quality liquid assets. Whilst EBIC understands the reasoning behind LCR, it herewith calls on the European Commission to provide improvements in the context of its application in the EU.

Moreover the European Commission should take into account that Basel III provides for an observation period during which these rules should not be binding, except for reporting requirements to supervisors.

Composition of the liquid asset buffer: Only certain types of assets are eligible for this buffer, where sovereign debt receives a preferential treatment (Level 1 assets), whilst instruments issued by the private sector (covered and corporate bonds) can make up at most 40% of the buffer (Level 2 assets).

In EBIC’s view, the composition of the liquid asset buffer is too restrictive as greater diversification of the buffer is a general necessity.

In order to diversify the liquidity buffer of the LCR sufficiently, it should be possible for banks to include assets other than cash, central bank reserves and sovereign debt of superior quality in the buffer. Generally, all central bank eligible assets should be included to the extent that a bank can transform these assets into liquidity under normal circumstances at the central bank. Also, at least bank bonds guaranteed by sovereigns or regional governments and covered bonds should be recognised as level 1 assets without a haircut. Furthermore, the Basel III text does not reflect the importance of covered bonds, banks’ corporate debt and highly liquid investment funds in the EU financial system.

EBIC therefore invites the Commission to consider the following adaptations to EU realities, and in particular to take into account that the structure of the liquidity buffer should be compatible with a bank’s underlying business model and its general investment strategies. Thus, it should be considered to:

- a) Increase the share of private sector instruments in the buffer, and allow covered bonds amongst Level 1 assets.
- b) Greater level of recognition of Covered Bonds in the LCR which fully reflects their excellent track record of safety, liquidity and resilience in times of stress by adopting less restrictive criteria concerning covered bond eligibility, so as to allow, for instance, covered bonds issued in pooled issuances.

- c) Allow (for level 2) the inclusion of bank issued corporate bonds.
- d) Take into account that many, especially smaller banks invest in money market funds, or in funds that invest in corporate bonds, sovereign bonds etc. EBIC believes that all such highly liquid funds – as well as other UCITS investments – should be eligible for Level 1 or (at least) Level 2 of the liquidity buffer. At the very least, the Commission should take a ‘look through’ approach for investments in such funds.
- e) In addition, reconsider whether ECB collateral eligibility would not be a sufficient criterion, as this would ensure that such assets would find buyers even under stressed market conditions.

In part the Basel Committee already recognises that sovereign debt may not be sufficiently available in countries where markets are too small for the relevant assets denominated in their own currency and that this issue needs to be solved in a rational way. Yet, EBIC has concerns about the three “options” proposed as a closer analysis reveals that none of them offer an alternative that would be appropriate.

Calibration of net cash outflows: Net cash outflows are calculated as the difference between hypothetical stressed cash outflows and cash inflows, where inflows are capped at maximum 75% of outflows.

EBIC is concerned that this will put those banks at a disadvantage, which due to the very stability of their business model would actually experience greater inflows. Rather than increasing comparability among banks, this actually creates a distortion and should thus be reconsidered as regards the implementation in the EU.

Regarding other types of liquidity flows, EBIC encourages the Commission to reduce the mismatch between the treatment of assets and liabilities (for instance concerning inter-group/renewal assumptions of inter-company loans/debts and liquidity lines obtained and sold) and points out that the run-off rate of corporate deposits is exaggerated. Against the background of covered bonds being eligible as highly liquid assets, the determination of a 100% net cash outflow for covered bonds is not appropriate.

In the context of the relationship between a credit institution and a counterparty which is its parent undertaking, its subsidiary, one or more subsidiary(ies) of its parent undertaking, or another undertaking affiliated to a Group operating under conditions of art 80.7 CRD, the ratio can be applied on a consolidated basis and deposits should be multiplied by 100%, in the event where the ratios are applied on a stand-alone basis. In that latter case, the corresponding inflows and outflows are not subjected to the 75% cap on total inflows.

Furthermore, it is essential that the specificities of development banks are fully recognised with the assumed liquidity outflow rates. Development banks often provide credit lines to other banks which are used by these banks for promotional credits only. According to the LCR, the development banks must assume that these loans will be drawn 100 % under stress conditions. In EBIC’s view, this is not a realistic assumption since these credit lines can be only drawn if a promotional credit is handed out. Therefore, the same percentage should be applied for those credit facilities as the ones assigned to credit lines to the respective debtor of the promotional credit.

ii) Net stable funding ratio (NSFR):

Given that it has been decided (within the Basel Committee) that the NSFR will be reviewed and will not become a Pillar I measure until 1 January 2018, EBIC questions, as a general remark, whether the EU’s transposition of the NSFR should be within the scope of the current CRD review. We also question whether such a concept is appropriate for application to those entities classified as credit institutions (at national level) that are not deposit takers.

However, should the EU transpose the NSFR as part of the expected legislative package, EBIC would like to stress the paramount importance of ensuring that a thorough review of this measure is carried out, as the NSFR will have a direct impact on maturity transformation – which constitutes the core of banking activity. At present it is EBIC's view that the NSFR should be, at most, a Pillar 2 requirement.

3) LEVERAGE RATIO and LEVERAGE RISK:

EBIC recognises that the leverage ratio will undergo a fundamental assessment and review before becoming a potentially binding regulatory standard in 2018. On this basis, EBIC argues that a leverage ratio should not be within the scope of the current CRD review. We also would like to suggest that, if the leverage ratio would nevertheless be brought under the scope of the CRD Review, EBA would be required to monitor in particular the specific impact which leasing transactions as well as trade and export finance and mortgage lending would have on the leverage ratio.

However, having said this, EBIC would like to reiterate its strong opposition to the introduction of a leverage ratio as a Pillar I measure, as it may distort risk taking incentives and thus undermine bank stability as opposed to increasing it. A single maximum leverage ratio imposed on banks with widely diverging business models could never take adequate account of different business models' special features. The leverage ratio should not make it impossible especially for low-risk business models to function, especially in view of the fact that they proved their worth during the recent financial crisis.

In addition to the discussions on the leverage ratio, it has become apparent that the European Commission considers the introduction of 'leverage risk' as an additional, risk category under Pillar 2, which is un-related to Basel III. EBIC would like to stress its concern regarding this approach, which would mark a radical departure from Basel III and will have a discriminatory effect on the European banking industry. Not only is leverage risk very difficult to define, it also is not straight-forward in terms of incorporation amongst the established risk categories in Pillar 2. Furthermore and most problematically, it is likely to interfere with current methods of managing liquidity risk and market price risk and allocating economic capital. The proposal also deviates from the initial idea of having the leverage ratio as a back-stop-regime counteracting the risk based provisions since with this concept it would become part of the risk based regime of ICAAP. We fear that the introduction of a new risk class leverage risk requires an increase of individual capital requirements, which would be stronger than a universal leverage ratio. EBIC therefore opposes an introduction of this new risk category and urges the Commission to take these concerns into account.

Ultimately, in light of imminent significant competitive distortions due to the effects of different accounting standards the leverage ratio should not be publicly disclosed from 2015 on.

4) SINGLE RULE BOOK:

In general, EBIC supports the objective of reducing the number of options and discretions in the CRD in view of facilitating the creation of a single rulebook, under the condition that the single rule book encompasses differentiation according to national or product circumstances when this is necessary. Furthermore, EBIC is also supportive of the so-called "gold plating" prohibition, which prevents Member States from introducing additional requirements in fully harmonised areas, thus contributing to a level playing field, and has not identified areas where more stringent requirements would need to be generalised and incorporated into a single rule book.

This being said, EBIC would encourage the Commission to take the effects of these proposals into account in the context of a comprehensive impact assessment.

Mortgage Credit:

Maximum harmonisation is not recommended in the area of residential and commercial mortgage credit risk given the fundamental differences in market structure across the EU. As CEBS - the predecessor of EBA - has recognised on a number of occasions, national supervisors are best suited to adapt the provisions of the CRD to national circumstances.

In particular, EBIC opposes the introduction of hard test on the waiver of the independence criteria, which has no visible added value. Given that the majority of residential purchases in housing markets across the EU are for owner occupation, therefore the borrower does not depend on the performance of the underlying property. Introducing hard tests would result in a substantial administrative burden for both credit institutions and supervisors but would not create any added value.

Physical collateral:

EBIC very much welcomes proposals to transform the existing national discretion in the CRD relating to the recognition of other (i.e. non real-estate) physical collateral into a general rule provided that relevant conditions relating to the quality of the collateral are fulfilled. Currently, supervisory practice as regards the recognition of other physical collateral is not harmonised throughout the EU (for instance, certain national supervisors restrict the recognition of collateral to certain, limited asset classes while others do not) and is not transparent (for instance, supervisors are not required to disclose their criteria for allowing or refusing the recognition of certain collateral). EBIC therefore supports the Commission's suggestion that the EBA develop a technical standard to further specify and operationalise these criteria. This being said, we do not consider that it is appropriate for the Commission to bring about changes to the existing criteria in the context of their forthcoming legislative proposals, as this should precisely be the result of the EBA's work. We also consider that industry's input to this process is essential to ensure that any new operational criteria are a real improvement over the existing situation.

Exposures to credit institutions:

Concerning the risk weighting of credit institutions under the 'Standardised Approach' EBIC supports the maintenance of the central government risk weight based method. A removal of this option would translate into a de facto risk weighting increase from 20% to 50% for many credit institutions. This is especially true for un-rated and hence typically smaller credit institutions and could have a seriously negative impact on these credit institutions' access to funding.

As the standard risk weight of covered bonds is linked to the risk weight of the issuing institution, the deletion of 'option 1' would lead to a 'de facto' increase of the standardised risk weight of covered bonds from 10% to 20% and potentially cause severe unintended consequences regarding the eligibility of covered bonds for many supervisory treatments and/or instruments. EBIC therefore calls for the maintenance of 'option 1'.

Finally, the removal of the central government risk weight based method for credit institutions is in direct conflict with the aim of reducing the reliance of banking supervision on external ratings.

Large Exposure Regime:

As mentioned before, EBIC advocates not re-opening issues which have already been agreed upon in the CRD II. Therefore, it urges the Commission to keep Article 113 Para. 4 CRD as it is.