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EU-Commission

1 (13)

## **Consultation on the finalisation of Basel III**

### **General questions**

#### **What are your views on the impact of the revisions on financial stability?**

From the perspective of Swedish and European banks it is important to keep the risk-sensitivity in the capital requirements to as great extent as possible. Depending on how the output floor is implemented it can become the constraining measure for many Swedish banks and will then have severe negative effects, both for financial stability and for the financing of the real economy. Especially low risk banks and their customers will be affected.

Capital requirements that are not risk based and not aligned with the models that banks use to control and price risk means that banks will:

- be incentivised to do riskier business compared to the current business mix,
- need to review the capital impact across all portfolios to understand if assets should be repriced, a change in profitability should be accepted or exposures should be reduced,
- review which assets will, from a capital perspective, be efficient to hold on the balance sheet and which assets can instead be funded by capital markets,
- need to decide if the overriding principle for capital allocation, steering and pricing should be risk based or based on regulatory capital consumption. The risk of choosing the first principle is low returns while the second principle can build up excessive risks on the balance sheet.

The consequence of a binding output floor will be that banks' capacity to finance the real economy will deteriorate. Due to higher capital requirements than justified by risk, the interest rates will be higher for a majority of customers, and many customers will have to use alternative sources of funding. Non-risk based capital requirements will thus have negative impact on the financing of the real economy, and the financial stability will be negatively affected, contrary to the objective of the revised Basel framework.

Against this background the impact of the revised Basel framework for Swedish banks will be highly dependent on how the output floor will be implemented in the EU rulebook. In case the floor is implemented in a way that it will be the constraining measure for a large number of Swedish banks it will result in sharp increases in capital requirements, especially for low risk banks, and in the kind of negative effects described above. In case the floor is implemented as we describe it in the later section about the output floor, and the risk sensitivity is kept in the capital requirements for most banks, the effects will not be as dramatic.

Furthermore, it is important that the Commission's impact assessment goes well beyond the aggregate analysis conducted by the Basel Committee and considers the impact for the banks in the different member states, their specific products and their importance for funding business activities. While it is important to consider the effects on REA and the capital impact, one should not overlook areas where the calibration of risk weights is materially overstating the real risk.

### **Standardised approach for credit risk (SA-CR)**

#### **What are your views on the revisions? Please provide details.**

The intension to enhance the risk sensitivity in the SA-CR is good and compared to the current SA-CR some improvements of risk-sensitivity have been introduced. The main problem arises if the SA-CR, depending on the implementation of the output floor, becomes binding for IRB banks. Then the risk-sensitivity and soundness in the capital requirements becomes substantially deteriorated.

In the case of Sweden, we believe that the biggest impact of a binding output floor will be on bank lending to commercial real estate (with a LTV>60) and to medium sized corporates that do not qualify as SMEs and do not have an external rating, i.e. general corporates, which according to the new standardised approach are assigned a risk weight of 100%, regardless of their risk profile.



Many mid-sized Swedish corporates are not active on the capital market, and thus heavily relying on bank lending to finance their activities and investments. We believe that the implementation of the output floor could drive these borrowers towards new, untested forms of borrowing money or untested new types of funding that they are not experienced in using. We believe this poses a significant risk to the stability of the Swedish financial system and to the Swedish economy.

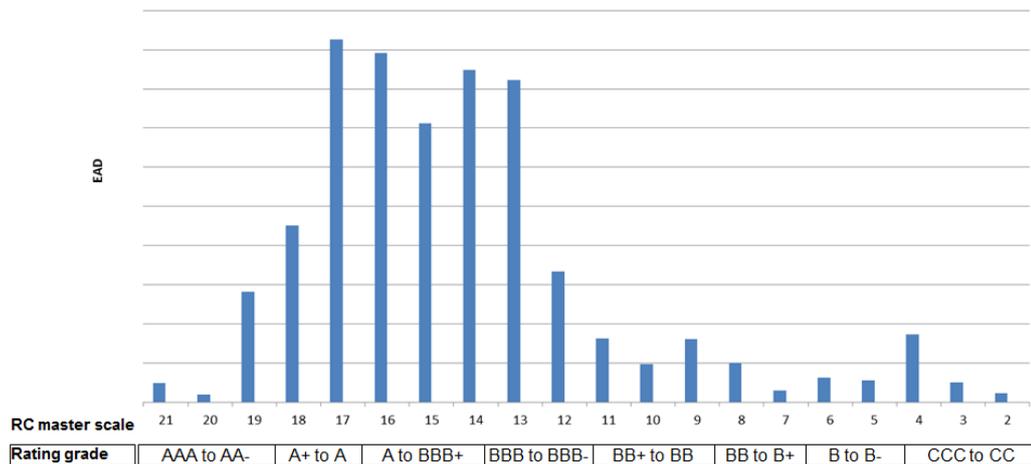
#### *Corporate exposures*

In combination with the output floor, the corporate exposure class would be negatively impacted, since the majority of companies within EU do not have an external rating. Unrated companies would under the revised standardised approach receive a flat risk weight of 100%. Such a punitive risk weight could especially reduce the supply of credit to mid-size companies that do not qualify for the definition of corporate SME's. Banks in jurisdictions that do not allow the use of external ratings for regulatory purposes may assign a 65% risk weight to both rated and unrated investment grade corporates, while a 100% risk weight apply to all other corporate exposures. The highest risk weight in jurisdictions that allow the use of external ratings is 150%. If an investment grade classification based on internal assessment is allowed in jurisdictions that do not allow the use of external ratings, this approach should also be allowed in jurisdictions that allow external ratings.

Further, our view is that IRB banks should be allowed to use their regulatory approved internal ratings for the purpose of classifying corporate exposures as investment grade or even assigning them to the external rating buckets in paragraph 40 of the revised Basel III standard. Any such solution would overcome the fact that most companies within EU are unrated and improve the risk sensitivity of the standardised approach.

In the large Swedish banks, the major portion of the unrated portfolio resides in internal rating levels corresponding to external rating grades between AAA and BBB, indicating that a more risk diversified measure than 100% risk weight is needed for this portfolio. In the bank used as an example in the graph below, the portion of the unrated portfolio residing in internal rating levels corresponding to AAA – BBB, is 80%.

## 1. Swedish example bank: Internal rating levels and corresponding external rating grades



Further, regarding commercial property the Basel standards state that higher risk weights shall apply in case the borrower's repayment capacity is, from a formal point of view, materially dependent on the cash flow generated by the property. From a practical point of view, it will be very difficult to make the assessment and identify in which cases the dependence criterion is applicable or not. Explicit guidance will be necessary in order for this provision to be implemented in a consistent way throughout EU. In our view, this provision must be applied in a proportionate and non-formalistic way. For instance, in Sweden large real estate companies' ownership of properties is commonly structured so that separate legal entities own each individual property. Loans to each of these separate companies could in theory be classified as income producing real estate although the properties owned by such legal entities are from a practical point of view a part of a larger portfolio of properties, and loans to one of the real estate owning entities are usually in addition to the real estate collateral also usually backed with a guarantee from the parent company. It is important that legal structures can be looked through in this respect, and that several legal entities within one group structure can be seen as one entity. This can be achieved by noting that guarantees within a group should imply that the repayment capacity is not materially dependent on a specific property.

For smaller institutions it will be a challenge to set up processes to perform due diligence to assess if the external ratings appropriately and conservatively reflect the creditworthiness of the bank counterparties. A small institution does not have the resources to "second guess" a rating set by a rating agency, which of course is specialised in this task. This especially refers to exposures to banks and covered bonds. A small institution often has its cash deposited in a larger, rated, bank. It also often has rated covered bonds issued by banks in its liquidity buffer. The

proportionality principle proposed by the Basel Committee: “*The sophistication of the due diligence should be appropriate to the size and complexity of banks’ activities*” is not very clear. It would be clearer with a materiality threshold (as for CVA), e.g. that due diligence for external ratings is required only for bank/covered bond exposures above XX billion euros.

#### *Real estate exposures*

The real estate exposure class could be negatively affected if the revision to Basel III standard is implemented without adjustments into EU legislation. The concept of an LTV based on value “measured at origination” has many drawbacks. One obvious issue is that a valuation that could be 30 years old hardly represents a reasonable indication of the risk of a mortgage.

Even the very simple case of only one loan being secured by a certain property becomes problematic. Take the case with two in practice identical properties (next to each other in the same street) and the same level of financing with the only difference that the loans to the properties were originated at different points in time and therefore with different valuations, everything else being equal (repayment capacity by the obligors etc). It is obvious that the loans share the same risk characteristics and should have the same risk-weight. But that will not be the case in the proposed LTV approach.

Further, it is not specified in the Basel document how the (relatively common) case of several loans with different origination dates being secured by the same property should be handled.

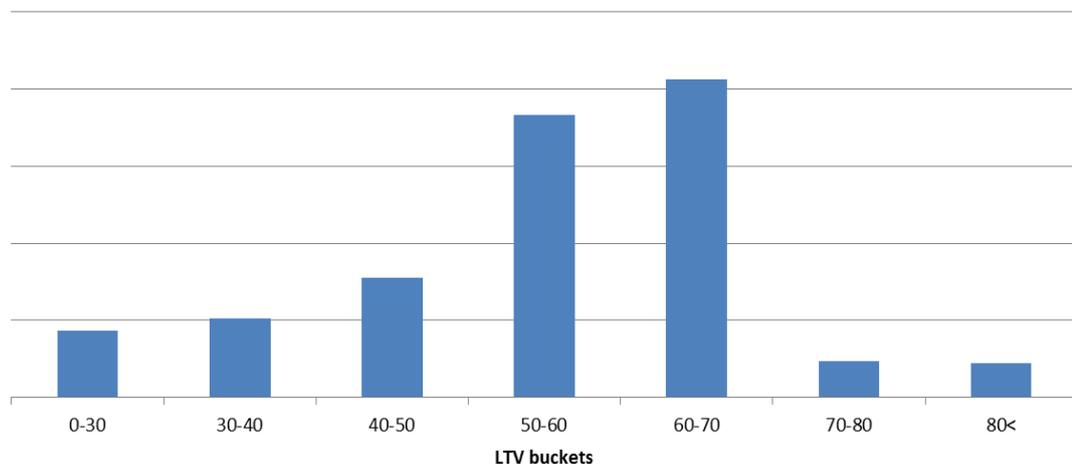
We propose that an actual market value approach is used instead of LTV at origination. An actual value approach can be combined with criteria to be fulfilled in order constitute an eligible valuation for calculating the LTV for the purpose of calculating capital requirements. Property values should at least be updated, upwards and downwards, each time a mortgage loan is prolonged. This would increase the level of risk sensitivity. Also, it would counteract that customers change from one bank to another only for the reason of getting a more accurate value of the property. As stated above it is not clear how the original value approach is intended to be implemented. Regardless, it is obvious that such an approach will be very challenging to implement. An actual market value approach would thus be much better also from an implementation point of view.

Regarding commercial real estate exposures, we believe that the new standardised approach is not granular enough and that the risk weights connected to the LTV-buckets are too high.

In the graph below, we illustrate the problem with one of the Swedish largest banks as an example. Around one third of the banks commercial real estate portfolio resides in LTV-buckets lower than 50%. The Swedish banks' advanced IRB models render an average risk weight for the commercial real estate portfolio significantly lower than the proposed 60% risk weight for LTVs under 60% in the standardised approach. When the output floor of 72.5% is applied, the risk weight for exposures with an LTV lower than 60%, will be around 43%. This is still several times higher than the average risk weight rendered by the advanced IRB models.

A similar situation may exist in other markets in the EU with similar characteristics, e.g. in other countries in the Nordics as well as in France, Germany and the Netherlands. We therefore suggest that the EU implementation of the revised Basel standard should secure that real estate market portfolios with historically low-defaults (commercial as well as residential), could be treated with a more risk-sensitive approach. The EU should introduce a bucket for LTVs lower than 50%, with a standardised risk weight below the proposed 60%. Making the standardised risk weights more granular on lower LTVs, and introducing one or two more buckets below 60%, would capture more accurately the risk profile of the commercial real estate portfolios of several prudent and stable banks in large parts of Europe.

## 2. Swedish example bank: LTV buckets for commercial real estate



In Sweden, living in housing cooperatives is very common. Such apartments constitute approximately 22 percent of the households compared to 46 percent for single family houses and 32 percent for rental apartments. About 33 percent of the Swedish banks total household lending secured with residential property, is to residents in tenant-owned apartments in housing cooperatives.

The SA-CR poses higher risk weights in cases where the prospects for servicing the loan materially depend on the cash flows generated by the property securing the loan rather than on the underlying capacity of the borrower to service the debt from other sources. However, some types of exposures are excluded from this treatment. One of the exemptions, in paragraph 68, refers to exposures secured by residential real estate property to associations or cooperatives of individuals that are regulated under national law and exist for the only purpose of granting its members the use of a primary residence in the property securing the loans. For Sweden, it is very important that this exemption is fully implemented in the European legislation due to the fact that a large portion of Swedish inhabitants live in property owned by tenant-owners' associations.

Further, regarding apartments in housing cooperatives the CRR clarifies that the right to inhabit an apartment in housing cooperatives located in Sweden shall be classified as a residential property. This is not explicitly stated in the revised SA-CR as the Basel Committee text does not explicitly name European specificities. For Swedish inhabitants in housing cooperatives, it is very important that the current definition of residential property in CRR is maintained.

Finally, the Basel standard is not clear on how the assessment of grades (A-C) for unrated banks & financial institutions should work. Dependent on how this will be implemented in EU, it could be challenging. The preferred way would be to allow banks to map their internal risk classification systems to the grades A-C.

### **Internal ratings-based (IRB) approaches for credit risk**

#### **What are your views on the revisions? Please provide details.**

In general, we find the proposed suggestions to be well-balanced considering the importance of applying a risk-sensitive approach while at the same time acknowledging limitations as to what can be modelled in a robust way for capital adequacy purposes. However, there is an ongoing work within the EU with the TRIM exercise and the regulatory requirements related to the EBA Future of IRB approach. The outcome of these actions will definitely adjust any deviation to an adequate regulatory framework by end 2020 at the latest.

The removal of the scaling factor decreases REA, and the introduction of constraints on the usage of models and input floors to models increases REA. On an aggregate level, an increase in IRB-based capital requirements is expected.

The fact that banks will not be permitted to use the Advanced IRB approach for exposures to large corporates, will result in unwarranted higher capital requirements for high quality corporate exposures. This is likely to create unfortunate obstacles for

banks' ability to finance growth in the real economy. This effect will be further accelerated in case the output floor would become a binding constrain for banks.

## **CVA risk framework**

### **What are your views on the revisions? Please provide details.**

Conceptually, the revised framework is as expected and the fact that the SA-CVA approach is closely linked to the SA-TB approach should facilitate implementation, although SA-CVA requires certain specific input parameters which are likely to require additional efforts in the development of the IT solution for the calculations. The revised framework is overall very conservatively calibrated and it is our view that the SA-CVA approach should be more incentivised compared to the BA-CVA. We believe that the BA-CVA approach could benefit from increased granularity in terms of counterparty sectors, such as i.a. the real estate sector.

It is important that the regulation around proxy construction and proxy hedging is pragmatic and allows for efficient hedging of CVA risk. We believe that this hedging is not sufficiently recognised in the revised framework. The effects on the bank's business will vary between interbank exposures and exposures to derivatives end users. It is highly likely that the introduction of SA-CCR, due to its current calibration and inherent conservativeness including i.a. the 1.4 alpha multiplier, will cause a significant increase of both CCR and CVA capital requirements. This is especially the case for banks applying the BA-CVA framework.

The SA-CVA, on the other hand, would enable banks to more effectively manage the CVA risk in a capital perspective and also better align the "regulatory" CVA to the CVA for accounting purposes, which is a welcome step forward. Considering the eligibility requirements for the SA-CVA, it is however likely that this approach will require significant effort in terms of developing the appropriate IT infrastructure to handle the computational demands.

The CVA risk charge under BA-CVA has been estimated to a close to 100% increase compared to the current standardised approach, driven mainly by the exposure increase when shifting method from the mark-to-market method (CEM) to SA-CCR and higher risk weights, in particular for non-rated entities, in the BA-CVA framework. The increase indicated above is however limited to the current CRR scope of covered entities. With those exemptions removed, the effect on the CVA capital charges is estimated to a close to five-fold increase. Clearly, this would mean a significant difference compared to the current situation, which to a large extent can be attributed to additional REA stemming from exposures to non-financial entities that are often unable to handle margining agreements. Therefore, it is of outmost importance that the exemptions from the own funds requirements for CVA risk for

exposures to corporates and sovereigns are maintained when the revised Basel III standard is implemented in EU.

We currently have no estimate based on the SA-CVA approach but acknowledge the major benefits of being able to hedge the exposure components of CVA risk, unlike the limited hedging possibilities allowed in the BA-CVA approach.

It should however be noted that in the estimates above, the effects of the increased shift to centrally cleared derivatives going forward and the introduction of initial margining between counterparties subject to the BCBS-IOSCO margining requirements for non-centrally cleared derivatives have not been taken into account.

The SA-CVA will pose considerable implementation challenges due to the wide variety of input data needed for the computations. However, since the SA-CVA shares many of the characteristics of the SA-TB, the bulk of the required development needed to enable SA-CVA eligibility is likely to benefit significantly from the SA-TB implementation.

*What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?*

We believe that the framework would potentially discourage certain end users from derivatives hedging due to the pricing effects of banks' increased CVA capital costs. Ultimately, being faced with potentially major increases of both CCR and CVA capital costs, it is likely that banks' offering of derivative hedging instruments to counterparties unable to enter into margining agreements will gradually become increasingly limited. We therefore support the current exemptions as outlined in Article 382 of the CRR.

## **Operational risk framework**

**What are your views on the revisions? Please provide details.**

In addition to earlier concerns raised by the EBF, we are concerned about the incentives created by the revised framework.

One aspect is the very long backward-looking loss period of 10 years. Having such a long backward-looking period for loss calculation means that a single year with significant operational losses will create higher capital requirements for a decade. It also reduces the link between efforts that reduce operational risk going forward and bank capital requirements.

A second concern is the high degree of national regulatory discretion. This increases the risk that in the longer run banks will end up facing quite different regulatory treatment when it comes to operational risk. In light of this concern we encourage the inclusion of operational risk in upcoming impact studies and assessments efforts.

The revisions to the operational risk framework will have a disproportionate impact on business areas that generate fee income for banks. As has previously been pointed out, an increase in fee income does not by definition imply higher operational risk.

## **Output floor**

### **What are your views on the revisions? Please provide details.**

A major concern is that capital requirements that are based on standardised approaches lose their risk sensitivity. For low risk banks, the output floor REA (calculated as 72.5% of SA risk weights) is typically significantly higher than the risk based REA, meaning that capital requirements will not be risk based for these banks.

This means that banks, for whom the output floor will be the binding restriction, will:

- be incentivised to do riskier business compared to the current business mix,
- need to review the capital impact across all portfolios in order to understand if assets should be repriced, a change in profitability should be accepted or exposures should be reduced,
- review which assets will, from a capital perspective, be efficient to hold on the balance sheet and which assets can instead be funded by capital markets,
- need to decide whether the overriding principle for capital allocation, steering and pricing should be risk based or based on regulatory capital consumption. The risk of choosing the first principle is low returns while the second principle can build up excessive risks on the balance sheet. Some combination of the two principles may be possible.

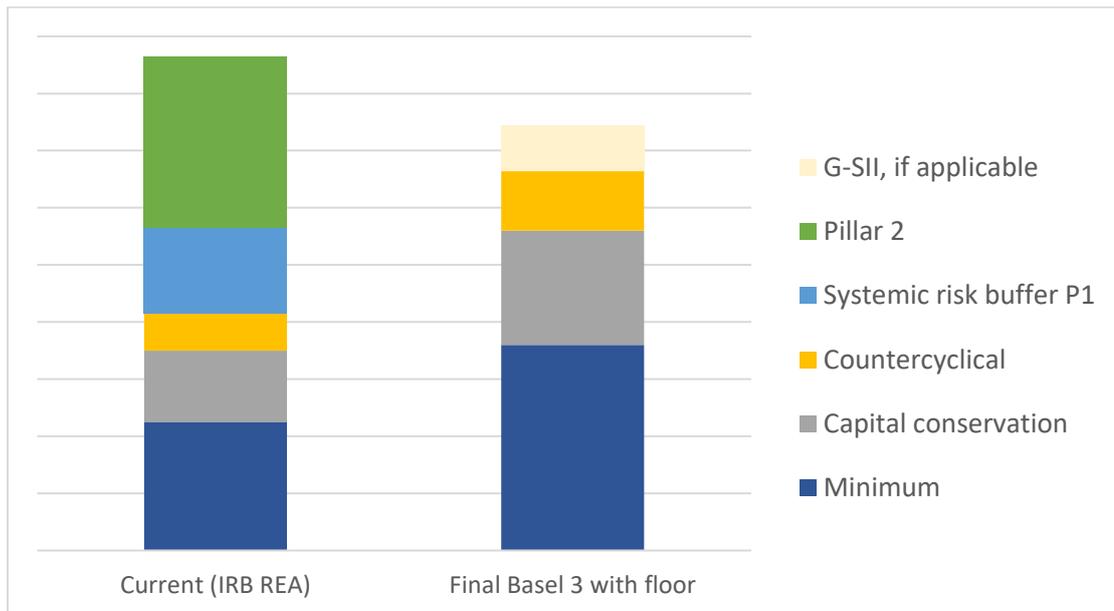
The result will be that banks' capacity to finance the real economy will deteriorate. Due to higher capital requirements the interest rates will be higher for a majority of customers, and many customers will have to use alternative sources of funding. Non-risk based capital requirements will therefore have a negative impact on the financing of the real economy, and the financial stability will be negatively affected, contrary to the objective of the revised Basel framework.

The capital impact of the output floor depends on how the capital floor is implemented. In case the floor is implemented without careful consideration it will become a binding constraint for many Swedish banks. The capital requirements will in that case increase significantly compared to the IRB approaches, especially for the banks with the lowest risks in their lending portfolio.

To keep the risk-sensitivity in the capital requirements to as great extent as possible, it is important that no EU specific buffers or requirements are added on top of the requirements laid down in the revised Basel III standard. The Basel standard states that the output floor requirement should consist of  $72.5\% \times RWA - SA$  (minimum requirement + capital conservation buffer + countercyclical capital buffer + GSIB buffer). No buffers or requirements related to O-SIB, Systemic risk buffer or Pillar 2 (both hard P2R and soft P2G) requirements should be included in the calculation of the floor amount.

- This model for applying the output floor, which is fully in line with the Basel framework, would be less punitive for banks that have low risk weights due to their client mix and due to low historical losses.
- The systemic risk buffer is an "EU invention" to cater for the need to hold higher levels of capital for macroprudential purposes in certain EU member states. It is not related to excessive variability of risk weights estimated by internal models.
- Pillar 2R and Pillar 2G is a EU concept, and those components are therefore not necessarily relevant from a global level playing field perspective.
- In the US the capital requirements are usually lower. They do not include Pillar 2 (at least not like in the EU) and hence it would make sense to harmonize the capital requirements when harmonizing REA.

### 3. Illustrative example bank: Fully risk sensitive IRB requirements and global floored requirements in parallel



In the above example, the fully risk sensitive requirement remains the binding restriction for the bank, provided that the pillar 2 requirement is set at a level so that the total requirement based on IRB REA remains higher than the sum of the globally agreed floored requirements.

For banks where the output floor would become a binding constrain the corporate exposure class would in our view be most heavily affected. Floored risk weights based on the revised standardised approach will be significantly higher than those that currently apply for IRB banks and those under the revised IRB approaches. The major reason for this is the punitive risk weights for exposures to unrated companies under the revised standardised approach, see our response under section SA-CR.



For banks where the output floor would become a binding constrain there is expected to be significant implementation challenges when it comes to capital allocation and pricing of credits. In this situation, capital consumption of specific counterparties will not be in line with IRB models and hence the internal view of the counterparties credit quality. More capital must be allocated to counterparties with the best credit quality and vice versa, which will also affect pricing.

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