Nederlandse Vereniging van Banken

NVB Response to the EC consultation on the Finalisation of the Basel 3 Reform

General questions

a) What are your views on the impact of the revisions on financial stability?

The finalization of the Basel 3 reforms requires an extensive impact assessment with a broad scope and sufficient time for banks and other stakeholders to respond. Considering the very short time frame of this consultation, the below mentioned response on behalf of the Dutch Banks cannot be considered as comprehensive.
The current proposal will increase the capital requirements and as such the capital cushion in times of stress. It also contributes to an extent to more comparability in capital between banks, in particular larger (mainly IRB) and smaller (mainly SA) banks. However the proposals to limit Internal Ratings Based (IRB) modelling options and the introduction of the output floor will lead to a disproportionate and unnecessary reduction of the risk sensitivity of the regulatory capital framework, in particular for assets with established low credit losses. Hence it should be considered whether goals of the output floor could also be achieved through alternative measures, such as mentioned in the end of this paragraph.

Moreover these proposals do not encourage sound risk management practices, in particular credit risk differentiation and do not recognise the benefits of internal modelling. If banks are required to carry capital for credit risk well in excess of economic requirements, the beneficiary is the unregulated finance industry. Thus, the costs of the product to the client become more expensive than required. No capital model can be perfect: but previous capital regimes, like Basel 1, which only allowed standardised models, displayed the adverse consequences of badly incorrect allocation. Flat capital allocation across assets with widely different risk has the inevitable effect of subsidising the bad risks, particularly in the latter stage of the credit cycle. There is more of a trade-off between soundness and simplicity than the proposals suggest, and poor calibration increases systemic risk rather than reducing it. Generally, banks don't fail by doing too much diversified good lending: they fail by not discriminating against bad lending and by having risk concentrations which ignore correlations.

So although we support the overall objective to reduce unintended variability in risk weights, we strongly view this should be addressed at its root causes, (as the European institutions together with the ECB (TRIM) and the EBA (various RTSs) are currently in the process of addressing), not by reducing the sensitivity of capital allocation towards the underlying risks, e.g. by the introduction of an output floor.

b) What are your views on the impact of the revisions on the financing of the economy?

The Dutch banks all share the concern, that these revisions adversely affect the financing of the economy, either through less availability of credit, increased pricing albeit at the discretion of the individual institution or both. We see several areas or asset classes with established low credit losses, which can be affected:

- Residential mortgages
- Project finance, agri, asset based finance , infrastructure and trade finance (all highly collateralised)
- Unrated mid-size corporates
- Equity investments of development banks

1. SA-CR

1 c) What are your views on the revisions? Please provide details.

We welcome some of the revisions to the proposed SA compared to current SA, such as the higher risk sensitivity of Real Estate risk weights and corporate risk weights. However, we still think the revised SA is insufficiently risk sensitive and have three suggestions to improve the risk sensitivity and comparability:

- More differentiation in risk weights for unrated corporates. Recall that the vast majority of corporate exposures on the balance sheet of European banks consists of unrated corporates
- Allow the Slotting approach under SA for Specialised Lending
- Use the actual (updated) property value for real estate exposures. This will also prevent arbitrage and allocate identical risk weights to similar risks

1 d) How would the revisions impact you/your business? Please specify and provide relevant evidence. More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

For the larger banks the direct capital impact is limited, as these banks mostly use the IRB approach. However the most important impact is the indirect effect through the output floor. For smaller or SA banks, we see a significant capital impact for a limited number of dedicated asset classes (see below)

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

For those banks using the SA approach, we see two assets classes or exposures, for which the capital requirement will significantly increase:

- Credit facilities, such as payment accounts, suffer from an increase in CCF from 0% to 10%
- Equity investments held by development banks are potentially more affected than other exposure classes. Equity investments by developments banks benefit from a high level of diversification over countries, regions, sectors and vintage years that is key to their business models. Even more so, this high level of diversification is one of the main reasons for the overall low credit risk profile and stable capitalisation of development financial institutions. Given the strong government involvement - and often government ownership - in bilateral banks and high level of diversification, we suggest that equity exposures held by bilateral developments should be explicitly mentioned under the 100% equity holdings category.

1 e) Where do you expect particular implementation challenges and why? Please specify.

- We do see the collection of real estate values at origination and all other required documentation as an extra operational burden, which does not contribute to risk sensitivity nor does it reflect the actual risk. A risk weight of 75% will apply, if you fail to document it properly.

2 Internal Rating Based (IRB) Approaches for credit risk

2 a) What are your views on the revisions? Please provide details.

For larger banks the Advanced IRB (A-IRB) is the preferred framework. It is in the interest of all stakeholders, including supervisors, banks and clients that capital has a correct relation to the actual risk profile, and that credit is priced accordingly.
We acknowledge that A-IRB could benefit from further alignment of definitions, modelling standards and methodologies to make results more transparent and comparable.
Exposure level input floors do not contribute to the objectives of comparability and transparency. Input floors could even increase unintended risk weight variation, as they may mask the true underlying risk levels and create cliff effects.

2 b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

The IRB proposals will lead to a significant increase in capital requirements for some portfolios. This is largely because of the move from A-IRB to F-IRB for several portfolios (with higher regulatory LGD and CCF), but also the input floors cause an RWA increase.

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

The wholesale operations are impacted by the IRB proposals. The retail operations (almost) not. This is largely driven by the reversion to F-IRB for several large A-IRB portfolios.

3 CVA Risk Framework

3 a) What are your views on the revisions? Please provide details.

The larger banks will mostly use the Standard CVA approach, while the smaller banks will mostly use the Basic CVA approach. Although the revisions are a simplification, both approach lack from several shortcomings.

- In the standard CVA approach the methodology to calculate the “sensitivities” in the capital model is rather sophisticated (in fact it has more characteristics of an internal model than a standard model) and differs from the methodology to calculate the “sensitivities” in the accounting model, potentially leading to incorrect hedging.
- In the basic CVA approach the less granular counterparty weighting for non-centrally cleared derivatives, such as cross currency swaps, creates cliff effects and reduces comparability. Also the risk weights are too conservative.

3 b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

The new CVA framework will lead to significantly higher capital requirements when applied to the current portfolio:

- Under the Basic CVA approach we see a doubling of the capital requirements for non-centrally cleared derivatives, such as cross currency swaps
- For banks, who provide hedging services to non-financial clients, the CVA capital charge will be dominated by exposures which are currently exempt. We consider the arguments for exemption of corporate exposures still valid, and would suggest continuation of the exemption.

3 c) Where do you expect particular implementation challenges and why? Please specify.
We consider it a challenge to have a complete set of all sensitivities cross all product classes for a particular netting set. It would be appreciated if some enhancement to the regulation is made which makes that in case of immaterial sensitivities missing not the complete netting set is compromised and falls back to the basic-approach.
Also the alignment between two different CVA frameworks, accounting and regulatory, will be rather cumbersome.

3 d) 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?

Although we recognise the necessity to include all derivative exposures into the CVA capital framework, The argumentation, which was used for the current exemptions as stated in article 382, did not change during the years. The removal of a number of these exemptions makes that it is unavoidable that it will have a direct impact on the pricing and cost of hedging exposures by our (corporate) clients.

4 Operational risk framework

4 a) What are your views on the revisions? Please provide details.
Overall, most of our members are positive about the newly introduced revisions, as it increases simplicity and transparency to the operational risk capital calculation, compared to the current model in use, creating a level playing field and allowing comparability with similar banks. However, some challenges related to sensitivity, granularity and super-additivity will require additional research to determine the impact, and possible ways of mitigation. Furthermore the new capital framework lacks a forward looking element.

4 b) How would the revisions impact you/your business? Please specify and provide relevant evidence.
More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

In the Netherlands only the largest banks use the advance measurement approach (AMA) for operational risk capital calculation. All other banks use the Standardised Approach.

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

We expect the impact of the new approach to be limited, although it might depend upon the inclusion of historical losses into the capital requirement.

4 c) Where do you expect particular implementation challenges and why? Please specify.

We do not foresee major implementation challenges, although a few elements require further investigation:

- Risk sensitivity: While no longer using scenario analysis, the model is absent a forward-looking risk view;
- Robustness & volatility: Experiencing cliff effects, with large losses either entering or departing the 10 years historical data set;
- Granularity & super-additivity: The need for a new capital allocation mechanism.
- Setting up an operational risk loss database for those banks, which currently do not have such a database or is not yet structured in accordance with the new framework

5 Output floor

5 a) What are your views on the revisions? Please provide details.

We believe that the proposed aggregate capital output floor is unnecessary and reduces comparability. The leverage ratio is already intended to serve as a non-risk based backstop and is largely founded on the SA exposure determination. This makes additional capital output floors based on SA an unnecessary duplication. As such, it adds a redundant layer and creates unnecessary complexity.
European banks in particular are accustomed to provide residential mortgage lending, which has a proven record in Europe of assets with established low losses (given strong collaterals and risk mitigating factors such as income norms restricting lending, social security protection, asset guarantee schemes protecting the value of assets to a certain amount (NHG e.g.) in case of non-ability of repayment by the borrower). Forcing unnecessary capital through floors simply imposes costs on the European economy. The proposals do not take adequate notice of the considerable difference with the United States practice of residential mortgage finance, held by state sponsored entities.
Also, the consequence of the definition of the output floor is that balance sheet composition has become a major driver for impact of the Finalization of Basel 3. Banks with substantial low risk portfolios are more affected by the output floor than banks with a higher risk profile. This business model specific impact cannot be justified from financial stability or prudential supervision perspective.

5 b) How would the revisions impact you/your business? Please specify and provide relevant evidence.
More specifically:

i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver.

The impact of the revised output floor, obviously only relevant for IRB banks, really depends upon the composition of the balance sheet and the business model:

- For a bank, of which the balance sheet mainly consists of low risk assets, such as residential mortgages, the impact can be significant and the minimum capital requirement, could increase by some 35%.
- For more complex banks, the impact of the revised internally modelled approaches, could be more important, although this is complicated by potential cliff effects, if the revised output floor is marginally binding.

ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

See also our response under revisions to SA: the impact of the output floor is mainly visible low risk assets, such as Residential Mortgages, followed by Large Corporates and Specialised Lending. Although the Basel proposals from December 2017 are an improvement over earlier proposals, the

risk weights for Residential Mortgages are still significantly higher than own internally modelled risk weights for this low risk portfolio.
Also: where Slotting is currently part of IRB, it should also be part of SA, so as to avoid unwanted effects via the output floor.

c) Where do you expect particular implementation challenges and why? Please specify.

We see several implementation challenges, such as internal capital allocation and pricing in light of the output floor (components of the use test requirement of the IRB framework). Furthermore additional data are required for assets, which are currently only reported under the IRB approach.