Luxembourg, 30 December 2019

Consultation on Implementing the final Basel III Reforms in the EU
ABBL Response

The Luxembourg Bankers' Association ("ABBL") is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector ("PSF"), financial service providers and ancillary service providers to the financial industry.

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1. CREDIT RISK: STANDARDISED APPROACH (SA-CR)

External credit risk assessment approach (ECRA) vs. standardised credit risk assessment approach (SCRA)

1) Views are sought on the relative costs and benefits of the ECRA provided by the final Basel III standards and the SCRA? In particular, how do the two approaches compare in terms of risk-sensitivity, impact on risk-weighted assets (RWAs) and operational burden? Please specify the relative costs and benefits of the two approaches for exposures to i) institutions, ii) covered bonds and iii) corporates. Please provide relevant evidence to substantiate your views.

Exposures to in institutions

The ECRA and SCRA are complementary approaches, which should not be opposed. We support keeping the ECRA for exposures to rated institutions, which is a simple, consistent, risk-sensitive and easy-to-use approach. One has to keep in mind that available external ratings provide updated information from the Credit Rating Agency and from the counterparty itself (some annual report and financial reports are more often available on their website). As a result, this is a virtuous circle and, in terms of risk follow-up, this information is useful and important. Unrated companies require more investigations.

In the Basel III proposal, we appreciate that the allocation of risk weights is now more granular, i.e. exposures rated A+ to A-, and consistent with the underlying risk. Furthermore, it is worth noting that Credit Rating Agencies (CRAs) now benefit from a fully-fledged regulatory and supervisory framework. The CRA Regulation was designed to enhance the integrity, responsibility, good governance and independence of credit rating activities to ensure quality ratings and high levels of investor protection. ESMA ensures the single supervision of CRAs, e.g. CRAs' registration, ongoing supervision and investigations, etc.

Nevertheless, it is well known that a large number of banking counterparties (e.g. smaller banks, subsidiaries of cross-border groups) are not rated. For most of these banks, replacing the current approach derived from the sovereign's rating by the SCRA will thus mechanistically significantly increase Risk Weights, from 20% currently on average to at least 40% or even 75% under the SCRA. All things being equal, the unrated Luxembourg subsidiary of an EU group will be risk-weighted at 40% (possibly 30%) under the SCRA, <u>in the absence of any deterioration of its risk profile.</u> Therefore, a unique approach based on SCRA is not satisfactory.
The SCRA also raises the issue of access to quantitative prudential data requested for the classification in grade A and B.

According to our Quantitative Impact Study, Luxembourg banks' exposures to institutions break down as follows:

- Rated exposures subject to the ECRA: 95% of total exposures to institutions.
- Unrated exposures subject to the SCRA: 5 % of total exposures to institutions.

Implementing the SCRA would increase RWAs by 54% compared to the current framework.

Exposures to covered bonds
Banks rely on CRAs' analysis and rating, plus any additional information provided by the counterparty when setting the exposure limit reviewing limits. However, it is difficult for SA banks to produce more sophisticated due diligence analysis. From this perspective, we recommend reviewing this requirement to align it with the current practice but without increasing the burden of the assessment.

Exposures to corporates
We support keeping the ECRA for exposures to rated corporates for the same reasons as those explained above in the first paragraph of our response to Question 1.

By contrast, the treatment of unrated exposures to non-SMEs corporates raises major challenges due to its lack of risk-sensitiveness and of granularity. Given the significant number of unrated corporates in the EU that would be in the future risk-weighted at 100%, we fear that the impact on the financing of the EU economy be very detrimental. Due to the mechanism of the output floor, also banks using IRB models will be captured by the revised SA that will limit their capacity to finance the economy.

This is why we propose in Question 2.1 to base the Investment Grade and non-Investment Grade assessment on the internal information that banks collect on their counterparties.

2)	Would you deem refinements or clarifications necessary concerning the approach that you generally prefer, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.

Similarly to the treatment of unrated exposures to institutions, we believe that the SCRA should be permitted as a fall-back approach for unrated exposures to non-SMEs corporates. Therefore, unrated exposures qualifying for investment grade classification should be risk-weighted at 65%. Finally, considering the lack of depth of EU capital markets due to the uncompleted Capital Markets Union, we call for removing the requirement to be listed on a recognized stock exchange as a condition to qualify for investment grade.

Indeed, the provisions of paragraph 42 of the Basel III standard suit better to IRBA banks, which have a counterparty analysis methodology discriminating between investment grade and non-investment grade. For SA banks, this detailed information does not reach this level of conclusion. In practice, if a loan is granted and not placed under a watch-list, the creditworthiness of the counterparty is still representative of the classification as investment grade. Conversely, if a counterparty is placed in a watch-list (but without yet an unlikely to pay or payment default), it is classified under as non-investment grade.

<u>Enhanced due diligence requirements</u>

3)	Views are sought on the costs and benefits of implementing the various clarifications and specifications provided by the Basel III standards (paragraph 4) in relation to the due diligence to be performed by institutions. Please provide specific answers on each of the clarifications/specifications and support your view with relevant evidence.

In line with long-standing regulatory requirements, banks' internal risk management framework entails sound assessment by a dedicated function of the risk of their various counterparties (banks, corporates, etc.), *i.e.* ex ante analysis of the counterpart's acceptability, definition of internal limits for the bank's exposure to the counterpart, regular follow-up of the counterpart's financial position, etc. Information published by CRAs plus any internal information on the counterparty and on its group are in practice sufficient for deciding to authorize the counterparty, and to set the level of the authorised exposure. As a consequence, we recommend removing this due-diligence and to keep the current approach.

The Basel III requirement "*to ensure that they have an adequate understanding, at origination and thereafter on a regular basis (at least annually), of the risk profile and characteristics of their counterparties*" is not problematic as it confirms existing practices. As a matter of fact, banks' practices in risk assessment prevent mechanistic reliance on external credit ratings, as required by the CRD, article 79. Thus, EU legislation already requires institutions to analyse the consistency of risk weights.

Against this background, we believe that the new Basel III due diligence requirement "*In cases where ratings are used, due diligence is considered necessary to assess the risk of the exposure for risk management purposes and whether the risk weight applied is appropriate and prudent"* is highly problematic because:

- It is vague and opens the door for divergent supervisory expectations;
- It has the potential to impose disproportionate requirements to banks, especially the small and non-complex ones, which are not well-equipped to re-perform the analysis process made by Credit Rating Agencies;
- It disregards the regulatory and supervisory framework of Credit Rating Agencies, which guarantees the integrity, responsibility, good governance and independence of credit rating activities, to ensure quality of ratings and high level of investor protection.

4) If you are of the view that the CRR/D should be amended to clarify/specify the rules on due diligence requirements, what would constitute an appropriate approach in your view? Please specify and provide relevant evidence.

It should be expressly clarified in the future CRR/CRD that due diligence of external ratings should not consist in redoing the analysis performed by Credit Rating Agencies. Instead, banks should be allowed to rely on the outcome of their internal risk assessment framework to take a critical look at the rating published by rating agencies as of today. Also, the ability to compare ratings issued by several agencies for a same counterparty should be maintained and accepted as a form of due diligence.

5) In your view, should the due-diligence requirements differentiate between exposures for which a rating exists and unrated exposures treated under the SCRA (see above 1.1.1.1.), and if so, why? Please elaborate and provide relevant evidence.

Whether the counterparty is rated or not, when a loan is granted or when the situation of the counterparty is reviewed, all the assessment relies on a documentation based on financial and economic perspectives. We should rely on this robust framework.

Exposures to institutions: Definition of grades under the SCRA

6) Views are sought on the costs and benefits of implementing the definition of grades under the SCRA provided by the Basel III standards (paragraphs 22-29). Please provide relevant evidence to substantiate your views.

The SCRA should be a complementary methodology to the ECRA for unrated counterparties. This methodology based on regulatory ratios can be used by all banks – be they SA or IRBA banks – in the same manner. As mentioned in section 1.1.2.1, the point is the availability of data, including for groups' subsidiaries.

7) In your view, are the quantitative and qualitative criteria for the classification of counterparties into grades sufficiently clear or do you consider more specifications necessary to ensure a harmonised application of these criteria throughout the Union? Please elaborate and provide relevant evidence.

With regards to quantitative criteria, it is key to specify which Pillar 2 requirements (P2R, P2G) and which capital buffers requirements will have to be met to comply with the classification in grade A.

We consider that the definition of SCRA grades and the associated risk weights is not granular enough. For example, the first grade A is allocated a 40% risk weight, to be compared to the existing minimum risk weight of 20% for banks established in jurisdiction with a sovereign rating of 0%. Even if Grade A makes a 30% risk weight possible, the requirement of having a CET 1 ratio of 14% or more seems too restrictive. We suggest setting up a 12% threshold for Grade A+ and maintain published minimum regulatory requirements for Grade A.

As for quantitative criteria, the most critical issue consists of **access to prudential data.** In order to make the new framework efficient and to give the right incentives, it is crucial that access to requested prudential metrics be ensured and mutualized by EU authorities. Under the existing setup, access to prudential data will be challenging given the diversity of disclosure formats and the non-binding character of disclosure for subsidiaries of banking groups. The issue is all the more sensitive because of the punitive approach taken by Basel III, where banks for which data is not available are classified into the lower grade (from A to B, for example).

In this context, we believe that the EBA should make the required prudential data (for EU banks) available in a central database open to stakeholders and easy to download. This would facilitate timely access to reliable data and avoid duplication of tasks across European banks. This innovative approach could then be adopted by other jurisdictions by following Europe's example.

Besides, we believe that allocating counterparties to Grade C (with its risk weight of 150%) in case prudential information is not available yet, could create misleading reporting and is too punitive. In fact, Grade C should be reserved to problematic institutions. In case of unknow information the usual "by default" risk weight of 100% should be maintained, considering that this has been a recurring feature in the CRR. 100% could be an alternative risk weight for Grade C, as 30% is for Grade A. We would then have 100% in Grade C when prudential data are "unknow, pending or missing", and 150% when prudential data are available and show a higher risk of default.

8) What are your views in relation to a potential clarification that also minimum capital and buffer requirements beyond the Basel minima (e.g. higher Pillar 1 requirements pursuant to Article 458 CRR or systemic buffers pursuant to Article 133) should be taken into account for the classification into grades, where applicable in the jurisdiction of the counterparty institution?

We are not convinced by this proposal, which would unduly complexify the framework: quantitative criteria should remain fair and should be consistent across banks and jurisdictions.

However, if the G-SIB/D-SIB buffers were not taken into account, the level of the quantitative criteria should be decreased to ensure consistency across banks.

9) Would you deem any other or further clarifications necessary to perform the classification into the three grades? Please elaborate and provide relevant evidence.

The key issue is that no ratios are specified for each of the three grades. In order to guarantee the global level playing field, the BCBS should monitor the detailed methodology used by countries applying the Basel III standard. At the moment, the level playing field is not certain for European banks. We are concerned by the application of such grades at international level and by the availability of the information on foreign counterparties too.

Identification of short-term exposures to institutions

10) In your view, what are the relative costs and benefits of using the original maturity as opposed to the residual maturity for identifying short-term interbank exposures? Please provide relevant arguments and evidence to substantiate your views.

We disagree with the proposed treatment of short-term exposures based on the original maturity, which does not properly reflect the risk incurred. We believe that the right criteria should remain the residual maturity, which adequately captures a broader range of exposures: as a matter of fact, there is no rationale from a risk perspective to discriminate exposures with a residual maturity below three months. Indeed, default risk decreases with time to maturity. It is fair to grant a lower risk weight to exposures close to maturity, which have well performed over time. With regards to portfolio management, this also provides more room of manoeuvre for granting new loans. Therefore, the current CRR approach, which is more risk-sensitive, should be maintained.

11) What are your views on the extension of the scope of the preferential treatment for short-term interbank exposures under Basel III from three to six months for exposures to institutions that arise from the movement of goods across national borders? To what extent would the change in definition change the amount of exposures benefitting from the preferential treatment? Please provide relevant evidence to substantiate your views.

No comment.

Treatment of unrated corporates

12) What is the share of your institution's/(member) institutions' exposures to rated and unrated corporate SMEs and to non-SMEs? What is the share of exposures to unrated corporates whose parent companies are externally rated? Please provide relevant evidence (e.g. underlying calculations, studies etc.).

Our **Quantitative Impact Study** shows the following breakdown for Luxembourg banks:

1. Corporate exposures (excluding SMEs)
   - Rated corporate exposures = 20%
   - Unrated corporate exposures = 80%

2. SMEs exposures: 100% unrated

13) Views are sought on the definition of 'investment grade' provided by the Basel III standards (paragraph 42).In particular, would you deem further refinements or clarifications necessary in order to ensure a consistent application across the Union? Please elaborate.

The SCRA is a complementary approach to the ECRA for unrated exposures. However, discriminating counterparties between Investment Grade and non-Investment Grade is easier for IRBA banks. Indeed, the ranking between the Investment Grade or non-Investment Grade is based on a methodology of scoring of the counterparty which is performed by IRBA banks, even for the external non-rated counterparties. As mentioned, the assessment relies on "*When making this determination, the bank should assess the corporate entity against the investment grade definition taking into account the complexity of its business model, performance against industry and peers, and risks posed by the entity's operating environment. Moreover, the corporate entity (or its parent company) must have securities outstanding on a recognised securities exchange*.", which lead to a counterparty score.

That is why, we propose below – Question 14 – an alternative to identify Investment Grade and non-Investment Grade counterparties.

14) What other measures, if any, could be taken to increase the risk-sensitivity of the standardised RW treatment of corporate exposures which currently have no external rating? Please elaborate and provide relevant evidence.

We propose to qualify unrated counterparties as Investment Grade, based on the counterparty assessment made by the Bank, as long as these unrated Corporate or SMEs do not fall in a watchlist (or worst in default). This implies that the counterparty "*has adequate capacity to meet its financial commitments*". Conversely, a classification in a watchlist takes into account the decline of the creditworthiness similarly to non-Investment Grade. Proposed risk weights:

- Investment Grades / unrated Corporate well performing => RW = 65%
- Non-Investment Grade / unrated Corporate under watchlist ⇒ RW = 100%

This proposal presents the advantage of a greater consistency between IRBA and SA banks.

15) In your view, which other aspects, if any, should be considered in the context of revising the standardised treatment of corporate exposures? Please elaborate.

With regards to SME exposures, the Basel III standard results in removing the SME supporting factor, which co-legislators recently confirmed and expanded, and also the newly introduced infrastructure supporting factor in the CRR2. We recommend maintaining the supporting factor, which is relevant from the economic perspective and for the sake of risk-sensitivity.

According to our **Quantitative Impact Study**, removing the supporting would make RWAs on SMEs **increase by 6%.**

Moreover, we would like to address the treatment of regulated insurance companies. Indeed, insurance companies are regulated and supervised in the EU, but this framework is until now not recognized in the Standardized Approach. Therefore, we consider that regulated insurers should benefit from the same treatment as for banks. For rated counterparties, the same approach could be applied. With regards to the SCRA approach, appropriate prudential ratios should be calibrated for each grade. This would lead to create two sub-asset classes: Institution-Banks and Institution-Insurance for instance.

Treatment of specialised lending (SL)

16) Views are sought on the costs and benefits of implementing the specific treatment of SL exposures provided by the Basel III standards (paragraphs 44-48). In particular, how does this treatment compare with the current treatment in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

We welcome this new exposure class for the SA approach, which complements the CRR exposure classes.

17) Would you deem further refinements or clarifications concerning the structure or calibration of the treatment for SL necessary, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.

No.

18) In your view, what other measures should be taken to better reflect the particular characteristics of SL exposures (as compared to general corporate exposures) thereby increasing the risk-sensitivity of the SA-CR and improving consistency with the IRBA? Please elaborate and provide relevant evidence.

To complete the framework, we recommend authorizing SA banks to use the existing slotting approach. Basically, the slotting approach is more risk-sensitive and granular as it relies on a detailed methodology based on the borrower’s financial figures and ratios. This method is standardised, so that SA banks may apply it as such. No further regulatory adjustments are necessary, as this method is extensively described in EBA/RTS/2016/02 on assigning risk weights to specialised lending exposures.

19) In your view, which other aspects, if any, should be considered in the context of revising the treatment of SL exposures?

No comment.

Standard treatment of equity exposures

20) In your view, are there any issues with the definition of equity exposures provided by the Basel III standards (paragraph 49) and the list of other instruments to be treated alike? In particular, would you deem further refinements or clarifications necessary regarding the scope of the equity exposure class in order to ensure a consistent application across the Union? Please elaborate.

The new equity exposure class is not granular enough in terms of risk weights, given that the various products belonging to the definition have different financial objectives. Long-term investments suffer from a punitive risk weight, whereas their contribution to the economy through capital market is positive and necessary.

21) Views are sought on the costs and benefits of the revised standard treatment for equity exposures under Basel III (paragraph 49-50). In particular, would you consider any further differentiation among equity exposures (apart from "speculative unlisted equity exposures" and "national legislated programmes" – see 1.1.4.2. and 1.1.4.3.) warranted, and if so, how should this differentiation be made and what would be its prudential rationale? Please elaborate and provide relevant evidence.

Reading footnote 24 of the Basel III standard "*Indirect equity interests include holdings of derivative instruments tied to equity interests, and holdings in corporations, partnerships, limited liability companies or other types of enterprises that issue ownership interests and are engaged principally in the business of investing in equity instruments*.", the economic impacts raise concerns.

Indeed, the exposure class also contains long-term exposures, which are not held for speculative purposes. We strongly support differentiating long-term investment from speculative ones in the general treatment of equities in the Basel III standard.

If unchanged, the proposed framework will reduce opportunities of capital investments for EU investors. From the economic point of view, we are concerned by such recommendations undermining capital markets, which the EU intends to revive via the Capital Markets Union initiative.

Outside the trading-book, banks often own equity exposures with a long-term perspective, in particular to invest in local infrastructure through consortium (pooling of resources in "hubs"). Choices are made with a strategic approach: operating a service internally, or pooling resources in shared platform in which a limited number of banks are partners to a common goal. Against this background, as long as there is a strategic goal and a long-term commitment, such exposures should be distinguished from other equity investments, and it should be possible to maintain a 100% risk weight. We strongly support introducing more granularity in this class exposure, in order not to penalise both the economy and the banks investing in local financial infrastructures.

22) What other measures or safeguards could be put in place with regards to equity exposures to increase the risk-sensitivity and robustness of the credit risk framework and prevent regulatory arbitrage between the banking book and the trading book? Please elaborate and provide relevant evidence.

Banks currently have the obligation to clarify their internal politics regarding their trading book and banking book. In addition, banks' risk appetite frameworks drive the level of risks, the nature of risk and selected maturities. In this respect, we support introducing sub-class exposures inside the equity class to take into account these different risk profiles.

Treatment of 'speculative unlisted equity exposures'

23) Do you agree that speculative unlisted equity exposures such as investments in private equity or venture capital firms should be subject to a relatively higher RW than other equity exposures? If you disagree, please explain and provide relevant evidence to substantiate your view.

The current CRR 2 framework is adequate with a 150% risk weight. We should keep in mind that a too punitive risk weight may kill innovation, while European regulation should also provide incentives to banks for encouraging new business initiatives.

24) Views are sought on the definition of 'speculative unlisted equity exposures' provided by the Basel III standards (paragraph 51 and footnote 31). In particular, would you deem further refinements or clarifications necessary and if yes, what should those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

The criterion of short-term expected gains looks clear enough to specify the speculative characteristics of an investment.

The definition "venture capital or similar investments which are subject to price volatility and are acquired in anticipation of significant future capital gains" is quite vague. Financing of start-ups should be part of the venture capital, but the punitive risk weight of 400% should be reviewed. In our opinion, what is at stake is the European financial strategy on promoting innovation and new business initiatives.

25) What other measures could be put in place to address the elevated risk from unlisted equity exposures? Please elaborate and provide relevant evidence.

If the Basel III standard is maintained, banks will need a 5 years phasing-in period for existing equity investments, so as to smooth the increase of capital requirements and to avoid massive divestments.

Retail exposures

Notion of 'transactors' and 'other retail'

29) Views are sought on the costs and benefits of introducing the sub-asset class of transactors for regulatory retail exposures and specifying the treatment for other retail exposures. In particular, how does the approach provided by the Basel III standards compare with the current approach in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

A lower risk weight for exposures that have well performed for one year is relevant. However, banks will have to adapt their IT systems to capture this new sub-asset class.

30) In your view, does the reduction in RWs for exposures to transactors under Basel III prudently reflect the risks associated with such exposures? Please elaborate and provide relevant evidence.

The products listed are daily payment product or physical person products. Considering that good transactions payers are less risky based on an historical assessment (one year) looks adequate.

31) Would you deem further clarifications necessary concerning the notion of transactors and other retail, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.

No comment

32) In your view, which other aspects, if any, should be considered in the context of revising the treatment of retail exposures? Please elaborate and provide relevant evidence.

No comment

'Granularity criterion' and additional measures to ensure diversification

33) In your view, is the current CRR sufficiently clear to ensure a harmonised application of the "granularity criterion" or do you consider further guidance necessary? If yes, what are

We consider that the relative threshold is a discriminatory provision between banks. Smaller banks will automatically be penalized for granting loan to retail physical persons as well as SMEs, compared to bigger banks benefiting from a size effect.

Currently, the CRR 2 imposes an absolute threshold, which is fair since it is unique for all banks, even for bigger ones. Since the objective is also to have a single rule, we consider that the current CRR 2 ensures both diversification and regulatory convergence.

Real Estate Exposures

Implementation of loan splitting (LS) approach vs whole loan (WL) approach

34) Views are sought on the relative costs and benefits of the LS approach and the WL approach provided by the final Basel III standard. In particular, how do the two approaches compare in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

Examples comparing the WL and the LS approaches.

1. **Example 1**

   Assumptions

   A natural person intends to buy a house as a second property financed by a loan of 800 000 EUR. The house is valued at 820 000 EUR and the borrower owns as additional guarantee a fully-paid studio valued at 120 000 EUR. As a result, the LTV is 85%.

   WL approach

   Based on the table 11 of the Basel III standard, this new loan of 800 000 EUR will support a risk weight of 40%. As a result, the WL approach leads to 25 600 EUR capital requirement. In the current CRR, 80% of the residential collateral are eligible, i.e. 752 000 EUR. This leads to 23 936 EUR capital requirement: [725 000 x 35% + (800 000-752 000) x75%]x 8% = 23 936 EUR. Even if the loan is fully collateralized from an economic standpoint (collateral of 940 000 EUR vs. loan of 800 000 EUR), the cost of risk **increases by 7%** under the WL approach compared to the current CRR.

   LS approach

   In the LS approach, two risk drivers are used:

   - The property market value, which is recognized up to 55%, i.e. the secured part of the exposure up to 55% of the property value receives a 20% risk weight for Residential Real Estate Exposures (Min (60%, RW of counterparty) for Commercial Real Estate)
   - The part of the exposure above 55% of the property value, which is considered as unsecured and receives the risk weight of the borrower

   Using the previous example, the 55% threshold is applied to both guarantees of 820 000 EUR and 120 000 EUR, and the uncollateralized exposure receives a 75 % risk weight like in the CRR. Therefore, capital requirements under the LS approach **increase by 5%,** i.e. from 23 936 EUR (CRR) to 25 252 EUR: [517 000 x 20% + (800 000-517 000) x75%]x 8% = 25 252 EUR.

2. **Example 2:** evolution of capital requirements over the duration of a loan

   See comparative graphs in point 4. of the annex to our response. Under the LS approach capital requirements decrease smoothly, while they decrease by 'jump' under the WL approach: each time there is a change of bucket, there is also a jump of capital requirements, everything being equal. Thus, under the WL, variations of capital requirements are not driven by variations in the risk profile of the exposures but are rather inherent to the methodology.

Quantitative Impact Study

In our Quantitative Impact Study, we have compared the average risk weights resulting from the WL and from the LS approach for the General Residential Real Estate and the General Commercial Real Estate asset classes. We observe **no significant difference**: +2% (GRRE)

and -1% (GCRE). See table in point 3. of the annex to our response.

Conclusion

As a conclusion, **we support implementing the LS approach** for the following reasons:

- By construction, the LS approach is more risk sensitive than the WL approach, that uses the LTV as single proxy for assessing the risk on real estate exposures. Indeed, the WL approach wrongly assumes that the LTV adequately reflects the risk of loss in case of borrower default.
- With regards to implementing costs, the LS approach will be less onerous to implement given that it is by nature close to the existing approach of the CRR.
- Monitoring of real estate properties received as collateral is more workable under the LS approach.
- The evolution of capital requirements over the life of the loan is more predictable under the LS approach, while it is subject to cliff effects under the WL approach.

35) Would you deem further refinements or clarifications necessary concerning the approach that you generally prefer, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

We propose the following refinements to the LS approach:

1. Differentiating the haircuts on residential properties

The risk sensitivities of residential properties and of commercial properties are empirically different, while both have the same haircut in the Basel III standard, i.e. only 55% of their market value is recognized.
Due to the fact that the market for residential properties is more liquid than the one for commercial properties, we recommend raising up to 65% the threshold for residential properties and to keep the 55% threshold on commercial properties. When defining the haircuts, it is important to opt for a risk sensitive approach in line with the underlying risks.

2. Creating a supporting factor for safe real estate markets

With regards to local laws and regulations, we would like to underline that European specificities are not yet taken into account in the current framework. Since local regulations already impose several safeguards on their markets (legal system regarding mortgages, guarantees system), we believe that it should be supported by European regulation through more granular and lower risk weights. Conversely, the CRR already offers the possibility for national competent authorities to increase risk weights in case of market turmoil. Therefore, we believe that the LS approach could be complemented by a supporting factor when the national competent authority and/or the government have introduced safeguards on the real estate market. These good market practices should be rewarded to encourage sound prudential practices: in Luxembourg, for example, the Code Civil explicitly mentions the obligations of real estate developers when selling buildings, which are not yet finalised. This law secures borrowers and by consequence loans granted.

A supporting factor between 0.6 to 0.85 would lead to an effective risk weight between 12% and 17%.: see table in point 5. of the annex to our response.

3. Extending the Hard Test from Income Producing Commercial Real Estate (IPCRE) to Income Producing Residential Real Estate (IPRRE)

The Basel III standard limits the Hard Test to the Income Producing Commercial Real Estate (IPCRE) asset class and excludes the IPRRE from its scope of application. In line with the EBA Recommendation CR-SA 24 (EBA Policy Advice on the Basel III Reforms: Credit Risk), we support extending the Hard Test to the IPRRE. We concur with the arguments exposed by the EBA, notably that the Hard Test *"provides incentives to correct property values downwards as soon as possible in order to reflect market deterioration upfront"*. As for calibration, we propose to stick to the current CRR, i.e. using a loss threshold of 0.3% for both IPRRE and IPCRE asset classes.

4. Summary of our proposed refinements to the Loan Splitting Approach: see table in point 6. of the annex to our response.

36) What would justify implementing both approaches in parallel from a risk perspective? If both approaches were to be implemented and made available on discretionary basis, how would comparability across institutions be ensured and how would regulatory arbitrage as well as undue complexity be prevented in this case?

We see little justification in implementing both approaches on a discretionary basis, neither at the discretion of the competent authorities nor at the discretion of institutions.

The drawbacks of such a discretionary approach are the following:

- Risk of unlevelled playing field,
- Lack of comparability across EU institutions and EU jurisdictions,
- Risk of regulatory arbitrage: if the discretionary approach was implemented, complex regulatory safeguards would have to be set up in order to prevent regulatory arbitrage.

Treatment of exposures where the servicing of the loan materially depends on the cash flows generated by a portfolio of properties owned by the borrower

37) Do you consider the assessment of the condition of "strong positive correlation" on a portfolio basis more appropriate than the assessment based on the individual RE exposure, and if yes, why? Please explain.

Risk assessment based on the individual RE exposures is fair and should be maintained. However, assessing the condition of strong positive correlation on a portfolio basis corresponds to the current practice of most Luxembourg banks. Indeed, where a borrower owns several collateralised properties, considering the cash flows generated by the whole portfolio of properties reflects more accurately the risk of the exposures to this borrower. With regards to 'finished properties', the market value of the whole portfolio is the most relevant.

In practice, banks analyse the borrower's total financial capacity to reimburse the loan, so that both aspects are relevant when granting a loan: the assessment at the loan level and the assessment of the borrower's total portfolio.

38) If the assessment based on a portfolio basis were introduced, what are your views on whether it should be the only approach available in the Union or it should be an alternative approach to be applied at supervisory discretion on a case-by-case basis? Please explain.

Both approaches are complementary and should be permitted to banks.

Eligibility of property under construction

39) What are your views on the costs and benefits of implementing the preferential treatment for certain properties under construction as provided by the Basel III standards? Please provide relevant evidence supporting your view.

The EBA Q&A 2015_2304 considers that residential properties under construction are eligible to the preferential residential mortgage treatment:

By reference to residential property "… which is or shall be occupied or let by the owner…" Article 125(1)(a) of Regulation (EU) No 575/2013 (CRR) allows the application of a risk weight of 35% to residential property under construction unless otherwise decided by the competent authority in accordance with Article 124(2) CRR. There is no contradiction between Article 4(1)(75) and Article 125(1)(a) CRR. The latter provision rather has a wider scope of application compared to what is defined in Article 4(1)(75) CRR. For the avoidance of doubt, the exposure has to be secured by a mortgage on residential property which "is or shall be occupied or let by the owner". This excludes situations where residential property "may" be built in the future (i.e. mortgages on land) but includes mortgages on building sites on which residential property will be built for the future owner of the property, or on residential property under construction, provided in both cases that there is certainty that the owner will occupy or let the property. In this sense, the 35% risk weight cannot be applied to exposures towards real estate developers.

We support the current CRR preferential treatment for residential property under construction, as proposed also by the Basel III standard. Indeed, prudential regulation should not penalise residential property under construction, i.e. the new housing markets, which represent a significant part of real estate markets development. This activity contributes to respond to households' demand, and to renew the existing property stock with more modern and more energy efficient constructions, among other benefits.

Besides, it is very important to maintain a virtuous circle between real estate development programs and the capacity of natural persons to buy these properties. Likewise, the prudential treatment of houses and apartments under construction should be identical. From the economic, social and risk perspectives, discriminating between finished properties and properties under construction is not appropriate.

40) Do you consider the threshold of one-to-four family residential housing units appropriate, and if not, which other threshold would you consider to be more appropriate? Please provide evidence supporting your view.

The one-to-four criterion is irrelevant as it brings no added-value to the existing risk assessment practices performed by our members when granting loans secured by residential properties. It is also worth noting that implementing the criteria would be unduly burdensome

from an operational point of view.

Prudently conservative valuation criteria

41) Views are sought on the costs and benefits of the valuation criteria provided by the Basel III standards. In particular, how does this approach compare with the current approaches available under the CRR (MV and MLV) in terms of simplicity, comparability, risk- sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

The current CRR contains efficient valuation rules, covering the overall phase of the economic cycle, whether in a raising or in a downturn trend. Therefore, we support both MV and MLV methodologies.

Luxembourg banks use the property value at the time when the loan is granted and do not incorporate any projection on future price increase. The economic data used for periodic valuation of properties are always based on the current environment at the valuation date, and, when available, the quantitative approach relies on figures published by the national statistics institute. Against this background, we believe that Luxembourg banks meet the Basel III requirement: "***To ensure that the value of the property is appraised in a prudently conservative manner, the valuation must exclude expectations on price increases…"***

Using the regular review approach (upwards and downwards) set out in the CRR, banks are able to adapt the property value based on official statistics: de facto, this approach ensures that banks "***take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan***" as requested by the Basel III standard.

Furthermore, this remains compliant with the CRR articles:

- Article 208.3(a)
  Institutions carry out more frequent monitoring ***where the market is subject to significant changes in conditions;***

- Article 208.3(b)
  "The property valuation is reviewed ***when information available to institutions indicates that the value of the property may have declined materially relative to general market prices…. For loans exceeding EUR 3 million or 5 % of the own funds of an institution, the property valuation shall be reviewed by such valuer at least every three years."***

In our views, compared to the Basel III standard, the current CRR article 208.3 ensures a more accurate valuation mechanism, based on the best and on the most recent information made available to banks.

42) Would you deem additional specifications necessary to clarify how the MV or the MLV currently used by institutions would need to be adjusted to meet the valuation criteria provided by the Basel III standards? Would you deem further clarifications necessary to ensure a consistent application of the valuation criteria across the Union? Please elaborate.

As mentioned in the previous question, statistics' publication and data availability are key issues. The EU Commission should ensure that Member States have consistent and duly published statistical methodologies. National statistics are the benchmark for consistent valuation amongst banks, real estate experts and regulators. The key matter is to ensure a sufficient level of granularity of the statistics among the type of mortgages and their location inside a country or a city. We also believe that a significant part of the residential portfolio should still be valuated with a statistical approach.

43) What other measures could be taken to ensure that the value of RE collateral is sustainable over the life of the loan? Please elaborate and provide relevant evidence.

Proper monitoring of the fundamental economic dynamics is crucial to understand the positioning in the economic cycle and to anticipate future trends impacting the value of residential properties. It is also relevant to maintain LTVs at a reasonable level over the life of the loan.

Regular re-evaluation as per the CRR is the relevant approach, which ensures incorporating the current property value, even in case of a downturn.

44) In your view, which other aspects, if any, should be considered in the context of revising the valuation criteria for RE property? Please explain.

In order to ensure a convergent approach among EU countries, the granularity of the local statistics should be monitored and made available at the European Level.

(Re-)valuation: value at origination vs. current value

45) Views are sought on the costs and benefits of capping the property value at loan origination. In particular, how does the approach provided by the final Basel III standards compare with the current approach of the CRR in terms of possible cyclical effects on RWs, risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

We do not see much merit in capping the property value at loan origination. This approach would be little risk sensitive, in particular for loans with longer maturities: it is indeed counter-intuitive and questionable to freeze the value of a property over the next 20 or 30 years.

As mentioned in our response to Question 41, we recommend keeping the current CRR approach, which gives the right incentives for the monitoring and for the prudent revaluation of collateralised properties. The current approach does not prevent upwards revaluations, which may be relevant for loans with longer maturities.

In addition, capping the market value at the original valuation creates groundless discrepancies in risk assessment. As an example, let us consider two identical apartments located in the same building: apartment 1 and apartment 2. Assuming apartment 1 is financed by a 25 years mortgage loan, and that the owner remains the same, it will keep its value at origination all over the duration of the loan. Apartment 2 is sold after 9 years to a new owner, who contracts a mortgage loan to finance his acquisition. As a consequence, the market value of apartment 2 is updated and differs from that of apartment 1, so that two different market

values would be used for prudential reporting (e.g. AnaCredit reporting), for risk calculations, etc. Even more, no external value and no internal statistic method valuation would be able to explain such artificial discrepancies.

46) What other measures or safeguards could be provided to address possible cyclical effects of the re-valuation of real estate property? Please elaborate and provide relevant evidence.

First, the current CRR provides some leeway for national competent authorities to increase risk weights on both commercial and residential real estate exposures (CRR, article 124 (2)).

In Luxembourg, macro-prudential measures elaborated from a systemic risk perspective are also a key tool to address potential cyclical effects of the revaluation of real estate property. They consist in the following:

- Risk Weight floor of 15% or IRB banks mortgage exposures
- Activation of the counter-cyclical buffer at 0,25%
- Introduction of borrower-based measures that can be activated when deemed necessary:
  - Maximum loan-to-value (LTV) ratio comprised between 75% to 100%
  - Maximum loan-to-income (LTI) ratio comprised between 400% to 1200%,
  - Maximum debt-to-income ratio (DTI) comprised between 400% to 1200%
  - Maximum debt service to income ratio (DSTI) comprised between 35% to 75%
  - Maximum limit for the initial maturity of the loan comprised between 25 to 35 years

This set of measures, coupled with the monitoring of the Luxembourg Systemic Risk Committee and of the European Systemic Risk Board, constitute a robust safeguard against potential cyclical effects.

Besides, national governments set up local consumer rules, which reinforce this regulation. For example, the Luxembourg government has set up in the Code Civil specific rules for real estate developers in charge of residential property, in order to protect consumers.

47) In your view, which other aspects, if any, should be considered in the context of revising the requirement for re-valuation of RE collateral? Please elaborate and provide relevant evidence to substantiate your views.

Since the EBA Guidelines on Loan Origination and Monitoring will retain both valuer and statistical models (while refusing borrowers' valuation), we consider this framework as adequately defined.

Land acquisition, development and construction (ADC) exposures – general treatment

48) What are your views on the costs and benefits of replacing the existing treatment of 'speculative immovable property financing' with the treatment of ADC exposures as provided by the Basel III standards?

We support an appropriate treatment of ADC exposures in order to avoid penalizing the financing of new housing and commercial buildings. The current treatment in the CRR, which qualifies exposures of art. 4.1(79) as speculative and leads to a risk weight of 150%, is not adequate. It should be replaced by a more granular and risk-sensitive approach: see our

response to Question 49.

49) Would you deem further refinements or clarifications necessary concerning the scope or definition of ADC exposures, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

Refinements are needed as the Basel III standard considers solely the risk incurred on the construction project as a whole and omits the risk on the borrower, i.e. the constructor / sponsor of the project. Basically, the current CRR lacks clarity in the definition of “speculative immovable property financing”, since it does not make any difference between professionals of the real estate sector, natural persons and investors looking for short-term profit. In our views, the ADC asset class should be more granular to properly reflect risk. We identify two distinct situations:

1. **The less risky situation,** where:
   - The borrower is a well-established corporate (e.g. a construction company) with sufficient financial resources to reimburse the loan. Projects developed by professionals duly registered as real estate developers should be assessed as less risky than projects initiated by investors, who perform a non-regular activity in real estate.
   - The borrower provides additional eligible collateral under the form of cash deposits, properties, etc.

2. **The most risky situation**, where the borrower is a special purpose vehicle set up specifically to carry out the construction project. Such exposures should remain risk-weighted at 150 %.

ADC activities may be financed in two different ways:

1. **Financing up-front the overall real estate program**, i.e. buying the land, financing the construction and the commercialisation. By definition, the amount of such loans and banks’ commitments are significant. The real estate developer may start the construction before reaching a significant level of pre-sale.

2. **Financing separately the various steps of the real estate program**, i.e. land acquisition and the construction phase: **this is the market practice in Luxembourg**.
   In this type of financing, the risk is lower due to the close monitoring of the pre-sales, the level of which is a condition for authorizing additional loans if required. Conversely, additional financing may be granted when the commercial phase is successful. The sequence is the following:

   i) ***First step: financing land acquisition***
   During this step, no additional financing is granted to the real estate developer, who starts selling the residential/commercial properties. Proceeds from these pre-sales are used by the real estate developer to reimburse the loan financing land acquisition within 2-3 years.

   ii) ***Second step: financing construction or issuing a completion guarantee***
   In the second step, the real estate developer starts the construction on the basis of the irrevocable pre-sales received (the guarantee is the irrevocable

notarial act). Therefore, bank receive only demands for completion guarantees (“garanties d’achèvement”). Additional loans to finance the construction may be granted only when the pre-sales cover the construction cost of the real estate program.

In the table attached in point 7. of the annex to our response, we recommend making the treatment of ADC exposures more granular and more risk sensitive, based on:

- The type of borrower
- The loan maturity
- The type of financing

ADC exposures – conditions for the application of 100% RW

50) In relation to the condition for applying the preferential risk weight of 100% to certain ADC exposures, do you consider further specification necessary to ensure a harmonised application of this condition across the Union, for example by defining or quantifying any of the terms mentioned above? Please elaborate and provide relevant evidence to substantiate your views.

The conditions for applying the preferential risk weight of 100% to certain ADC exposures are too restrictive when compared to the reality. As mentioned in our answer to question 49, the Basel III standard covers only large financing programs, from land acquisition to construction. Surprisingly, less risky financing programs (i.e. financing only land acquisition in a first step) do not benefit from this 100% risk weight.

A first issue is that (1) the land acquired is not retained as an eligible collateral i.e. ‘commercial real estate property’ and (2) the land acquisition is risk weighted at 150%. Another issue is that any additional collateral (e.g. cash) provided by the real estate developer is not eligible under the CRR (see EBA Q&A 2013_215 : “ […] *regardless of whether these exposures are securitised by collateral*.”.) As a result, the safest financing approach for real estate development is also the most penalized by (1) the current framework as well as by (2) the new Basel III standard.

RW multiplier to certain exposures with currency mismatch

51) What are your views on the costs and benefits of introducing the RW multiplier described above? Please provide relevant evidence to substantiate your views.

In terms of risk-sensitivity, we agree that a currency mismatch between the loan and the payment must be covered. However, a new risk weight of 150 % is quite punitive, given that not all exchange rates have the same volatility.

52) In your view, what other measures could be taken to address the risks associated with currency mismatches? Would the restriction of this measure to retail and residential RE exposures to individuals be appropriate to tackle such risks in the EU? Please elaborate and provide relevant evidence.

We consider that an approach similar to the treatment of current currency mismatch in the CRR, based on volatilities, is more relevant than applying a unique standard high-risk weight.

Article 354 CRR relating to the calculation of own funds requirements for foreign-exchange risk, gives institutions the possibility to provide lower own funds requirements against positions in closely correlated currencies. The list of the relevant closely correlated currencies is maintained by EBA and any changes are published in the Official Journal as ITS (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1580&from=EN). If any provision addressing risk arising from currency mismatches was added, it should contain a similar differentiation between more and less riskier currency pairs.

53) In your view, which other aspects, if any, should be considered in the context of revising the treatment of exposures with currency mismatch under the SA-CR? Please provide relevant evidence to substantiate your views.

The currency mismatch on collateral is already addressed in the CRR and it does not need additional treatment.

Off-balance sheet (OBS) items

Definition of commitment

55) What is your view on the Basel III definition of commitments? Please provide relevant evidence to substantiate your views.

No comment.

56) What is your view on the national discretion to exempt certain arrangements for corporates and SMEs from the definition of commitments? In your view, which arrangements should be exempted from the definition of commitment, if any? Please provide relevant evidence to substantiate your views.

Impacts on Corporates and SMEs should be carefully assessed, since the changes undermine banks' cost of capital and thus their lending capacity.

Concerning the UCC, banks have the right to cancel the position. The legal framework constitutes banks' best protection and this is why, historically, the CCF has been set to 0%.

57) In your view, which other aspects, if any, should be considered in the context of the treatment of off-balance sheet exposures? Please provide relevant evidence to substantiate your views.

No comment.

New credit conversion factors (CCF)

58) What are the costs and benefits of the new CCF introduced by the Basel III standards? In particular, how does the Basel III treatment of OBS items compare to the current treatment in terms of risk-sensitivity and impact on RWAs. Please provide relevant evidence to substantiate your views.

First, we observe that the Basel III standard doesn't introduce new buckets but replaces the

current ones. In that sense, it is not an increase of the granularity, but a fully change in the approach.

We believe that credit lines that are unconditionally cancellable at any time by the institution without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness, should keep a 0% CCF. Similarly, short term commitments should benefit from a lower risk weight as well. Our recommendation is supported by the BCBS national discretion to exempt certain arrangement and to treat them as uncommitted (footnote 53) therefore with a 0% CCF.

While we understand the objectives of the Basel III standard, we believe that EU regulation should also recognise the well-working areas of the current framework. This is all the more important that off-balance sheet items regard usually SMEs and their treasury lines. If EU regulation undermines this economic flexibility, the impacts on the banks' lending activities and therefore, on the economy, will be significant.

59) In your view, which other aspects, if any, should be considered in the context of revising the treatment of OBS exposures? Please provide relevant evidence to substantiate your views.

An area of improvement may be the definition of items or of examples for implementation (See Annex I CRR) in order to achieve a better convergence in Europe.

Implementation challenges and administrative burden

60) Which elements of the revised SA-CR, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.

The most challenging and burdensome elements would be:

1. The very strict requirements of the SCRA and the associated administrative burden.
2. The due diligence requirements: clearer guidance should be provided, and mode emphasis should be put on proportionality.
3. Implementing the threshold of one-to-four family residential housing units.
4. The treatment of ADC exposures: more granularity should be introduced to take into account less risky loans.
5. The recalibration of CCFs, in particular the introduction of a 10% CCF for unconditionally cancellable commitments (UCCs).

61) Which elements of the revised SA-CR, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.

See Question 60.

3. OPERATIONAL RISK

3.1. DISCRETION TO SET THE ILM EQUAL TO 1

123) How would exercising the discretion affect the link between capital incentives and management of operational risks? Please elaborate.

Our **Quantitative Impact Study** shows that Luxembourg banks are **classified in bucket 1**, with an average Business indicator of **EUR 303 million**. Therefore, we do not express any opinion on this question, which regards banks of buckets 2 and 3.

124) Would you deem it necessary to mitigate possible cliff effects that might derive from the introduction of an institution-specific ILM? If so, which measures should be considered, for how long should they be applicable, and what would be the prudential rationale to implement them? Please elaborate.

N/A: see our response to question 123.

3.2. DISCRETION TO INCREASE THE LOSS DATA THRESHOLD TO EUR 100,000

125) What are your views on how a loss data threshold that is increased for some institutions may affect the soundness and risk-sensitivity of the operational risk framework, the volatility of the ILM, its comparability between institutions, and the incentive to carefully manage small to medium-sized losses? Please specify your views.

N/A: see our response to question 123.

126) If the discretion was retained, which conditions and criteria should be introduced in order to ensure a level playing field in its application by supervisors? Please elaborate.

N/A: see our response to question 123.

127) Which threshold (EUR 20,000 or EUR 100,000) would better reflect the current threshold used for your loss data collection? Please elaborate and provide relevant evidence.

N/A: see our response to question 123.

3.3. DISCRETION TO USE THE ILM FOR BUCKET 1 INSTITUTIONS

128) What are your views on how this discretion might affect the overall level of own funds for operational risk of bucket 1 institutions and the comparability within bucket 1? Please elaborate your views.

We support implementing the supervisory discretion to use the ILM for banks in bucket 1, in order to establish a robust connection between capital requirements and sound management of operational risk. Indeed, such banks should be allowed to implement a risk-

sensitive approach, thereby benefiting from more accurate capital requirements. In return, banks should abide by governance and organizational requirements for operational risk (e.g. the loss data requirements specified in paragraphs 19 to 31 of the Basel III standard), taking into account the proportionality principle expressed in our response to question 136.

Our **Quantitative Impact Study** highlights the following features for Luxembourg banks:

- The ILM is **below 1 for 13 banks out of 16** that are part of our sample.

- The average values of the ILM are 0.92 for 2016, 0.88 for 2017 and 0.90 for 2018. Point 8. of the annex to our response shows the evolution of the drivers of the ILM, i.e. the Loss Component and the Business Indicator Component. The LC and the BIC are expressed as indices with a reference value of 100 for 2016. While the LC decreases in 2017 and increases again in 2018, the BIC increases continuously in 2017 and 2018.

  ⇨ See graph in Point 8. of the annex to our response.

- Not using the ILM would increase RWAs for operational risk **by 4.4%** compared to the current framework. Using the ILM would decrease RWAs for operational risk **by 13.3%** compared to the current framework.

  ⇨ See summary table in Point 9. of the annex to our response.

In our views, the sequence for supervisory authorization should be the following:

1. Bucket 1 Bank introduces the demand to use the ILM to the competent authority;
2. Competent authority assesses the demand and grants authorization provided that governance and organizational requirements for operational risk are met.

Comparability among bucket 1 banks will be ensured when considering the interplay between Pillar 1 and Pillar 2 requirements for operational risk, which should be viewed as a whole:

- Most bucket 1 banks using the ILM for Pillar 1 will adopt from the start a more risk sensitive approach for the purpose of their ICAAP, thereby potentially reducing the Pillar 2 requirement;
- Bucket 1 banks not using the ILM for Pillar 1 might be subject to Pillar 2 capital add-on if they stick to a less risk-sensitive approach for their ICAAP.

129) If the discretion was retained, which conditions and criteria should be introduced in order to ensure a level playing field in its application by supervisors? Please elaborate.

Where the discretion is retained, level playing field will be ensured in two ways:

1. Framing the supervisory discretion, i.e. making it conditional upon governance and organizational requirements for the sound management of operational risk, constitutes a robust safeguard against divergent application.

2. Consistency of supervisory expectations will be ensured by (i) the SSM acting as single supervisor (ii) colleges of supervisors where relevant.

Moreover, the bank having exercised the discretion should commit to use the ILM during a minimum period (e.g. three years) in order to prevent cherry picking.

130) If the discretion was retained, do you consider this could help smoothing the transitioning of institutions from Bucket 1 to Bucket 2? Please elaborate.

In our response, we assume that the discretion to set the ILM equal to 1 for buckets 2 &3 banks **is not** implemented, and that bucket 1 banks **use** the ILM. Under this scenario, implementing the supervisory discretion to use the ILM for banks in bucket 1will undoubtedly smooth the transition of bucket 1 banks to bucket 2, as it will mitigate anticipated cliff effects, i.e.:

- Quantitative cliff effects due to the use of the ILM in the calculation of the capital requirement for bucket 2 banks;
- Qualitative cliff effect due to the obligation to comply with governance and organizational requirements (e.g. with regards to loss data requirements) for bucket 2 banks.

3.4. DISCRETION TO REQUEST INSTITUTIONS TO USE LESS THAN FIVE YEARS WHEN THE ILM IS GREATER THAN 1

131) What are your views on the discretion for supervisory authorities to request the institutions to use less than 5 years of loss data (when the ILM >1)? In which circumstances would such a request be justified? Please elaborate and provide relevant evidence.

Using less than 5 years of loss data would make sense in case of newly established banks or activities.

3.5. EXCLUSION OF CERTAIN OPERATIONAL RISK LOSS EVENTS

Materiality threshold

132) What would you consider to be the appropriate thresholds for allowing a request for exclusion of loss events from loss data history, for current and divested activities? Please explain and provide relevant evidence to substantiate your views.

We are not convinced that a materiality threshold would be relevant when requesting exclusion of data losses from the loss data history. For example, where a bank stops providing a given product or service (e.g. it does no longer offer payment services to its customers), there is no reason to retain any loss data related to such activity, no matter their size may be: here, imposing a materiality threshold would distort the reality of operational risk.

More broadly, there would be some merit in refining the concept of divested activities, which should include, beyond the sale of a business, also the termination of an activity.

Minimum retention period

133) What would be in your view an appropriate minimum retention period for the losses that will be excluded from the loss dataset? What would be an appropriate starting point of this period? Please explain and provide relevant evidence to substantiate your views.

The concept of retention period is not relevant for losses exclusions linked to divested activities: by nature, such activities will no longer affect the operational risk profile of the bank and no minimum retention period should be requested.

With regards to non-divested activities, we believe that the length of the retention period should be function of the remedial actions undertaken by the bank to tackle the cause of excluded losses: the more robust remedial actions are, the shorter the retention period should be.

3.6. OTHER OPERATIONAL RISK TOPICS

Governance and organisational requirements

134) What are your views on retaining the aforementioned CRR provisions and adapting the corresponding CDR provisions with a view to maintain their binding status?

Point (b) of article 321 CRR requiring institutions to have an independent risk management function for operational risk should be adapted to recognize the proportionality principle. Indeed, many smaller banks, do not have an independent risk management function for operational risk, the latter being part of the global risk management function. Therefore, we recommend that Bucket 1 banks should not be required to have an independent, specific, risk management function for operational risk. Taking this into consideration, articles 320 and 321 CRR can be retained and be applied to all banks.

Similarly, CDR provisions should be adjusted to the specificities of smaller banks: see our response to question 136.

135) Does your institution already comply with the relevant requirements? Please list the requirements that are not currently applicable to your institution and whether there is any additional operational burden associated with achieving compliance.

N/A.

136) Are there any concerns in terms of proportionality that you would consider important to raise? Which threshold would you consider appropriate for the applicability of thegovernance and organisational requirements? Please elaborate.

The quantitative and qualitative provisions of CDR 2018/959 are calibrated for banks using the AMA approach. While these provisions make sense for large groups deploying internal model-based methodologies for operational risk, they are clearly too complex and too burdensome for smaller banks that use currently non-AMA approaches. In this context, we believe that Bucket 1 banks constitute the population of banks eligible for a more proportionate application of governance and organizational requirements. Therefore, we

recommend the following:

- Exempting Bucket 1 banks **not using the ILM** from binding CDR provisions.
- Alleviating CDR provisions **for Bucket 1 banks using the ILM,** e.g.:
    - Removing the obligation for the institution to evaluate the effectiveness of its operational risk governance, process and risk measurement system ***at least on an annual basis***: art. 7.1(f) CDR
    - Alleviating reporting requirements, e.g. their frequency: art. 10 (c) CDR
    - Removing the requirement for internal validation: art. 16 CDR
    - Removing the requirement for the audit function to verify the operational risk framework ***at least on annual basis:*** art. 16.1(b), (g), (h) CDR
    - Removing the obligation to make use of external data: art. 18.1(a), 20, 25 CDR
    - Alleviating the requirements of art. 18 CDR on Data quality
    - Removing art. 19 CDR, which was designed for AMA specifically

ICAAP and Pillar 2

137) What are your views on requiring the inclusion of the abovementioned elements (internal loss data, scenarios, external loss data and key risk indicators) in the ICAAP for operational risk? Please explain your reasoning in case of disagreement (separately for each element).

Internal loss data, internally-developed scenarios and key risk indicators are commonly-used metrics for the purpose of the ICAAP. In particular, internal loss data and scenarios combine adequately experience from the past and forward-looking analysis.

By contrast, banks do not regularly make use of external loss databases, which (i) are very costly (ii) may not reflect the specificities of some business models. Consequently, we would disagree with any binding requirement forcing banks to utilize external loss data for the purpose of their ICAAP, which must remain self-assessment exercise driven by banks' risk profile.

138) Would you deem further refinements or clarifications necessary concerning the ICAAP for operational risk, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

The ICAAP on operational risk must remain an internal exercise driven by banks' specific risk profile. From that perspective, no further prescriptive requirements should be added to the existing framework.

139) What threshold would you consider appropriate for the applicability of the aforementioned ICAAP requirements for Pillar 2? Please elaborate.

Provided that the observations made in our response to questions 137 and 138 are taken into account, we do not deem appropriate any threshold for the applicability of Pillar 2 requirements.

Identifying BIC items in Financial Reporting (FINREP)

140) What are your views on the costs and benefits of using FINREP templates as a reference for a harmonised identification of BIC items in the EU? Please substantiate your views with relevant evidence.

We are fully supportive of using FINREP templates as the reference for identifying BIC components via the mapping table elaborated by EBA. This measure will bring clarity, simplicity, consistency and comparability in the calculation of the BIC across European Banks. It will be beneficial for both banks and banking supervisors.

141) What are your views on introducing a mapping table via Level 2 measures to allow for timely updates in case the corresponding FINREP standards change? Please elaborate.

See our response to question 140. For the sake of efficiency, Level 2 measures should be concomitant with the publication of the level 1 regulation.

142) In your view, which other aspects, if any, should be considered in the context of mapping BIC components and FINREP items? Please elaborate.

N/A.

3.7. OTHER PROVISIONS

143) In your view, which other aspects, if any, should be considered in the context of revising the operational risk framework? Please elaborate and rank your answers from the most important to the least important aspect

N/A.

3.8. IMPLEMENTATION CHALLENGES AND ADMINISTRATIVE BURDEN

144) Which elements of the revised SA-OR, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.

See our response to question 145.

145) Which elements of the revised SA-OR, if any, would in your view cause additional administrative burden? Please elaborate and provide relevant evidence on the expected recurring costs.

Proper application of the proportionality principle is crucial to prevent excessive administrative burden and undue complexity when implementing the Basel III standard on operational risk.

As observed in our response to question 136, CRR and CDR provisions concerning AMA

approaches should not be applied one-to-one to small and less complex institutions, i.e. those pertaining to Bucket 1.

We see also very burdensome and inefficient any mandatory requirement for banks to make use of external data in the context of their ICAAP: see our response to question 137.

5. CREDIT VALUATION ADJUSTMENT (CVA) RISK

5.2. EXEMPTIONS UNDER THE CRR

165) What would you consider to be the potential impacts on RWAs and in terms of operational burden stemming from removing the existing exemptions under the CRR would have? Please provide relevant evidence to substantiate your views.

The current CRR (article 382.4) provides certain exemptions concerning the scope of the CVA risk capital charges that have been introduced in Europe to fix the shortcomings of the calibration of the CVA framework.

Such exemptions should be maintained as CVA regulation is not adapted to the EU reality, where a majority of banks perform OTC derivatives on behalf of their customers (corporate customers, private customers, etc.) for hedging purposes. These transactions are non-speculative banking services that prove to be crucial for the well-functioning of the "real economy": customers usually initiate with their banks tailor-made foreign exchange transactions to hedge their risk exposures in foreign currencies, or interest rate swaps to hedge their interest rate risk. We are concerned that, in the future, the cost of these hedging OTC transactions becomes prohibitive, thereby hampering the competitiveness of the EU economy. The impact is likely to be the most severe on clients / banks using long term hedging strategies, e.g. pension funds, investment funds, corporate, mortgage banks, banks issuing covered bonds. It is also worth noting that keeping the intra-group exemption is key for some Luxembourg subsidiaries. Where they act as counterparty of the customer for a OTC derivative transaction, they usually cover the risk by performing a transaction of opposite sense with their parent company. As a result, the bank keeps in its books only the residual position, which corresponds to its margin on both transactions.

5.3. PROPORTIONALITY IN THE CVA FRAMEWORK

167) Views are sought on the costs and benefits of the simplified approach provided by the Basel III standards to calculate the own funds requirements for CVA risks. In particular, what would be the impact in terms of RWAs and operational burden? Please provide relevant evidence to substantiate your views.

As a general rule, banks with a simple and limited activity (e.g. in derivatives) should be able to implement simplified approaches in order to avoid undue complexity:

- Complex approaches are costly to implement, and they have no added value when it comes to measure the risk incurred by simple activities;
- Undue complexity is a source of risk for both banks and regulators

168) Would you consider a simple multiplier applied to the own funds requirements for counterparty credit risk to provide an appropriate proxy for determining the own funds requirement for CVA risks of institutions with smaller derivatives portfolios, and if not, what would be a better proxy to measure those risks? Please provide relevant evidence to substantiate your views.

It is key to introduce as such the simplified approach proposed by the Basel III standard. We believe that this simple methodology is proportionate to the limited activity and to the low risk of the derivatives activity of Luxembourg banks. This activity consists of customer-related transactions, where the bank acts as counterparty of the customer for a derivative transaction and covers the risk by performing a transaction of opposite sense with another counterparty, e.g. their parent company. As a result of these "back-to-back" transactions, the bank keeps in its books only the residual position, which corresponds to its margin on both transactions.

The new SA-CVA approach proves to be much more complex than the current methods and it is not adapted to the activity of Luxembourg banks. As a consequence, many banks would have to invest in costly developments without any obvious benefit in terms of prudential requirements: costs would be clearly out of proportion to the associated benefits.

169) Views are sought on the appropriateness of the EUR 100 billion threshold for allowing institutions to use the simplified approach. How would this threshold compare to the eligibility criteria for the use of the existing simplified approach to calculate the own funds requirements for CVA risks under Article 385 of the CRR? How would the EUR 100 billion threshold compare to the eligibility criteria for the use of the simplified methods to calculate the exposure value for counterparty credit risk under Article 273a CRR? Please provide relevant evidence to substantiate your views.

We support replacing the existing approach under article 385 CRR by the simplified approach proposed by the Basel III standard. We believe that the EUR 100 billion threshold is the appropriate metric for the following reasons:

- It is simple and easy-to-use;
- It is stable over time;
- It will ensure comparability and level playing field among EU banks and their competitors of other jurisdictions.

By contrast, applying the restrictive threshold of article 273a CRR is not appropriate in the context of the CVA risk, considering that it will put EU banks at a competitive disadvantage.

5.7. IMPLEMENTATION CHALLENGES AND ADMINISTRATIVE BURDEN

175) Which elements of the revised CVA framework, respectively, IMA, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the expected one-off costs to substantiate your views.

The most challenging and burdensome elements of the revised CVA framework would be:

1. Removing the existing exemptions (CRR art. 382.4) from the scope of application of the CVA

2. Deviating from the Basel III proposed EUR 100 billion threshold for implementing the simplified approach

ANNEX TO THE ABBL RESPONSE

1. ABBL Quantitative Impact Study

The ABBL has launched towards its members a targeted Quantitative Impact Study (the QIS) with the objectives of substantiating the advocacy priorities identified. The Luxembourg National Competent Authority, the CSSF, has provided methodological and operational support to the ABBL, with regards notably to the specification of the templates and the data quality checks. The items tested in the QIS are the following:

- Operational risk
- Credit risk: Standardised Approach
- Credit Value Adjustment (CVA) Risk

The ABBL Secretariat has selected a sample of 27 member banks to ensure fair representativeness in terms of size and business models, i.e. universal banking, custodian banking, private banking, corporate banking, retail banking.

18 banks have participated to the study, which represent (see table below):

- 14% of the whole population of Luxembourg banks
- More than EUR 29 billion in total capital, i.e. 61%
- More than EUR 137 billion of risk weighted exposure amounts (RWAs), i.e. 72%
- An average of 20.9% of CET 1 ratio and 21.3% of total capital ratio, compared to averages for all Luxembourg banks of respectively 23.8% and 25.2%.

	Luxembourg	Participating banks	
		Absolute	Ratio
Number of participating banks	130	18	14%
Total Current Tier 1 Capital *	46,864	27,610	59%
Total Current Common Equity Tier 1 Capital *	45,705	28,769	63%
Total Current Capital *	48,343	29,327	61%
Total Risk Exposure Amount *	192,043	137,703	72%
Average LU participating banks' Tier 1 ratio	24.4%	20.1%	
Average LU participating banks' CET1 ratio	23.8%	20.9%	
Average LU participating banks' capital ratio	25.2%	21.3%	

* Absolute amounts in EUR Million

The detailed report of the QIS will be made available to the Commission by January 17th, 2020, on a confidential basis. For the purpose of the public consultation, we have inserted key elements

of the QIS in the relevant responses and in this annex.

2. QIS: Overall impact of the Basel III standard

The overall impact on banks participating to the QIS is the following:

- Total RWAs: + 5.2%
- Capital ratios: - 5% in relative terms, i.e. -1% in absolute terms

Summary table

Overall impact on participating banks	Current framework	Basel III Framework	Evolution
Number of participating banks	18		
Credit risk SA RWA *	52,018	56,064	7.8%
Operational risk RWA *	6,954	7,261	4.4%
Total RWA of participating banks *	137,703	144,880	5.2%
Total Capital Tier 1 ratio	20.1%	19.1%	-5.0%
Total Capital Common Equity Tier 1 ratio	20.9%	19.9%	
Total Capital ratio	21.3%	20.2%	

* Amounts in EUR Million

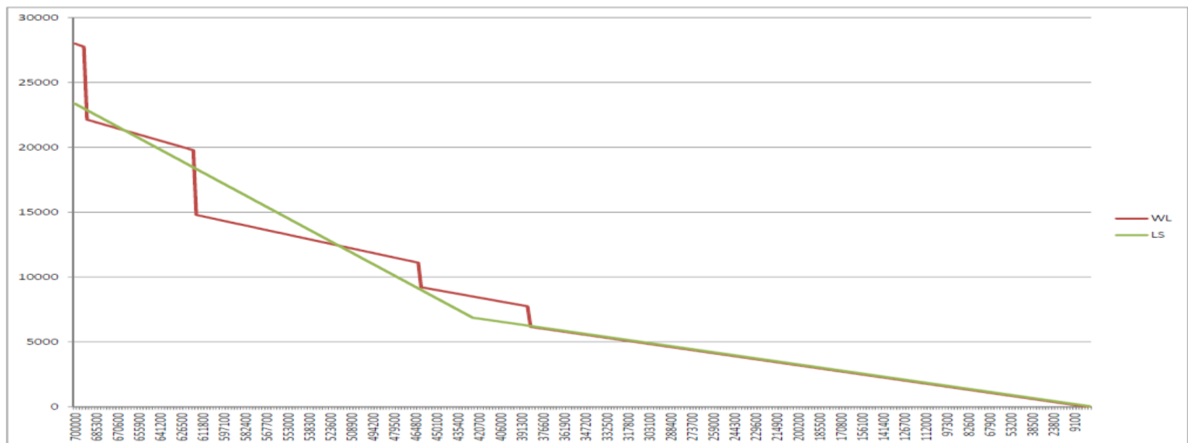
3. QIS: Difference in RW by using the Loan Splitting approach instead of the Whole loan one for General Real Estate exposures.

No significant difference is observed.

	Average RW using the Loan Splitting approach	Average RW using the Whole Loan approach	RW difference between the LS approach and the WL approach
General Residential Real Estate	39%	37%	**2%**
General Commercial Real Estate	76%	77%	**-1%**

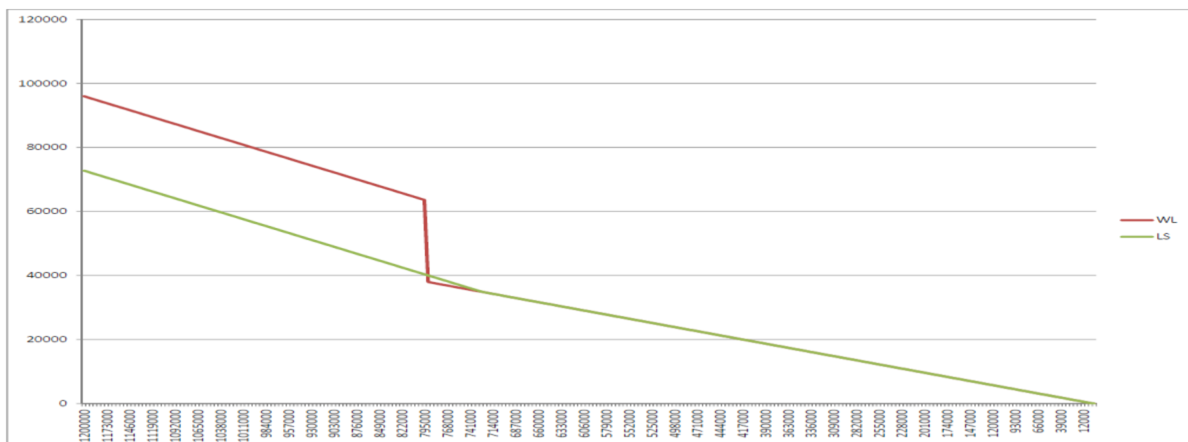
4. WL vs. LS approach: Evolution of capital requirements over the duration of a loan

Figure 1: Evolution of Capital Requirement - Residential Real Estate



Assumptions: Loan 700 000 €; Residential Property Value 770 000 €; Borrower: Natural person (75% RW)

Figure 2: Evolution of Capital Requirement - Commercial Real Estate



Assumptions: Loan 1 200 000 €; Commercial Property Value 1 320 000 €; Borrower: Corporate unrated (100% RW)

5. Supporting factor for safe real estate markets

RW LS based on 55% of the Property	Supporting Factor	Effective RW
20%	0,85	17%
20%	0,8	16%
20%	0,75	15%
20%	0,7	14%
20%	0,65	13%
20%	0,6	12%

6. Proposed refinements to the Loan Splitting Approach

55% collateral haircut for RRE

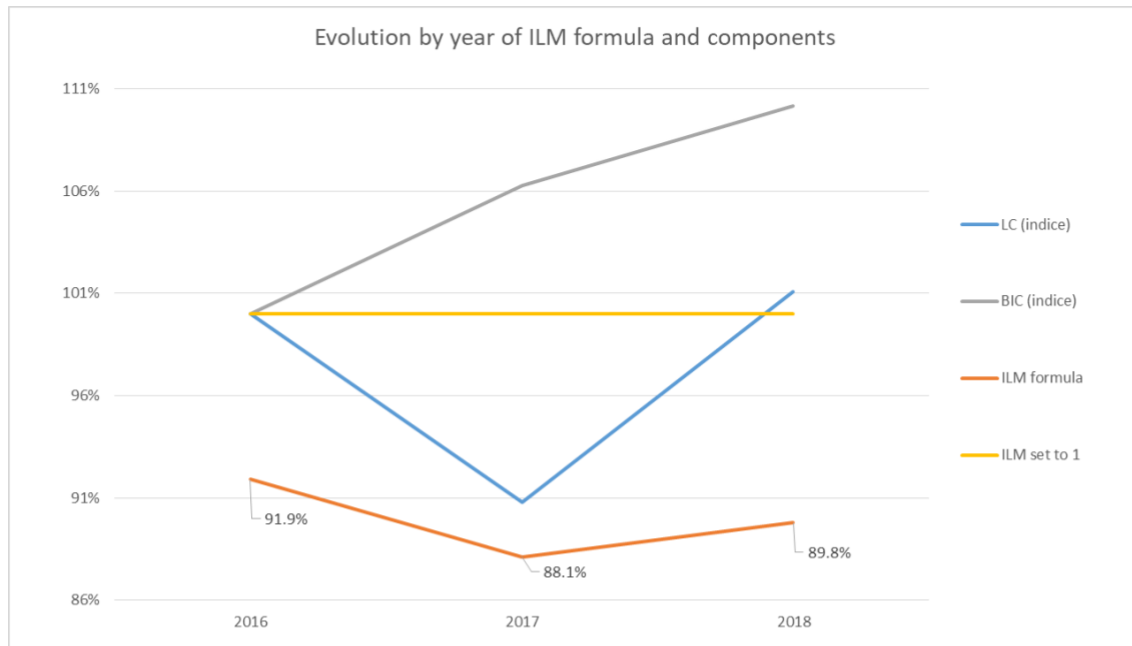
65% collateral Haircut for CRE

		LTV ≤ 50%	50% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LT > 100%
Low risk exposures	SL approach for RRE with supporting factor	20% x Supporting Factor		20% * Supporting Factor (for secured part) + Counterparty RW (for unsecured part)			
	SL approach for CRE with supporting factor	60% x Supporting Factor	60% x Supporting Factor (for secured part) + Counterparty RW (for unsecured part)				
Standard risk exposures	SL approach for RRE	20%		20% (for secured part) + Counterparty RW (for unsecured part)			
	SL approach for CRE	60%	60% (for secured part) + Counterparty RW (for unsecured part)				
Low risk exposures	SL approach for Hard Test IPRRE	20%		20% (for secured part) + Counterparty RW (for unsecured part)			
	SL approach for Hard Test IPCRE	60%	60% (for secured part) + Counterparty RW (for unsecured part)				
Standard risk exposures	SL approach for IPRRE	30%	35%	45%	60%	75%	105%
	SL approach for IPCRE	70%		90%	110%		

7. Proposed refinements to the treatment of ADC exposures

<table>
<tr><td colspan="3"></td><td></td><td colspan="2">55% collateral haircut for RRE</td><td colspan="2">65% collateral Haircut for CRE</td><td colspan="3"></td></tr>
<tr><td colspan="3"></td><td>LTV ≤ 50%</td><td colspan="2">50% < LTV ≤ 60%</td><td colspan="2">60% < LTV ≤ 80%</td><td>80% < LTV ≤ 90%</td><td>90% < LTV ≤ 100%</td><td>LT > 100%</td></tr>
<tr><td rowspan="3">ADC programs by a professionnal real estae developer</td><td colspan="2">Land financing</td><td colspan="8">100 % RW</td></tr>
<tr><td rowspan="2">Develpment and Construction financing</td><td>SL approach for RRE</td><td colspan="4">20%</td><td colspan="4">20% (for secured part) + Counterparty RW (for unsecured part)</td></tr>
<tr><td>SL approach for CRE</td><td colspan="2">60%</td><td colspan="6">60% (for secured part) + Counterparty RW (for unsecured part)</td></tr>
<tr><td rowspan="4">ADC programs by a SPV, a SCI or a Physical Person</td><td rowspan="2">Short term investment</td><td>RRE</td><td colspan="8">150%</td></tr>
<tr><td>CRE</td><td colspan="8">150%</td></tr>
<tr><td rowspan="2">Long term investment</td><td>SL approach for RRE</td><td colspan="4">20%</td><td colspan="4">20% (for secured part) + Counterparty RW (for unsecured part)</td></tr>
<tr><td>SL approach for CRE</td><td colspan="2">60%</td><td colspan="6">60% (for secured part) + Counterparty RW (for unsecured part)</td></tr>
<tr><td colspan="3">ADC programs by a speculative investor</td><td colspan="8">150%</td></tr>
</table>

8. QIS: Evolution of the ILM and of its drivers



9. QIS: Impacts of using the ILM for Bucket 1 banks

Operational risk		Included participating banks
Current framework	RWA *	6,954
Revised framework with ILM = 1	RWA *	7,261
	RWA evolution	4.4%
Revised framework with ILM formula	RWA *	6,030
	RWA evolution	-13.3%

* Absolute amounts in EUR Million