Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

ABBL priorities on the EU Commission Proposal amending the Capital Requirements Regulation

Published: 7 February 2022
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Introduction

In the context of a faithful implementation of Basel III in EU legislation, some clarifications and refinements to a few provisions of the CRR are necessary to ensure that the future prudential approach reflects economic rationales and EU specificities. Also, the Basel III implementation should take due care of the proportionality principle to preserve the diversity of the EU banking sector in terms of size, business models and complexity.

We are keen to provide hereafter our views on the main priorities identified for Luxembourg banks, i.e. the application of the principle of proportionality, the standardized approach for credit risk, CVA risk and operational risk.

Detailed Comments

1. Scrutinizing the EBA mandates for a fair application of the principle of proportionality

As an international financial centre, Luxembourg hosts a great diversity of banks in terms of geographic origin, of business models and of size. The ABBL counts among those players a significant proportion of small/medium sized size banks performing low risk and moderately complex activities, for which the volume and the complexity of financial regulation are extremely onerous and disproportionately costly. Costs are now becoming clearly out of proportion to the associated benefits in terms of financial stability.

In the context of promoting proportionate regulation, the ABBL is concerned that the proposed banking package (i.e. the CRR + the CRD) includes **68 new mandates granted to the EBA** for elaborating:

- 14 Guidelines
- 43 Regulatory and Implementing Technical Standards
- 11 reports

While some mandates make sense, many others are questionable because:

- They would bring limited added value to the provisions existing in the CRR/CRD
- Given their importance, the related provisions of the CRR/CRD should be subject to the democratic co-decision process and set out in Level 1 texts.

It is obvious that this additional layer of secondary legislation will add significant complexity to the single rulebook and will go against the principle of proportionality. Therefore, the ABBL calls the European lawmakers to perform **a critical review of the mandates** with a view to limiting them to the essential.

The ABBL keeps thinking that **enhancing proportionality and reducing complexity is mutually beneficial for banks and for banking supervisors**, by promoting more supervisory judgement and a better dialogue

2. Standardised approach for credit risk: real estate financing

2.1 The requirements for residential properties under construction should be refined

Article 124.3 (a) (iii) of the proposal lists the conditions that residential properties under construction must meet to be eligible to the general treatment set out in Article 125.1, i.e. the general treatment. Where such conditions are not met, then the exposures are assimilated to Income Producing Real Estate (IPRE) and they would follow the treatment of Article 125.2, which is less favorable.

2.1.1 Criterion of four residential units

The first condition of Article 124.3 (a) (iii) is that "***the property does not have more than four residential housing units** and will be the primary residence of the obligor and the lending to the individual is not indirectly financing ADC exposures;* "

We understand this condition as limiting to four residential units the size of the property under construction, meaning that only small properties would become eligible to the general treatment of Article 125.1. Such a restrictive interpretation would unduly distort the housing market by discriminating larger residential housing projects, at a time where pressures on prices are exacerbated. Prudential regulation should not penalise residential 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.

Referring to the text of the Basel III standard in p. 18, § 60 (i) "*the property is a one-to-four family residential housing unit that will be the primary residence of the borrower*", the criterion might also be understood as a limit applied to the borrower. In this case, a maximum number of **four residential units per borrower** could be eligible to the general treatment of Article 125.1. There is no doubt that this interpretation would make more sense from an economical and prudential point of view.

Against this background, we urge lawmakers to **clarify the meaning of the criterion of four residential units.**

2.1.2 Clarifying the legal mechanism ensuring the termination of the construction

The second condition of Article 124.3 (a) (iii) is that "*a central government, regional government or local authority or a public sector entity, exposures to which are treated in accordance with Articles 115(2) and 116(4), respectively**, has the legal powers and ability to ensure that the property under construction will be finished** within a reasonable time frame …."*

We welcome this mechanism, which aims at protecting buyers from the risk that the construction will not be completed in due time. Nevertheless, we observe that the wording used is somewhat specific and **does not clearly recognize the market practice where a bank issues "completion guarantees"** applicable in the case of "sale before completion contracts" ("garanties d'achèvement" applicables aux ventes en futur état d'achèvement). Completion guarantees are a legal mechanism ensuring that the property under construction will be finished, should the real estate promoter face bankruptcy. In Luxembourg, completion guarantees are mostly, but not solely, issued by banks.

Therefore, we call for broadening the provisions of Article 124.3 (a) (iii) to properly recognize completion guarantees, rather than limiting the mechanism to the "legal powers and ability of the central government [..]".

2.2 Land acquisition, development and construction (ADC) exposures: Recognizing bank financing as a risk mitigant for the 100% Risk Weight

Article 126a.2 (a) of the proposal allows for the application of a preferential Risk Weight of 100% to ADC exposures where, among others, the following condition is fulfilled:

"legally binding pre-sale or pre-lease contracts, for which the purchaser or tenant has made a substantial cash deposit which is subject to forfeiture if the contract is terminated, amount to a significant portion of total contracts"

The requirement of ***substantial cash deposits which is subject to forfeiture if the contract is terminated*** needs to be refined to fit reality. In most cases, purchasers of a house or of an apartment under construction finance a significant part of their acquisition by contracting a mortgage loan to a bank. The mortgage loan is duly registered by a notary together with the deed of purchase.

Therefore, we suggest inserting in Article 126a.2 (a). the situation where the purchaser has ensured bank financing.

3. CVA risk: raising the threshold for using the simplified approach to introduce proportionality

The Credit Valuation Adjustment is a change to the market value of derivative instruments to account for counterparty credit risk. It depends on counterparty credit spreads as well as on the market risk factors that drive derivatives' values and, therefore, exposures.

We welcome that the Commission proposal keeps the existing exemptions from the CVA risk capital requirements for transactions with non-financial counterparties, intra-group transactions, etc. However, banks will have to report to their competent authorities the results of the calculation of the capital requirements for CVA risk for the transactions exempted.

Against this background, the threshold in **Articles 385 and 273a(2) CRR** (i.e. where the bank's derivatives business is below 5% total assets and EUR 100 million) for using the simplified approach is too restrictive and would entail increased complexity for smaller banks with a limited activity in derivatives. **This would go against the principle of proportionality**. Therefore, we suggest using the threshold of **Article 273a(1)**, i.e. **where the bank's derivatives business is below 10% total assets and EUR 300 million.**

4. Operational risk

4.1 Making the calculation of capital requirements for operational risk more risk-sensitive

As a reminder, the Basel III formula for the standardised approach is:

*Operational risk capital requirement = Business Indicator Component * Internal Loss Multiplier*

In the proposal, the EU Commission has decided to exercise one discretion granted by the Basel III standard and to neutralize the Internal Loss Multiplier (hereafter **the ILM)** for all banks. By doing so, the proposal **disregards historical operational losses**, given that the ILM is a function of the average annual operational risk losses incurred over the previous 10 years.

Therefore: *Operational risk capital requirement = Business Indicator Component*

Such an approach, while having the merits of simplicity, nevertheless **removes any risk sensitivity** in the calculation of capital requirements and penalizes the banks that experience a good track record of historical operational losses. For the latter, the ILM is indeed comprised between 0,5 and 1 thus reducing the capital requirements.

in order to establish a robust connection between capital requirements and sound management of operational risk, we propose implementing in the CRR the possibility to use the ILM for banks pertaining to the **bucket 1** (**those with a Business Indicator up to EUR 1 billion**), which is foreseen in p. 130, § 12 of the Basel III standard, i.e.:

"12. At national discretion, supervisors may allow the inclusion of internal loss data into the framework for banks in bucket 1, subject to meeting the loss data collection requirements specified in paragraphs 19 to 31. "

To do so, **banks of the bucket 1 should have the discretion to use the ILM** provided they abide by the requirements for the loss data set (Article 317 of the proposal) and by the calculation of the annual operational risk loss (Articles 318 to 321 of the proposal). The use of the discretion should be notified to the competent authority.

4.2 Proportionality: removing the EBA mandate specifying the principles governing the operational risk framework

We believe that **the principles** governing the operational risk framework set out in Article 323.1 are **sufficiently clear and detailed** to ensure proper implementation of the requirement. Therefore, the proposed mandate granted to EBA in Article 323.2 for specifying these principles is superfluous as it would induce disproportionate complexity.