

Feedback on the European Commission's Communication on the Competitiveness of the Banking Sector and the Single Market in Banking

Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken, vdp)

General Comments

We welcome the Communication, as it correctly identifies weaknesses in the existing regulatory framework. However, the Communication remains relatively general in outlining problem areas and possible courses of action and thus falls short of developing the concrete solutions that would have been desirable.

To achieve tangible improvements within a reasonable timeframe, we advocate a two-stage legislative approach. This would avoid the contentious issues of the Banking Union delaying negotiations of EU specificities and complexities.

In the aftermath of the global financial crisis, regulatory requirements have been continuously expanded for almost two decades. Strengthening financial stability was important. The current level of stability is generally considered adequate. It is therefore important to avoid the additional increases in capital requirements already scheduled to take effect by the beginning of 2033 and to reduce complexity in the EU prudential framework that are not necessary to safeguard financial stability.

This would ensure that banks continue to have sufficient capital available to finance the substantial investment needs associated with the transformation, digitalisation and resilience of the real economy. Improved competitiveness would also enable European banks to narrow the profitability gap with international peers and remain attractive to investors when seeking funding.

However, the further increase in capital requirements through to 2033 is not addressed. The Communication merely announces a review of the output floor for banks using internal models such as the IRB Approach. Under regulatory changes already adopted, German banks particularly affected by the output floor face an increase in capital requirements of around 20%. Permanently fixing the output floor at its initial level of 50% would be a minimally invasive yet sufficiently effective measure. It would also support financial stability by allowing banks with exceptionally low model-based capital requirements to be addressed in a targeted manner, rather than affecting the majority of IRB banks.

In addition, we propose the following specific measures to increase risk sensitivity and/or reduce complexity:

- For real estate financing under the Standardised Approach, greater risk sensitivity could be achieved by introducing additional risk-weight categories for lower and higher loan-to-value (LTV) ratios.
- Under the Foundation IRB, graduated recognition of income-producing real estate (IPRE) as collateral could also be introduced where the "hard test" demonstrating low loss rates is not met or the necessary information is unavailable, applying graduated LGDs from 20% to 40% depending on the LTV ratio.
- For ADC exposures, the definition could be narrowed in a more risk-sensitive manner. The reduced ADC risk weight for residential real estate could be extended to commercial real estate where additional criteria, such as pre-sales/pre-leases or a sufficient equity contribution, are met.
- The systemic risk buffer should be abolished rather than merged with the countercyclical capital buffer, as it goes beyond the Basel III requirements.
- Residential mortgage lending is frequently funded through covered bonds, which have proven their reliability, particularly in times of crisis. As part of the review of the securitisation framework, minimum risk weights for low-risk securitisation tranches are being reduced. Without a corresponding adjustment for high-quality covered bonds, this would create an unwarranted regulatory disadvantage and could

increase mortgage funding costs being an additional burden on Europe's already strained housing market. The risk weight for covered bonds in the highest credit quality step should therefore be reduced to the level of the minimum risk weights applicable to securitisations.

Specific Comments to the proposed measures

3. *A way forward for the EU banking sector*

The European Commission intends not only to propose measures addressing specific challenges but to take a comprehensive approach. However, combining targeted prudential reforms with more complex structural and institutional issues in a single legislative package is likely to result in significant delays, given the diverging views among stakeholders in many areas.

We therefore advocate a two-stage legislative approach. In a first step, the European Commission should address sufficiently mature measures to improve the competitiveness of the EU banking sector, in particular targeted adjustments to the prudential regulatory framework and simplification measures. These measures should not be delayed by negotiations on more controversial structural and institutional reforms.

In a second step, more complex issues concerning the further development of the Banking Union should be addressed separately and with the time required to reach a sustainable political consensus.

3.1 *Fostering integration with appropriate safeguards*

➤ *Addressing prudential barriers to integration*

- *Measures to allow cross-border groups to enhance efficiency in the allocation of capital and liquidity*

Measures to enable a more efficient allocation of capital and liquidity within banking groups are important. However, the broadly worded link to appropriate safeguards for creditors and depositors could lead to lengthy negotiations. The focus should therefore be on measures that can be implemented swiftly.

- *Measures to apply a similar regulatory treatment of intragroup exposures at both domestic and EU levels*

Such measures should be supported.

- *Measures to address the risk of excessive concentration of sovereign exposures (bank-sovereign nexus)*

Measures to reduce the bank-sovereign nexus have failed to achieve consensus in the EU in the past. Therefore, this issue should not be given priority alongside other important measures.

- *New draft merger guidelines*

No comments.

➤ *Providing appropriate safeguards*

- *EDIS*

No comments.

- *Measures to improve the predictability of group resolution strategies*

No comments.

- *Strengthen backstop funding mechanisms for the provision of liquidity in resolution*

Irrespective of the resolution tool chosen outside ordinary insolvency proceedings, access to liquidity is likely to be the greatest challenge for an institution in resolution, as direct access to capital markets will in most cases be unavailable, at least immediately following the resolution action, or would entail prohibitive costs. Consequently, any attempt to keep a bank or parts of a bank operating could fail simply due to a temporary lack of liquidity.

It is therefore unsurprising that, for example, in the UK the Bank of England can provide liquidity directly to an institution in resolution, while in the US the FDIC performs a comparable role through its funding mechanisms. The EU, however, lacks a comparable liquidity provider. Against this background, there is an urgent need for a Liquidity in Resolution Facility, which in the euro area should be established at the ECB.

Such a short-term liquidity bridge should also be available to a covered bond bank with limited business activity following the insolvency of the issuer. The purpose of such an entity is to ensure the timely and full payment of outstanding covered bonds even after the issuer has become insolvent. While credit quality should generally not be a concern, a temporary liquidity shortfall represents the greatest risk in this context as well, despite the various statutory safeguards in place to address liquidity risk.

- *Addressing non-prudential barriers to integration*

The European Commission intends to further harmonise insolvency law. The vdp will comment on the individual proposals in a separate position paper together with the leading German banking-sector associations of The German Banking Industry Committee (GBIC).

As this issue has been subject to controversial debate for many years and no timely solutions currently appear to be in sight, we suggest that it should not be addressed as part of this competitiveness package.

- *Anti-money laundering*

No comments.

- *Consumer protection rules*

No comments.

- *Digitalisation and IT implications*

No comments.

3.2 *Implementing international standards while taking account of EU specificities and ensuring proportionality*

- *Implementation of international standards taking account of EU specificities*

- *Make clear proposals regarding the **output floor** and its transitional arrangements on unrated corporates and mortgage lending on the competitiveness of EU banks, as well as its interaction with the other parts of the framework, including measures to properly balance resilience and the broader financing of the economy.*

For German banks affected by the output floor, a significant increase in capital requirements of around 20% is expected by the beginning of 2033. Low-risk business models, such as first-lien real estate financing, are particularly affected by the output floor. Although the output floor forms part of the international Basel III framework, it has either not been implemented or has been implemented inconsistently across jurisdictions. An EU-specific approach is therefore urgently needed, particularly in the EU, where bank-based financing plays an especially important role.

During the Basel III negotiations, the European Commission had good reason to advocate regulatory strengthening of internal models rather than an output or capital floor. The measures taken in the EU to strengthen and ensure the robustness of internal models are unparalleled worldwide, including the EBA's IRB repair programme and benchmarking exercises as well as the ECB's Targeted Review of Internal Models (TRIM).

From a risk perspective, the output floor is therefore not necessary in the EU. However, in order to take account of both the international Basel III framework and EU-specific requirements, the output floor should be permanently set at its initial level of 50%. This would be straightforward to implement in the legislative text, thereby contributing to simplification, while remaining sufficiently effective. It would also support financial stability by allowing potential outlier banks to be addressed in a targeted manner, rather than affecting the majority of banks using internal models. This would also ensure an appropriate balance between the rules applicable to banks using the IRB Approach and those using the Standardised Approach for credit risk. In particular, larger banks frequently use the Standardised Approach for portfolios exhibiting higher levels of risk.

If this straightforward approach is not pursued, a range of other measures would be necessary to prevent significant increases in capital requirements. For example, the two transitional arrangements for low-risk exposures to unrated corporates and low-risk residential mortgage lending could be made permanent. However, these two measures alone would not be sufficient to prevent significant increases in capital requirements by 2033 and, unlike simply maintaining the output floor at 50%, this option would add further complexity.

Further measures relating to real estate financing under the Standardised Approach for credit risk could include increasing risk sensitivity by introducing additional risk-weight categories for lower and higher loan-to-value (LTV) ratios. For ADC exposures (land acquisition, development and construction of real estate), the definition should be narrowed on a risk-sensitive basis to income-producing real estate (IPRE), as the lower risks associated with non-IPRE exposures do not justify risk weights comparable to those for defaulted exposures. Energy-efficiency renovations should also be excluded from the scope of ADC exposures. Furthermore, the reduced ADC risk weight for residential real estate should likewise be extended to commercial real estate where the additional criteria, such as pre-sales/pre-leases or an adequate equity contribution by the obligor, are met.

Irrespective of these measures, a structural flaw in the treatment of real estate financing under the Foundation IRB Approach should be addressed. Under both the Standardised Approach and the Advanced IRB Approach, IPRE can be recognised even where the so-called "hard test", demonstrating low loss rates, is not met or the necessary information for the "hard test" is unavailable. Accordingly, the Foundation IRB Approach should provide for a graduated recognition of IPRE as collateral. This could be achieved by prescribing differentiated LGDs between 20% and 40% depending on the loan-to-value (LTV) ratio – for example, an LGD of 25% for LTVs below 60%, 30% for LTVs between 60% and 80%, and 35% for LTVs above 80%.

In the context of real estate financing, it should also be taken into account that such lending is frequently funded through covered bonds. Covered bonds are a long-established funding instrument and have proven their reliability, particularly in times of crisis. As part of the welcome review of the securitisation framework, minimum risk weights for low-risk securitisation tranches are being reduced. Without a corresponding adjustment for high-quality covered bonds, there is a risk of creating an unwarranted regulatory disadvantage for covered bonds. A resulting decline in demand for covered bonds could increase the cost of real estate financing and place an additional burden on Europe's already strained housing market. The risk weight for covered bonds in the highest credit quality step should therefore be reduced to the level of the minimum risk weights applicable to securitisations.

In addition, the large exposure exemption for covered bonds, together with the other existing large exposure exemptions, should be retained beyond 2028 (Article 400(2) and Article 493(3) CRR). However, its application should no longer be left to the discretion of competent authorities or Member States but should instead be converted into an option available at institution level. This would reduce complexity and uncertainty surrounding the requirements and strengthen the prudential framework. Institutions could then decide individually whether and which exemptions to apply, thereby determining for themselves the degree of complexity they wish to assume. This is because exposures with similar risk should, for consistency, also be assigned a similar risk weight.

- *Continue to monitor the implementation of international standards across jurisdictions and implement a long-term, strategic, EU approach to **market-risk** capital requirements, based on the experience gathered and on level playing field considerations.*

The fundamental review of the trading book (FRTB) that revised the market risk framework has now been incorporated into the CRR and will become fully applicable from the beginning of 2027, subject to a limited number of transitional arrangements for the three-year period from 2027 to 2029. Its application had previously been postponed twice, in 2025 and 2026, in particular to take account of delays in implementation in other major jurisdictions, notably the US and the UK.

Against this background, there does not appear to be a clear long-term strategy for the application of the market risk framework in the EU. Instead, the regulatory approach is currently based solely on the limited mandate provided by Article 461a CRR. This legal basis is insufficient, inter alia because of its temporary nature.

If such a strategy for the period from 2030 onwards has not yet been developed, this should be addressed as soon as possible, in close consultation with the industry and taking into account developments in the jurisdictions referred to above. In particular, there should be a comprehensive dialogue with the industry to identify the reasons why the Internal Models Approach currently appears to be relatively unattractive. This may also require more substantial revisions to the applicable requirements.

- *Evaluate the regulatory treatment of strategic investments through **specialised lending**, including project finance for infrastructures and the energy transition, as well as the regulatory treatment of trade finance with a view to ensuring that European banks can support European companies and strengthen supply-chain security.*

It is welcome that the prudential treatment of trade finance and specialised lending is to be subject to an in-depth review, including an assessment of its impact on project and infrastructure finance. However, the review should explicitly include object finance, in particular ship and aircraft financing, which also plays an important role in financing the European real economy.

- *Propose a revision of the prudential treatment of banks' investments in **software** assets to ensure that the framework is prudentially sound, consistent with the digital and cyber-risk environment and that it provides the correct incentives for banks to invest in innovation and digital resilience.*

We welcome the announced review of the regulatory treatment of software. Instead of deducting software assets from capital, we propose treating them in the same way as other assets (risk weighting).

- *Ensure access to lending for IP-intensive companies*

No comments.

- *Remuneration framework for material-risk takers*

No comments.

➤ *Ensuring proportionality in the regulatory framework*

- *Propose a regime in CRR that allows **small and less complex banks** to be more clearly identified within the regulatory framework, regardless of their legal and organisational structure, possibly adjusting current criteria and thresholds to reflect the reality of the EU banking sector, with less, adapted and simpler requirements in the relevant frameworks for the prudential, macroprudential and resolution dimensions. Such a regime should also enable the EBA to work on Level 2 and Level 3 measures in a way that caters more effectively for small and less complex banks, with a reduced number of requirements and processes.*

From the perspective of competitiveness and the proportionality of prudential requirements, it is necessary to reduce the regulatory burden for small and less complex banks across all levels of banking regulation, i.e. Levels 1 to 3, while maintaining the current level of financial stability. No simplifications should apply at the customer interface in order to avoid competitive distortions.

The current framework for small and non-complex institutions under the CRR should be significantly broadened with regard to the total-assets threshold, at least for EU Member States such as Germany. Relevant benchmarks for such an increase could be the asset thresholds applied in other jurisdictions, such as Switzerland (approximately EUR 18 billion) or the UK (approximately EUR 23 billion).

- *In the context of completing the Banking Union, the Commission will continue its dialogue with the SSM and SRB on the efficient application of proportionality, including in relation to the particular circumstances that justify the qualification of credit institutions as being less significant, despite meeting the default **significance criteria** in the SSM Regulation.*

The criteria for classifying an institution in the euro area as significant and thus subjecting it to the direct supervision of ECB Banking Supervision, should be revised. First, the EUR 30 billion total-assets threshold, which was set more than a decade ago, has become far too low due to inflation and economic growth. A substantial increase to at least EUR 60 billion would therefore be appropriate.

Second, a purely size-based criterion is not appropriate for institutions with simple business models. For such institutions, the national competent authority should remain responsible for supervision even above the revised total-assets threshold, provided that no material foreign subsidiaries are included in the consolidated financial statements

3.3 *Simplifying the regulatory framework*

➤ *Microprudential rules*

The European Commission points to the extensive framework of Pillar 1 minimum capital requirements as well as supervisory Pillar 2 requirements and guidance, in each case with regard to both risk-based (RWA) and non-risk-based (leverage ratio) measures. However, the two measures referred to in the Communication concerning Pillar 2 guidance and Pillar 2 requirements related to the leverage ratio, as well as the reference to the ECB's measures on Pillar 2, remain insufficient.

The European Commission should examine how the ICAAP can once again be strengthened as an institution-specific risk management tool. Institutions should be given greater methodological flexibility in designing their ICAAP, including stress testing, while detailed supervisory requirements and expectations regarding the supervisory assessment of the ICAAP should be reduced accordingly. This would strengthen institutions' own responsibility and enhance the relevance of the ICAAP as a key risk management tool. Such an approach would also go hand in hand with the cultural shift advocated by the European Commission, away from a zero-risk mentality towards a risk-based regulatory and supervisory framework.

The Commission Staff Working Document also addresses the NPL framework, with particular reference to the NPL backstop as well as the CRR definition of default together with the relevant EBA Guidelines.

With regard to the NPL backstop, it should be emphasised that it constitutes gold-plating compared with the Basel framework. Moreover, the accounting requirements under IFRS 9 and the German Commercial Code (HGB/German GAAP) already provide a comprehensive framework for loan-loss provisioning. The additional capital deductions under the NPL backstop should therefore be abolished.

With regard to the definition of default, it should be emphasised that any material change would entail substantial implementation costs for IRB banks and supervisory authorities, as changes to internal models would subsequently require the approval by the competent authority. Changes to the definition of default should therefore be avoided. At the same time, it should be clarified that collective moratoria do not constitute a default.

- *Propose measures to enhance the functioning of **Pillar 2 guidance** to ensure its targeted application.*

The clarification that Pillar 2 Guidance (P2G) does not constitute a binding capital requirement is welcome. However, this will not provide greater flexibility as long as P2G continues to be perceived in practice as a strong supervisory expectation.

The P2G ratio is currently derived from the results of supervisory stress tests. These stress tests impose a very significant burden on both institutions and supervisory authorities.

- *Propose to remove **Pillar 2 capital requirements** related to the leverage ratio.*

We do not consider the leverage ratio to be an appropriate prudential instrument, either under Pillar 1 or Pillar 2. In particular, it constrains low-risk business models, such as residential mortgage lending to private individuals, and creates incentives to engage in higher-risk activities, as these allow higher margins to be generated with the same amount of capital.

Against this background, the abolition of the Pillar 2 requirement to hold an additional capital add-on (LR-P2R) on top of the 3% leverage ratio requirement is welcome. However, only a very small number of large institutions will benefit from this change – for example, only two German banks.

In addition, the possibility of imposing additional Pillar 2 Guidance in relation to the leverage ratio (LR-P2G) should also be abolished.

➤ *Resolution rules*

- *Revise the MREL framework*

It is welcome that the European Commission acknowledges the excessive complexity of the resolution framework and intends to align it more closely with the international TLAC standard. In this context, it is important that small and medium-sized institutions generally remain outside the scope of the resolution framework and that ordinary insolvency proceedings continue to be available as an appropriate mechanism.

- *Propose a streamlined process for granting permissions of buybacks / liability management*

The prior permission regime should be simplified in line with the European Commission's proposal and, consistent with the international TLAC standard, should apply only where there is a reasonable likelihood that the MREL requirements may no longer be met in the future.

- *Resolution planning*

No Comments.

➤ *Macroprudential rules*

- *Propose to revise the macroprudential framework to ensure a simpler toolbox and greater convergence and consistency in the application of macroprudential tools across the EU. More specifically, the number of buffers (countercyclical buffer, systemic risk buffer) should be reduced and their design and calibration improved. The framework for other systemically important institutions (O-SII) should be harmonised by addressing shortcomings in the O-SII identification and buffer calibration.*

The proposal to simplify the macroprudential capital buffers should be supported. The systemic risk buffer, which goes beyond the international Basel requirements, should be abolished rather than merged with the countercyclical capital buffer for the sole purpose of reducing the number of buffers. Furthermore, the review of the macroprudential framework should not be used as an opportunity to implement the frequently criticised concept of a positive neutral countercyclical capital buffer.

The review of the O-SII buffer is also welcome. The objective should be to ensure a harmonised design of the O-SII buffer that is proportionate to the buffer for global systemically important institutions (G-SII buffer). The O-SII buffer is currently implemented across European countries on the basis of national methodologies and therefore varies considerably between Member States. The same institution may be subject to a different buffer in Germany than in another EU Member State – a situation that is inconsistent with the objective of a harmonised Single Market. Moreover, the O-SII buffer may exceed the buffer applicable to global systemically important institutions. The O-SII buffer should therefore be capped at 1% of risk-weighted assets. The minimum level of the G-SII buffer would thus constitute the maximum level of the O-SII buffer, which would appropriately reflect the relative systemic importance of an O-SII.

In practice, capital buffers introduced during periods of favourable economic conditions – whether systemic risk buffers or countercyclical capital buffers – are often not reduced when economic conditions deteriorate, as has been the case in recent years. National authorities have discretionary powers and, for prudential reasons, may be reluctant to reduce capital levels once they have been built up. To address this issue and ensure that capital buffers are genuinely usable as intended, legislative measures should limit the discretion available to national authorities.

➤ *Interaction among microprudential, resolution and macroprudential rules*

- *Propose stronger coordination mechanisms between authorities*

The European Commission acknowledges that resolution requirements, in combination with micro- and macroprudential capital requirements, may result in the same risks being covered more than once. Concrete provisions are needed to prevent such unintended consequences. Stronger coordination mechanisms between the competent authorities are an important step in the right direction, but they are not sufficient.

To achieve a meaningful reduction in the complexity of the prudential framework and avoid overlaps, the complex fragmentation of responsibilities among different authorities should be addressed, with overall responsibility for an institution consolidated within a single appropriate authority.

- *Strengthen impact assessments and enhance accountability/control mechanisms*

Strengthening the requirements for impact assessments and improving accountability and oversight mechanisms would be important steps. However, their effectiveness will largely depend on the specific design and implementation of these measures.

- *Move microprudential, resolution and macroprudential rules into directly applicable regulations*

A generalised approach of transferring requirements into directly applicable regulations should be viewed critically, as this may not sufficiently take into account the specific characteristics of national markets. Where requirements are instead laid down in directives, an appropriate balance can be struck between common European standards and national flexibility. This allows European requirements to be integrated coherently into national prudential frameworks. A case-by-case assessment is therefore necessary.

➤ *Streamlining reporting and disclosure requirements*

The European Commission's clear commitment to more integrated reporting across the areas of supervision, statistics and resolution is welcome. The further initiatives still to be developed – including greater proportionality, materiality thresholds and simplified data sharing between authorities – are also important.

Frequent changes to reporting requirements should be avoided, and sufficiently long implementation periods of preferably two years must be provided, which has often not been the case in the past. The Commission's request to the EBA to provide greater transparency regarding the links between reporting requirements and their underlying legal bases is also welcome.

4. *Competitiveness as a shared responsibility*

The European Commission calls for a welcome cultural shift away from a zero-risk mentality towards a risk-based regulatory framework and risk-based supervision. This approach should also be reflected concretely in Level 1 and Level 2 legislation. The European Commission should also take appropriate measures to ensure that this cultural shift is implemented at Level 3 and in supervisory practice.

The Communication rightly calls for a clearer distinction between binding regulatory requirements and non-binding supervisory guidance. At present, however, supervisory guidance clearly has a binding effect in practice and thus de facto goes beyond the regulatory requirements (e.g. EBA Guidelines and ECB Guides). The European Commission should take measures to effectively prevent this. For example, introducing competitiveness as a secondary objective for the EBA and the competent supervisory authorities in the relevant legislation could be an appropriate measure.