EBF_046508

Brussels, 31 May 2024

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Subject: Enhancing the financing capacity of a resilient European banking sector by an increasing dialogue

[redacted],

Seventy years after its inception, the European project has been a clear success, for decades delivering safety, peace, prosperity, and democratic accountability. The complexity and ambition of this project was remarkable, with Member States ceding a meaningful part of their national sovereignty in the name of European integration.

However, over recent years we have seen that further integration in key areas has become more challenging, which, in turn, does not support the creation of truly liquid and deep European markets on the one hand and stronger cross-border banks in the EU on the other hand. Consequently, Europe has not been able to scale up its economy across sectors, including defense, and therefore has lost its competitive edge globally.

In many key industries, European companies and their offerings to European citizens are lagging behind their global competitors: new technologies, telecommunications, energy, defense, and financial services are all suffering a competitiveness drag.

This loss of competitiveness hampers European economic output. It also has the potential to undermine Europe's Open Strategic Autonomy, i.e. the EU's capacity to make its own choices and to embed resilience in key sectors of the economy. Ultimately, a less competitive European economy could hamper the dual transition to sustainability and digitalisation.

European banks consider the complex, risk averse and fragmented regulatory and supervisory environment as a key reason behind this loss of competitiveness. At this pivotal moment in history, to continue delivering on the pursuit of economic development, the objective set by the founding fathers, the European project needs to evolve with a clear focus on competitiveness.

The EU lacks deep capital markets – currently only 10% of global market share - and EU firms still receive 70-80% of their financing via the banking sector. So, the European banking sector is of strategic importance in stimulating Europe's economic development, as well as keeping the wider European industry and economy internationally competitive. This has already been recognised by the European Commission in its communication on Open Strategic Autonomy for financial services. Especially, it highlighted that Europe was in danger of overreliance on non-bank financial institutions, notably those from outside the EU, which could create problems in times of financial market disruption. The market share of EU investment banks has been falling over the last 15 years, both globally and in the EU. In times of financial crisis, non-EU banks may choose to reduce their presence in the EU and to focus on their domestic markets. This could hamper the access of EU companies and Member States to capital-market funding, risk management solutions or other financial services, and could compromise the liquidity or even solvency of EU financial counterparties[1]. And specifically, the larger, cross-border European banks are those most confronted by these constraints; constraints that internationally active US banks do not face.

Improvements can be made in four key areas concerning regulation and supervision, to improve European competitiveness and allow European banks to step up, without reducing their resilience:

1) Removing undue conservatism in the regulatory framework, thanks to increased resilience of the banking sector;
2) avoiding the cycle of continuous policymaking via Level 2 mandates, especially when this leads to gold-plating political agreements;
3) eliminating additional conservatism via supervisory reviews; and
4) simplifying and speeding up rule making, to improve the capacity of the banking sector to finance European industry.

1) Undue conservatism in the regulatory framework can be eliminated thanks to increased resilience of the banking sector

Since 2014 European banks have built up additional € 360 bn in going concern capital (more than 300 bps of aggregated CET1 ratio). In addition, they have put in place recovery and resolution plans, added gone-concern loss-absorption capacity (MREL/TLAC). The increase of capital and liquidity ratios has been significantly bigger in Europe than in other global regions, in addition to a thorough implementation of Pillar 2 governance and risk controls that has been instrumental to the strength of the EU banking system in the face of the 2023 bank crises.

All these achievements are deemed by supervisory and regulatory authorities, including the ECB and the SRB, to have increased resilience. The industry successfully clears stress tests and real-life stress events, supported by this framework that European policymakers put in place during the regulatory reform. It has also successfully faced the more recent crisis. The challenge will now be how to adapt this framework for the new geopolitical reality, in particular by steering toward increasing European growth and resilience of the wider European economy longer term as highlighted by Mr Letta in his report.

The implementation of the Final Basel III in the EU (via CRR III) will add further resilience and capital to the EU banking sector, as it increases the capital the banking system must hold to support their activities.

This increased resilience should give policymakers comfort that conservatism put in place over the years, can be eliminated and improve the sector's competitiveness. This can be done via a European Commission proposal for targeted amendments to the Level 1 regulatory framework (see Annex 1):

I. Short term action: The Commission should act now, i.e. in H1 2024 on matters like Market Risk and liquidity requirements (NSFR), to avoid an uneven playing field – It has the legal power and the justification to do it.

[1] Communication from the Commission (COM (2021)32) on the European economic and financial system: fostering openness, strength and resilience

i. Specifically on Market Risk (FRTB): Notably, the UK has already announced that it only aims to implement FRTB as of July 2025, and US Agencies consulted in 2023/2024 with a plan to implement FRTB in July 2025. In May 2024, the heads of the leading US Agencies have committed in front of Congress to issue final rules by the autumn of 2024. The US application date of the Basel Endgame, which will include FRTB, is hence not known, but it is inconceivable that it would be earlier than what was already consulted on. Consequently, European banks are already operating in an uneven playing field.

ii. Ask: provide a delay in the EU implementation of FRTB of 2 years in order to maintain a level playing field with the US and the UK. European banks with less complex or less significant trading activities should be allowed to opt-in to FRTB at the originally agreed application date of January 2025

II. Medium term action: The Commission should start preparation, so that as soon as the new Commission is in place, it can present an omnibus package with regulatory measures that will provide more financing power of EU banks. The package should cover:

i. A revision of the entire securitization framework, including necessary improvements to the prudential treatment for securitisations, in the context of the Capital Markets Union (CMU) and in line with the European Council summit conclusions (17-18 April 2024). These revisions should be put forward to the co-legislators via the so called fast-track procedure.

ii. Proposal for harmonisation of the EU macroprudential framework, in line with the European Commission report (January 2024) to ensure capital buffers are usable and that there is no duplication in the coverage of risks within the various macroprudential tools and with the microprudential framework in place. The revision should not increase capital requirements.

iii. Defer the otherwise perpetual contributions by banks to the Single Resolution Fund (SRF), which now has € 78 bn that sits idle, versus an original target of € 55 bn.

iv. Encourage bank digitalisation by changing the regulatory treatment of software, allowing full exemption from CET1 deduction, like in the U.S.

v. Reduce or eliminate the capital burden from conservatism in asset valuation beyond high quality IFRS accounting. Specifically, this relates to additional regulatory capital deductions for NPLs (which have significantly reduced in the EU in any case) and Additional Valuation Adjustments (AVA) for fair value assets, both of which served their purposes and should be reduced or removed.

vi. Eliminate additional capital deduction and other regulatory and supervisory overlays for Non-Performing Loans (NPL), given NPLs are consistently reduced and CRR III (Final Basel III) increases conservatism in capital across all types of lending.

vii. Give banks margin of maneuver to negotiate with individual clients on the financial conditions of loans. A certain degree of forbearance within reasonable limits is beneficial for the economy, but the EU guidelines push clients to default status at the slightest setback (oftentimes due to external factors like the interest rate volatility) without letting the bank assess the solutions, thus pushing viable companies down the stigma of default (higher cost of credit, reduced access to credit, loss of competitiveness and business disruption).

viii. Remove obstacles for cross-border capital and liquidity waivers by treating the

Eurozone as single jurisdiction. This would free up significant amounts of own funds and liquidity.

ix. Remove superfluous conservatism in the prudential treatment of off-balance sheet items.

III. In addition, any regulatory initiative should assess and take into consideration the global view of banks' capital requirements and the impact of any new requirement on the competitiveness of the EU banking sector and EU economy vs. competitor economies.

The Commission should include a thorough review of the regulatory framework as part of its work program from 2024, minimizing double counting and redundancies, eliminating inconsistencies and making the framework more efficient.

2) Avoid cycle of continuous policymaking via Level 2 mandates, especially when this leads to goldplating political agreements

For bank regulation, when the level 1 legislative process is closed and a political agreement is reached between Council and European Parliament, the European Supervisory Authorities (EBA, ESMA, EIOPA) start their work to prepare level 2 regulatory products, acting on mandates in the level 1 text.

The legislation of this policy cycle (2020-2025) produced a staggering 440 mandates for the ESAs (see Annex 2).

Based on the consultations so far in this round, we have indications the ESAs approach these mandates as an opportunity to increase conservatism versus the level 1 text, effectively changing the balance policymakers achieved. This is done by either choosing the most constraining approach possible, or even breaching the mandate of legislators.

While the industry will flag these instances through public consultations, the volume of mandates means there are 440 opportunities to deviate from the policy intent set out in Level 1. This has two effects:

I. The volume and depth of consultations means both industry and supervisors will spend resources in responding to this process, instead of working together to identify areas where competitiveness can be achieved without compromising resilience.

II. This creates a situation of constant rule-making, creating lack of predictability from the regulatory framework, making Europe and European banks less attractive for investors, as well as impairing banks´ ability to manage their capital and investment plans. Clear examples are on Prudent Valuation (see below) and Credit Conversion Factor (CCF) mandates where additional conservatism is added, with additional 140 mandates of the CRR III still outstanding.

III. The following examples illustrate these concerns:

i. Respect for transitional arrangements and date of entry into force of CRR3:

The EBA stipulates public disclosures of hypothetical capital requirements as of 31 December 2024 based on the assumed rules of 2033, based on CRR3 with fully-loaded calculations disregarding the transitional arrangements adopted by level 1 co-legislators.

Such disclosures would undermine the European interests at a critical time when investment and financing capacity is essential to support the challenges of the EU economy, notably the green and digital transitions, leading investors to take the fully-loaded data as the point of reference. This would significantly limit the attractiveness of investing in EU banks, thus their capacity to extend credit to the economy.

The same holds for the upcoming EU-wide stress test, where it is planned to require 2024 year-end starting point data on a CRR III basis, and that has hence to be postponed. In order to avoid inconsistencies, it would be sensible to postpone the stress test exercise to 2025 when the Basel III data will be totally integrated according to CRR3.

ii. European standards on Prudent Valuation (PruVal), a Europe-only prudential overlay on accounting rules.
   - PruVal requires EU banks to hold prudential capital for trading instruments on top of their accounting fair value.
   - This was already a competitive disadvantage for EU banks as it does not exist in the U.S.
   - The EBA has proposed an own-initiative (no level 1 mandate) review of the EU framework, which will make the framework even more conservative for EU banks, adding on average 30% more capital requirements for trading positions.
   - This will harm EU bank competitiveness even more.

iii. European standards on off-balance sheet items and Unconditionally Cancellable Commitments (UCC) considerations, currently under consultation, which will fundamentally change the current allocation of off-balance sheet items if implemented, increasing the cost of guarantees and letters of credit and restricting credit limits to EU companies and households. Based on EBA's draft RTS proposal, we have a material concern that EU banks' capital requirements will be significantly increased, which would undermine the EU's objectives towards the implementation of the Basel 3 package.

iv. Level 2 mandates for the EU Digital Operational Resilience Act (DORA)
   - Because this is a new area of regulatory focus, which requires significant change to banks ICT risk management and subcontracting arrangements, the expertise in the market is limited. So, supervisors and the industry find it challenging to adhere to implementation deadlines set out in the level 2 acts, with entry into force in January 2025.
   - We therefore believe that the European Commission should issue a statement allowing the ESAs/NCAs to issue regulatory and supervisory forbearance for 6 months from 17 Jan 2025.

Short term action: The European Commission should write to the ESAs and ask them to respect the balance between the political agreement at level 1 and the technical work at level 2. The ESAs should ensure that the options they pursue do not contradict the spirit of the level 1 in terms of conservatism. Own-initiative work should be balanced and not always lead to higher impact. Level 2 proposals should include an impact analysis. Their approach should also reflect broader improvements on resilience, and not only look at mandates in isolation.

Medium-term action: For the next legislative rounds, the Commission should limit the mandates for level 2 in their legislative Level 1 proposals and put more explicit requirements and expectations in the language setting out each mandate. Also, more conservative Level 2 standards should allow at least 12 months for implementation for the purposes of institutions' capital planning and be accompanied by a thorough impact assessment.

3) Avoid additional conservatism via supervisory reviews

The ECB expects European banks to have a consistent and stable capital planning. European banks also see value in this. However, adhering to this objective is challenging:

- The afore-mentioned constant rule-making makes capital predictions unstable, leading banks to make long-term conservative estimates. This removes capital capacity from the system, without adding to resilience.
- Supervisors like the ECB add conservativeness, for instance by being more restrictive in the approval of internal models, gold-plating level 1 or level 2 requirements, such as is the case for NPLs and Leverage Finance (see Annex 3).
- Many of these supervisory impacts can be considered as discretionary without clear economic rationale and risk-sensitivity. These unpredicted supervisory impacts must be mitigated with management actions that are very costly for the banks and adversely impact their capacity of financing the economy. In order to have consistent and predictable capital adequacy plannings for European banks, it would be really helpful if the Commission could underline to the supervisors the importance that any supervisory request with a significant capital impact must be communicated at least 12 months in advance.

Short-term action: the new Commission should support a dialogue with both the industry and the supervisors to discuss how to achieve a better level playing field between the EU and other jurisdictions, the objective of EU competitiveness and the resilience of the banking sector.

As part of that dialogue, banks, supervisors and policymakers should discuss about the extra conservatism of internal model supervisory decisions, the discount rates being applied to some portfolios, undue dividends distribution restrictions, the risk sensitivity in the supervisory decisions on the mortgage portfolio, the benchmarking techniques or the determination and transparency of the Pillar 2 Requirement (P2R), and other issues that could have significant impact on the right balance between resilience and competitiveness.

4) Alongside simplifying rule-making – speed of rulemaking will determine ability of the sector to support the wider industry in time

The average process is 2.5 years from the Commission proposal to a finalised text. This does not take into account the preparatory work (e.g. European Commission consultations), nor the finalisation of level 2 acts, which can take an additional 1-2 years.

While this pace may be appropriate for long-term projects or reforms, the underused approach of fast- track procedures (with the exception of the Covid package) means that the system is not able to adjust in a timely fashion. Even when it is justified, e.g. when a mistake/unintentional consequence in the rules has been identified, or an international development leads to uneven playing field.

Even if all the above recommendations were accepted, with the normal pace of policymaking, the European industry would only see change in 2029. This way of doing things is no longer feasible for a fast-paced environment the global economy finds itself in. The Commission should instead propose to use fast-track procedures.

We fully support the next legislative cycle to make use of the fast-track procedures more often and are willing to assist the European Commission in convincing the co-legislators of the need to do so.

Please note that the list of examples in the annexes is non-exhaustive and for illustrative purposes. The EBF's full position on these and other dossiers are at the disposal of policymakers with all depth of details.

In closing, we stand ready to continue our dialogue and further discuss all elements mentioned in this letter at your convenience.

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Annex 1 – proposals for Level 1 flexibility Short term – quick fix

Category	***Topic***	***What is needed***	***Legal ref.***
Competitiveness	FRTB	Exercise the power for a Delegated Act and give EU banks the option to delay FRTB implementation in 2 years to ensure global level playing field with the U.S. and UK banks	CRR Art.461a
	NSFR	Maintain the treatment of short-term financing transactions in the Net Stable Funding Ratio (NSFR) (i.e. maintain Regulation (EU) No 575/2013)	CRR Art.428r(1)(g), Art.428s(1)(b), Art.428v(a)
	PruVal	Avoid capital increase introduced from PruVal now introduced of PruVal proposals by EBA	Effect is from PruVal RTS, fix can be in CRR

Medium term – Omnibus package

Category	***Topic***	***What is needed***	***Legal ref.***
Competitiveness	FRTB	Permanent changes in the SA and IMA in line with UK/U.S.: ▪ SA: CIU ▪ IMA: DRC, NMRF ▪ TB/BB topics	CRR Arts. 325j, 325y, 325bp, 325be, 104b, 325az, 104-106
	Non-EU CIU	Allow look-through for RW non-EU CIUs , when below materiality threshold, as per UK approach	CRR Art.132(3)
	Private equity	Review the treatment of unlisted private equity and venture capital investments in sufficiently diversified portfolios to allow for the financing of EU start-ups	CRR Art. 133 EBA GL on high-risk exposures
	Software	Improve the capital treatment of software assets by allowing full exemption from CET1 deduction, like in the U.S.	CRR Art.36(1)(b)
	Unrated corporates	For unrated corporates, banks' internal risk assessments may be used temporarily for the application of the output floor. It is important rating coverage improves in the EU.	CRR Art. 465(3)
	UCCs and off- balance sheet items	Remove any excessive conservatism in the prudential treatment of off- balance sheet items harming the ability of banks to provide funding to the	

		economy	
Unnecessary/ obsolete conservatism	NPL Prudential Backstop	Eliminate additional capital deduction for NPLs, given NPLs are reduced and CRR III increases RW	CRR Art.47a
Support dual transition green/digital	Securitisation	Review of the securitization framework including closer to capital neutrality reducing the multiplication of capital requirements from the underlying assets to the securitized assets Permanent changes in the SA and IRBA: ▪ SA: p factor (half) ▪ IRBA: RW floors (1/3) ▪ Include non-STS	CRR Art.261-262, 259-260
		Change the capital charge for insurers	Solvency II EC Del. Act 2018/1221 Art.178

Please note that the list of examples and proposals in the annexes is non-exhaustive and for illustrative purposes. The EBF full positions on these and other dossiers are at the disposal of policymakers with all depth of details.

Annex 2 – overview outstanding Level 2 mandates leading to continuous adjustments

The rough number of level 2/3 policy products for ESMA/EBA is around **440** – even to **489** if we add EIOPA work on SII. In practice, this means that European banks can never look forward to a regulatory pause that allows them to further invest in future technologies as they are caught in an everlasting cycle of operational, IT and methodological changes. This is not only a burden for the sector, but also for supervisors who often compete with banks for the onboarding of the same consultants/external expertise to assist them in implementation programs.

The clearest example of this is the implementation efforts needed on the back of Level 2 mandates for DORA. Here, expertise in the market is limited, leading to an inability of supervisors and the sector to adhere to implementation deadlines set out in the Level 2 standards alongside the uplift required by the regulation.

See below a more detailed breakdown of all outstanding mandates per file:

Prudential/resolution (banks/insurance)

- Solvency II review - 27 RTSs – all outstanding
- IRRD –22 RTS/ITS/Guidelines/Reports – all outstanding
- CRRIII/CRD VI – 140 RTS/ITS, guidelines, opinions, reports – around 5 to 9 RTSs are underway
- CMDI (Based on original COM proposal) 14 Level 2 measures in total – BRRD 1 RTS + DGSD 7 RTSs and 6 sets of Guidelines (nothing in SRMR)

Capital markets

- EMIR – 31 RTS/ITS/Guidelines/Reports – all outstanding
- MiFIR/MiFID (from 2021 proposal) – 24 RTSs 8 Reports – 2 RTSs are being taken care of
- CSDR – 19 RTSs 6 reports
- RIS (Based on original COM proposal) – 18 RTSs and 2 sets of Guidelines
- AIFMD/UCITS review : 7 RTS/ ITS – 6 Guidelines - 4 Reports
- ELTIF Review: 3 RTS/ ITS – 0-Guideline 2 Reports
- BMR (negotiations have not started) 1 RTS/ ITS (Parliament) – 0 Guideline - 1 Report
- Prospectus Regulation**:** 2 RTS/ ITS – 3 Guidelines - 4 Reports
- Market Abuse Regulation**:** 3 RTS/ ITS – 1 Guideline - 3 Reports
- Multiple Vote Share Structure Directive : 1 RTS/ ITS - 1 Report
- Listing Act**:** 2 RTS/ ITS – 2 Guidelines - 1 Report

Payments/AML

- MiCA- 41 RTS/ITS/Guidelines/Reports. For most, public consultation is already closed
- AML Package (AMLD6, AMLR, AMLA) 32 RTS/ITS/Guidelines/Reports – all outstanding
- PSD3/PSR (under negotiation) 25 RTSs (expected to be extended during negotiations) and 2 Reports
- Instant Payment- 1 ITS and 3 reports

Sustainability

- ESG Ratings – 10 RTS and 1 ITS – all outstanding
- Green Bonds – 10 all outstanding
- ESAP – 4 ITS – 3 outstanding and 1 in review

Tech

- DORA – 4RTS and 2 sets of guidelines ongoing

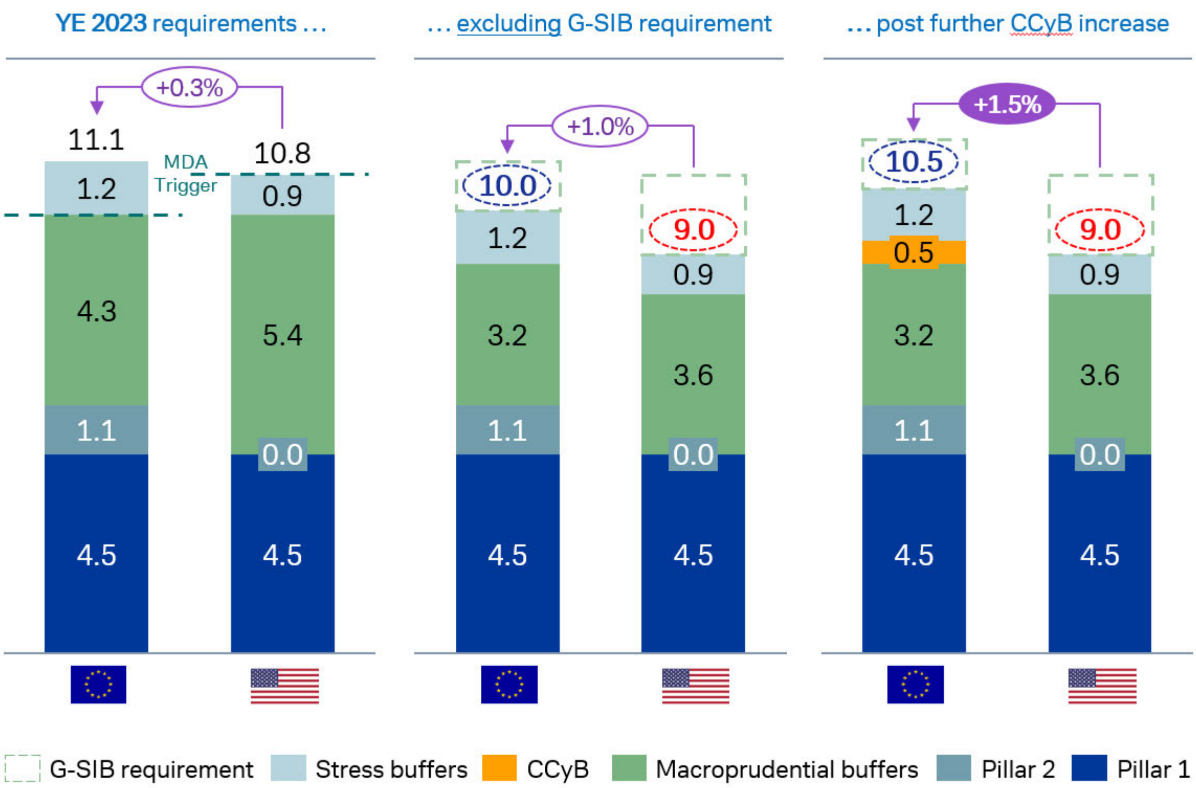
Annex 3 – Comparison of EU versus U.S. regulatory capital frameworks

EU G-SIBs face ~1.5% higher CET1 capital ratio requirements compared to G-SIBs in the U.S., while reporting ~1.4% lower ratios due to higher capital deductions solely applicable in the EU, impacting reported CET1 capital negatively

EU G-SIBs have ~1.5% capital requirements compared to G-SIBs in the U.S.

- At first glance, notional capital requirements for G-SIBs in the EU and the U.S of ~11% seem to be roughly the same
- However, given the G-SIB framework is fully harmonized and applied consistently in the EU, U.S. and globally, the **comparison needs to be adjusted to reflect the objectively larger size** and thus fully justified ~0.7% higher G-SIB capital buffer requirements **for U.S. G-SIBs versus EU G-SIBs**
- Excluding the G-SIB requirement, **EU G-SIBs thus face ~1.0% higher capital requirements than U.S. G-SIBs at year-end 2023**
- This is mainly because there is **no Pillar 2 Requirement (P2R) in the US** and the **stress capital buffer add-on in the US** (over and above the Countercyclical Capital Buffer (CCB) requirement) is **lower than the European Pillar 2 Guidance** (P2G)
- Major European countries (France, Italy, Spain, Netherlands) have **announced further increases of Countercyclical Capital (CCyB) and Systemic Risk Buffer requirements (SyRB)** to a "positive neutral" level for 2024 and beyond which need to be considered in addition.
- This further **widens the gap by ~0.5%, <u>leaving EU G-SIBs with ~1.5% higher capital requirements</u>.**

Comparison of CET1 capital ratio levels and requirements between EU and US G-SIBs (in%)



EU G-SIBs report like-for-like ~1.4% lower regulatory CET1 capital ratios through higher capital deductions solely applicable in the EU

- The **capital deduction regime in the EU** is **more conservative** than in the U.S. given all U.S. deductions are equally applicable in Europe whilst **at least five additional deductions are prescribed in Europe** which are not applicable in the U.S.

  1. **Ordinary dividends & AT1 coupons** to be paid in the future ("foreseeable charges") are excluded from regulatory capital
  2. **Regulatory prudential valuation** of fair value assets **overwrites accounting rules**
  3. Additional **NPE backstop deductions** to be reflected for non-performing exposures
  4. **Software assets** are included in the intangible **deduction in Europe** whilst being **risk weighted in the U.S. as "other assets"**
  5. Committed **contributions to resolution funds and deposit guarantee schemes** are deducted in the EU (whilst not being recorded in capital under IFRS)