SwissFinanceCouncil
Fostering International Dialogue

Commission Review of the impact of CRR/CRD4 on bank lending

Swiss Finance Council response, 7th October 2015

Introductory remarks

1. The Swiss Finance Council (SFC) wishes to note the efforts of the EU in responding to the crisis and putting into place a programme of financial regulatory reform that has contributed significantly to making the sector more stable and resilient. We welcome the current review and the opportunity to contribute to the discussion of the capital framework. Before turning to the Commission's questions in detail, we note three factors that have guided our responses and wish to highlight as overriding considerations.

2. First, while the impact of the current reform programme has served to increase the quality and quantity of capital, the SFC considers that it is important for the Commission to consider the responses to this consultation in the context of other regulatory changes affecting the banking sector - including those yet to come - so that the cumulative impact on the market can be properly understood. While when viewed in isolation many of the post-crisis measures were necessary to increase financial stability and reduce systemic risk, market participants do not respond to individual measures but to their aggregate requirements. We have concerns about the impact of layered conservatism and the way in which many different regulations each target the same underlying issue. **The overall impact on the market, which the Commission is rightly trying to gauge, cannot be properly understood without assessing the aggregate impact of not just capital, but also liquidity and leverage, as well as taking account of changes underway at the international level to the capital framework.** Specifically, we cannot assess the adequacy of capital requirements based on RWA ratios today, in the knowledge that Basel are planning to fundamentally change the yardstick tomorrow i.e. the RWA rebasing in Basel IV. As the market response to Basel III has clearly demonstrated, banks need a long lead time to plan and adjust business models in anticipation of regulatory changes.

3. Secondly, we wish to stress our support for the Commission's Capital Markets Union (CMU) Action Plan, and Commissioner Hill's initiative to review existing bank regulation with a view to ensuring there is "stability and not rigor mortis."[1] Striking the right balance between stability and growth means ensuring banks are able to contribute to the still fragile recovery through activities such as market-making as well as traditional lending, and ensuring there is sufficient market liquidity to enable the CMU project to be a success. Crucial to this balance is the right trade-off between risk sensitivity and uniformity/simplicity. **While simplicity and uniformity are alluring concepts, an over-reliance on risk insensitive measures to achieve them will likely lead to exaggerated capital requirements that will frustrate banks' capacity to contribute to growth and in inefficient and risky capital allocation.**

4. Finally, the SFC wishes to stress the importance of a fair and level playing field in what is very clearly a global market. **Consistency at the international level should be assured, while divergence in the implementation of the Single Rulebook avoided, including between the Banking Union and non-Banking Union countries.** While we believe that the EU authorities should play an important role in influencing the international standard setters such as the Basel Committee to recalibrate its standards in light of market reactions, the

---

[1] Commissioner Hill, keynote speech at Eurofi conference, Luxembourg, September 10th 2015. See http://europa.eu/rapid/press-release_SPEECH-15-5624_en.htm.

EU should not front-run any re-calibration of global standards, but move in lock-step with the rest of the world.

Capitalisation

1. What role has been played by the CRR and CRD IV requirements in the recapitalisation process, in terms of the timing and overall effect on the levels and quality of capital held by banks? How have market, supervisory and regulatory capitalisation demands interacted to make banks adjust the level of capital they hold to the current level? Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role?

5. Many parts of the prudential framework are still under review, meaning that assessing the overall impact without taking a broader view is quite difficult. The CRR included a gradual phase-in of capital requirements, but in the face of market forces all banks front-loaded these. Indeed, CET1 has increased to 11.1 per cent for Group 1 banks according to the latest BCBS review.[2] To that extent, the market has dictated the timetable and set expectations around acceptable minima, but it remains the standard setters and regulators who determine the framework. Given this experience, it is likely that forthcoming changes in several ongoing international work streams – Fundamental Review of the Trading Book (FRTB,) Interest Rate Risk in the Banking Book (IRRBB,) the revisions to the standardised approach for credit risk, and capital floors – will lead to similar market reactions. The EU therefore must adopt a more proactive approach in international fora to ensure that standard setters appreciate the real life impact of their signalling on market participants' behaviour long before formal implementation dates have been agreed.

6. Market forces have been less evident in less transparent areas of banks' capital structures, namely Pillar 2. Consistency in supervisors' approach to setting Pillar 2 is crucial to ensure a level playing field, and so we welcome the more harmonised approach now being adopted by the Single Supervisory Mechanism.

2. If you consider that capital levels go significantly beyond what is necessary in light of the level of risk incurred and posed by banking activities in certain areas, please specify those areas and back up your view with specific evidence.

7. When considering the appropriateness of capital requirements for the levels of risk incurred it is important to take account of the basis on which that risk is assessed. The SFC believes that properly vetted and calibrated internal models, with a comprehensive set of risk factors and incorporating full credit history, are better measures of genuine economic risk than less risk sensitive assessments based on standardised approaches which often do not fully recognise risk mitigating factors, such as collateral and diversification. Therefore, one of the biggest risks of forcing banks to hold capital in excess of underlying risk comes, and will come from the imposition of front stop leverage ratios, less risk sensitive standard approaches, and potentially high capital floors. Moreover, Banks will in practice always run their own 'management buffer,' on top of the regulatory minima, thus further exacerbating the distortion. Furthermore, we welcome efforts to improve the consistency of Pillar 2, but note that a move towards less risk sensitive Pillar 1 standardised approaches would widen the gap between Pillar 1 and the risk-based Pillar 2 concepts, and dilute efforts to improve harmonisation and comparability across the two pillars.

---

[2] See http://www.bis.org/bcbs/publ/d334.htm for the latest Basel III monitoring report. Group 1 banks are those that have Tier 1 capital of more than €3 billion and are internationally active.

8. This consideration is important because the overall effect of the capital framework not being sufficiently risk sensitive will be negative for financial stability. This is the case because it distorts the allocation of capital within the banking sector, leading to perverse outcomes that undermine liquidity and the functioning of financial markets, notably the re-pricing of, shrinkage of, and withdrawal from business lines associated with inappropriately higher risks weights and capital costs. This reduces the ability of banks to act as shock-absorbers in times of volatility, with the loss of liquidity and concentration in asset classes with lower capital costs, thus potentially introducing a new source of systemic risk.

9. To be specific, examples of elements in the framework where the actual/proposed regulatory treatment has a disproportionate impact on the wider economy/end-users to the risk incurred include the following items:

- **Pension funds / asset managers use of capital markets**

  End-users such as pension funds and asset managers rely on equity, bond and derivative markets to manage and hedge future liabilities and risks. Liquid securities financing markets (e.g. repo/reverse repo and securities lending) are critical to the functioning of those cash markets as they allow banks and broker dealers to make markets without carrying inventory in every security (too costly under leverage ratio rules). The Net Stable Funding Ratio (NSFR) would have a major impact on the cost of fixed income and equity market making, due to the lack of recognition of interdependent securities financing transactions (SFTs), which increases funding costs for short-term pass-through trades. This issue can be remedied via a more flexible transposition of paragraph 45 of Basel's NSFR standard. The absence of an amendment here would impair capital market functioning, and increase costs for both market makers and importantly end-users. The additional prudential rationale comes from the fact that many interlinked SFTs are self-funding (liabilities effectively fund the assets) meaning the effective liquidity risk is very low.

- **Pension funds – negative impact on their ability to hedge liabilities**

  Pension funds use interest rate and inflation swaps to hedge the discount rate on their liabilities. They use derivatives to manage the cash flow payments of their underlying pension schemes allowing them to stay invested in assets such as equities, property and fixed income bonds, to grow their assets over the life of the scheme and fund their liabilities. This bilateral derivative hedging is done via ISDA's underlying Credit Support Agreements (CSAs) that typically have both cash and government bonds as eligible collateral. The NSFR introduces a new rule that requires long term funding of positive mark-to-market balances on derivatives exposures where securities are posted by the pension fund as collateral. The net effect is that pension funds will face significant higher capital and trading costs for hedging via derivatives. They will also have funding issues in terms of a shortage of cash, so they will need to transform their securities into cash and run significant cash buffers. This will result in less long-dated government bond assets being held against their liabilities. Pension funds' cash collateral deficit is one of the reasons they were exempted from mandatory clearing. A change to the NSFR rules to recognise non-cash High Quality Liquid Assets (HQLA) as eligible collateral is recommended.

- **Insurance companies**

  Large insurers will typically have a diverse capital and funding base, often including substantial long dated and undated subordinated debt. By their nature, they maintain large liquidity reserves/marketable investments and will supplement those for flexibility purposes with

commercial paper programmes. In order to facilitate their short and long term ratings, however, they also usually maintain sizeable committed debt facilities. These facilities are seldom if ever drawn (events in 2008 illustrated this), but nevertheless attract Liquidity Coverage Ratio (LCR) outflow factors which are in some cases more punitive than regulated banks. This in turn increases balance sheet HQLA and exacerbates Leverage Ratio (LR) constraints. The combined impact of the LCR and LR here discourages banks from providing these facilities to top rated insurance counterparties and may reduce the diversity of funding sources for insurers who are key constituents of the long term financing market. Consideration should be given to reviewing and separately categorising these outflow factors for well rated insurers, taking into account the nature and profile of their liability mix.

- **Large corporates – clearing risk management transactions**

  The policy objective to reduce bilateral inter-bank derivative exposure by obliging clearing of certain categories of derivatives is a positive step. To fully deliver on this aim, clients (e.g. large corporates) who are not themselves members of Central Clearing Counterparties (CCPs) will require banks to provide clearing services as they would in the existing futures and equities markets. Unfortunately, the current LR treatment of such clearing services specifically disregards clients' segregated margin in measuring the potential future exposure of the service provider. Disregarding such segregated client margin ignores the capital that clients are required to fund to cover their derivative exposures and, therefore, inaccurately measures the potential bank leverage from clearing services. This approach to the LR makes this service prohibitively costly, which is already substantially increasing the minimum expenses borne by end-users (disincentivising hedging), including for long-established services for existing futures and equities markets. Further, banks will retrench from providing this service, thus reducing competition and portability. These concerns arise directly from the fact that the leverage capital treatment misstates the potential exposure, as banks must ignore the clients' segregated margin capital for determining leverage. The EU should ensure the final LR rules recognise the exposure-reducing effect of clients' segregated margin.

- **Shadow Banking**

  The CRR includes a requirement for banks to cap their exposures to so-called shadow banks. This is an aggregate exposure cap to an industry group vs. single names, which is novel and a departure from the existing and well-functioning large exposure regime currently in place. Given the risk from shadow banks is both addressed directly in other sectoral legislation, banks' interaction with shadow banks are constrained via the increasing regulatory burdens on SFTs, and the imperative to shift credit intermediation in the EU more towards market-based alternatives, we recommend an approach based on enhanced disclosure and reporting before any new binding restrictions are introduced.

- **Risk Management / Capital Markets Union (CMU) – intragroup exposures**

  To satisfy the overarching CMU objective to ensure increased intra-EU and extra-EU inward capital flows, ensure effective risk management, and facilitate Single Point of Entry resolution strategies, we suggest the treatment of intercompany exposures is reviewed to ensure these existing and new objectives are all met. Well managed inter-affiliate lending is inherently low risk.

  1) **Intragroup Credit Valuation Adjustment (CVA):** we believe it is inappropriate to levy an intragroup CVA risk charge for transactions between affiliates in the same banking group. Where both affiliates are guaranteed by the same parent the counterparty credit risk is negligible. The charge penalises cross border intragroup capital flows (to

the detriment of the CMU project), and also disincentivises effective risk management practices whereby risk is aggregated and managed centrally in the locations with the appropriate infrastructure, expertise and CCP connectivity. We recommend the continuance of the EU exemption from CVA for intragroup transactions, both intra-EU and internationally, as per the current text.

2) **Risk weights for intragroup exposures:** the CRR allows for a 0 per cent risk weight for certain intragroup exposures, but the eligibility criteria lack flexibility and result in too narrow a scope. We suggest that article 113 is amended to remove some subjective criteria, and in order to more appropriately recognise the increased integration of banking in the EU (and Banking Union), and the cross-border objectives of the CMU:

- Article 113, (6d): "the counterparty is established in the same Member State as the institution**, or is established in a jurisdiction deemed equivalent**;"
- Article 113, (6e): "there is no current or foreseen material ~~**practical**~~ ~~**or**~~ legal impediment to the ~~**prompt**~~ transfer of own funds or repayment of liabilities from the counterparty to the institution."

10. On top of these *existing* examples, it is also appropriate to highlight *forthcoming* measures which could move prudential standards further from real underlying risk. The objectives of the so-called Basel IV agenda are worthy, namely to restore trust in banks' RWA calculations, but excessive constraints for internal models, standardised approaches lacking risk sensitivity, and high capital floors could lead to a step-change in capital requirements with significant impacts on markets and lending.

- **Fundamental Review of the Trading Book**

  The Residual Risk Add-On is a notional gross up, which significantly inflates capital requirements and undermines the goal to make the sensitivity-based approach more risk sensitive. In addition, the rules on securitisations currently result in some cases in scenarios where the capital requirement exceeds 100 per cent of the notional position. We also have concerns on the rules around non-modellable risks and P&L attribution. Rushing to finalise an imperfect reform before all the known issues are fixed risks very significantly exacerbating market liquidity issues, and fundamentally undermining banks' ability to make markets and support the CMU.

- **Standardised Approach to Credit Risk**

  The risk weight changes result in higher capital requirements to lend to corporates, especially small SMEs. Furthermore, the Standard Approach for Credit Risk rules on SFT haircuts do not recognise hedging or diversification, meaning a diversified portfolio would generate the same exposure as a single name, in contradiction to accepted norms of good risk management (see our response to question 4 for examples of the estimated impact of this on lending costs in Switzerland).

- **Capital floors**

  If the proposed capital floors are calibrated at too high a level, they will not constitute complementary "backstop" measures as intended, but simply undermine any risk-based approach. This will undermine efforts to restore proper risk taking in the banking sector, distorting capital allocation in the market, and comparisons between banks. A high capital floor would reduce banks' incentives to invest in internal models which, as stated, we continue to think are the best mechanism available to ensure capital is allocated commensurate to the underlying economic risk.

Furthermore, and as we state in our answer to question 14 on simplicity, the advent of capital floors will introduce greater levels of complexity.

- **Review of Interest Rate Risk in the Banking Book (IRRBB)**

  The review could lead to an increased IRRBB capital requirement, making it more costly to hedge interest rate risk if such hedging is not taken into account in the requirements. There is also a level playing field issue here, given that some jurisdictions already have interest rate risk capital requirements.

11. We have highlighted areas in both existing and forthcoming regulations where we think capital exceeds or likely will exceed genuine underlying risk. However, we are also aware of outstanding areas where capital underestimates risk, most notably perhaps in the treatment of sovereign risks in the CRR (the 0 per cent risk weight available to IRB banks). Consistent with our overarching support for a risk sensitive capital framework, we support global and regional policy maker's efforts to remedy these remaining issues on a timeline consistent with broader financial stability concerns.

12. To conclude, we would note that while risk sensitive modelling is preferable to a standardised approach, such modelling has to be credible and transparent, and avoid the mistakes of the past that led, in some cases, to misjudgements about levels of risk exposure and made comparisons between banks unreliable. For this reason the Basel Committee has made it a central priority in the short-term to restore confidence in risk-weightings by better balancing the objectives of robustness and risk sensitivity.[3] However, achieving the right balance between these objectives is not straightforward, and the point is to restore confidence in risk sensitive modelling without doing away with it completely. When all of the measures noted above, past and future, are applied in aggregate such an outcome could come about, with negative consequences for the economy, financial stability, and the management of the banking sector. Like many commentators, we believe that some variation in RWAs is to be expected and entirely appropriate given the different business models and management practices of banks, and efforts to standardise RWAs may lead to further unintended consequences as banks' ability to adapt to market circumstances, and their managers access to risk sensitive data is further reduced.

13. Finally, we also wish to stress that the LR already serves as a binding backstop, and hence the case for additional floors is unclear, while their imposition again risks complicating the interactions between regulatory requirements even more, leading to further unintended consequences.

3. What role have the additional capital requirements and buffers exceeding the harmonised requirements set out in the CRR played in the capitalisation process? Are such additional micro- and macroprudential capital requirements and buffers commensurate to the level of risk incurred and posed by banks? Please back up your view with specific evidence.

14. The complex new requirements include capital buffers, national gold-plating, management buffers, liquidity buffers, and will shortly also include gone-concern loss absorbing capacity buffers (TLAC/MREL). Measures have been applied at the international, EU and national levels on top of one another, with insufficient understanding of how they interact or what the effects will be. Many of the buffers seem to address similar or the same underlying risks, and the effect is increased complexity and risk coverage duplication. It is therefore appropriate to consider how they interact, and what the unintended consequences have been as

---

[3] See 'The Basel Committee's Work Programme for 2015 and 2016' at http://www.bis.org/bcbs/about/work_programme.htm#simplicity.

a result. We believe there is scope for simplification, and recommend supervisors apply offsets where duplication in risk coverage is identified (e.g. G-SIB buffer and TLAC).

15. We also have concerns that some buffers are in practice unusable, given that disclosing a buffer below the minimum required percentage would likely create signalling effects in the market that could accelerate stress. This means that banks are forced to run buffers on buffers, to avoid the consequences of a breach.

16. Over and above the complexity and quantum issues, other concerns with the new buffers include:

    - **Concern about the interaction between the HQLA requirements in the LCR and the LR**: banks are required to hold a portfolio of low-risk assets under the LCR, but the LR then requires them to be valued at their full nominal value. This interaction means that in order to optimise under the LR banks have to acquire high-yield/high-risk assets, with a consequent reduction in exposures to middle range assets, such as lending to SMEs.
    - **Similarly, overlapping requirements in the HQLA and derivatives regulation** are making it difficult to secure, and reduce the availability of, high-grade collateral. There are several unwanted effects of this in the market place, such as the increasing use of lower quality collateral, and an incentive for banks to hold sovereigns on their balance sheets instead of other assets.

Regulation — a cause of the fall in corporate lending?

4. Have increased capital requirements influenced the overall capacity of banks to lend? Which factors, including demand-side factors, regulatory changes and other supply-side factors (such as the volatility of interbank and capital markets), contributed most significantly to the change in the volume of loans? How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?

17. It is clearly the case that there has been a reduction in the demand for lending, caused both by the non-financial sector deleveraging, and the slow recovery in growth. This has even been the case during a prolonged period of very low interest rates. However, to the extent that regulations have been aimed at encouraging the industry to be more cautious in its approach to risk, and more resilient in terms of regulatory capital, prudential regulation has contributed to the reduction in credit flowing to the economy. Simply speaking, banks have strengthened their balance sheets and therefore hold fewer assets against their capital.

18. Moreover, yet to be finalised aspects of the capital framework, could exacerbate the situation. For example, a recent study assessing the impact of the Basel Committee's proposed standardised approach to risk modelling and capital floors on Swiss lenders suggests that the impact of those measures could have a negative impact on the economy. The study, based on thirty-seven Swiss IRB banks, found that the proposals would lead to increases in the cost of capital for lenders, with an impact on corporates and commercial mortgages by 160 and 215 per cent respectively, whilst reducing the costs for residential mortgages for banks heavily engaged in mortgage lending.[4] All this at a time when concerns about lending to corporates and the risks of a housing bubble abound. In addition, the overall amount of capital needed to underpin the whole credit business would increase by a factor of two.

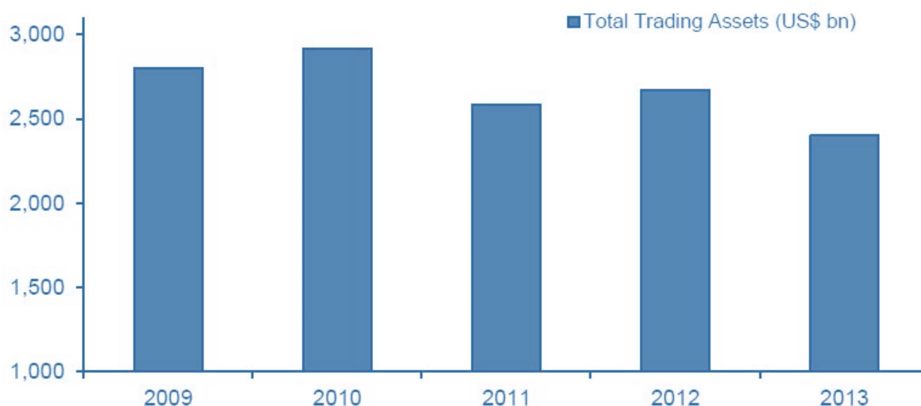
---

[4] Capital Floors, the Revised SA, and the Cost of Loans in Switzerland, Bernardi, Perraudin, and Yang, June 2015.

19. Lending, however, is not the only way in which the banking sector supports the wider economy. Banks play a key role in supporting market liquidity through their role as market makers and their activities in bond markets. The increased costs of trading in certain asset classes has led to a significant deterioration in banks' ability to perform these roles, and this has been one of the factors contributing to the reduction in market liquidity - important for growth and stability in the broader economy by helping to facilitate capital flows; manage risks; transmit monetary policy, and disseminate market information.[5]

20. A discernible reduction in market liquidity is evident in reductions in corporate bond trading volumes, by 45 per cent in Europe since 2010, and a decline of over 60 per cent in dealer inventories of corporate bonds in the US over the same period. In addition to this, a Credit Suisse research study published in May 2014 finds that the implementation of some of the new prudential requirements (capital requirements, and some pre anticipation of the LR) have reduced banks' appetite and ability to warehouse risk, leading to smaller and less elastic balance sheets. Shrinking dealer inventories, down 17 per cent across the fixed income markets (see figure 1), mean that the regulatory changes have impeded banks from fully carrying out their market making function as per pre crisis.[6]

Figure 1: FICC and Equity Trading Assets for 10 largest US & European banks by trading assets



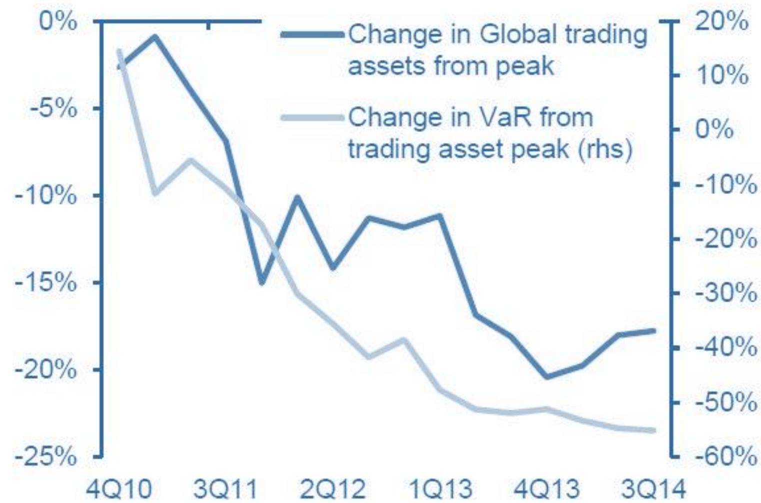
Source: Credit Suisse estimates, Company Reports

21. In a second research study, Credit Suisse analysts demonstrate that the decline of trading assets among the largest firms has unsurprisingly contributed to the sharp reduction in Value-at-Risk (VaR)[7]. However, while trading assets have fallen about 17 per cent from their peak, VaR has fallen 55 per cent over the same period to Q3 2014, see figure 2. Although reduced VaR as a consequence of less illiquid fixed income assets (e.g. mortgage, corporate and structured products) is an intended effect, some of the VaR reduction in e.g. liquid rates assets is an unintended consequence that takes liquidity out of the market. This reduction in liquid assets potentially increases risk, by reducing dealers' balance sheet elasticity and thereby lowering their intermediary and warehousing potential.

---

[5] Global Financial Markets Liquidity Study, PwC, 2015, p.18.
[6] Downside of Prudential regulation: Lower liquidity, Credit Suisse Fixed Income Research, May 2014
[7] Diminished balance sheet elasticity, lower VaRs and fickle liquidity, Credit Suisse Fixed Income Research, December 2014

Figure 2: Trading assets and Value at Risk for primary dealers reporting data

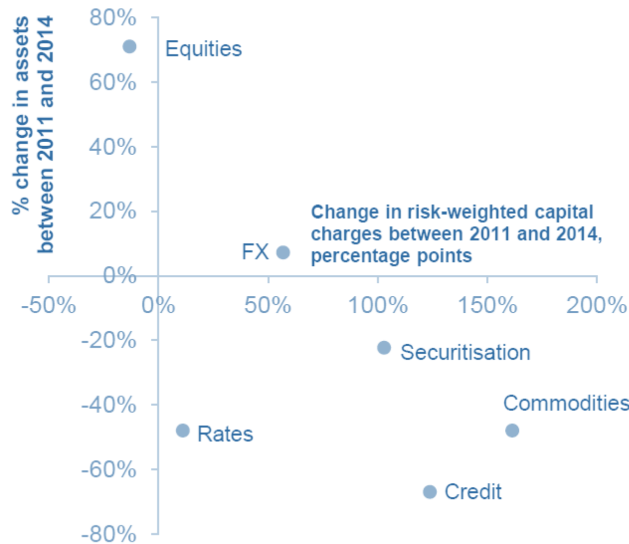


Source: Credit Suisse estimates, Company Reports

Although there have been multiple drivers behind these developments, changes in the capital and liquidity framework have contributed to the reduction in liquidity in the market.

22. We elaborate in our answer to question 6, but it seems there is a correlation between the degree of deleveraging, and the change in risk weighted capital charges by activity, see figure 3.

Figure 3: Correlation between in risk-weighted capital charges and deleveraging by asset class



Source: PwC analysis, Tricumen

23. This deleveraging in the banking sector has undermined banks' ability to act as market makers in secondary markets, and therefore contribute as effectively as they might have done to the recovery. Combined with ongoing changes to the capital regime, as well as structural reforms and measures to ensure resolvability, it is likely that banks' role in this regard will be further reduced. As such, regulatory developments in the banking sector are, and will continue to be, a headwind to efforts to create a functioning capital market in the EU (CMU). A number of practical ways in which this impacts the real economy are increased issuance costs due to higher liquidity premia, making it more expensive for firms to borrow on capital markets;

increased bid/ask spreads making hedging more expensive, and crowding-out of non-bank investors in highly liquid assets.

24. It is important to note that many of the negative effects of these developments have not yet been felt by end-users because banks have been internalising the costs, at the expense of shareholders, and while monetary policy has been extremely accommodating. Indeed, PwC conclude that *"[t]he risk is that as a result of QE, the liquidity risk premia may have been compressed to artificially low levels in financial markets, which masks the impact of reduced market-making capacity. The effect of QE on portfolio rebalancing and liquidity risk premia are likely to reverse following the withdrawal of QE, which could expose the structural reduction in liquidity in capital markets."*[8]

25. A further area where regulation has had an impact on banks capacity to lend and support the economy is in the structural impact it has had on banks' business models, reducing their ability to hedge risk through diversification, cross-subsidise, and offer a variety of products to potential borrowers. We now turn to this in our response to question 5.

5. Are the effects of increased capital requirements, such as they are, generally temporary and transitional or have structural changes been seen? Has the requirement to hold higher levels of capital increased the cost of funding banks? Has the per-unit cost of bank capital decreased as banks have become less risky?

26. In our members' experience, the tightening of the capital and liquidity regime has led to structural changes in funding costs so we would not regard the effects as temporary or transitional. Put simply, capital requirements have increased by at least between 7x – 10x[9], new rules require the terming out of funding, a significantly larger proportion of banks' liability structures will have to be subordinated, and the implicit government guarantee has been dramatically reduced (leading to downgrades across the board). All of these factors point to a structural increase in funding costs. We do not oppose a rise in funding costs to the extent that this reflects the reduction/elimination of any implicit state subsidy, but as stated we do have concerns where capital and liquidity requirements are calibrated in excess of underlying risk and inflate costs unnecessarily.

27. We do not propose to enter into the Modigliani-Miller debate, which we do not think is applicable for banks, but instead highlight the factual examples of how both Credit Suisse and UBS have adapted/are adapting their business models to take account of the new prudential regime and increased costs:

    - Between 2007 and 2014, Credit Suisse has reduced its balance sheet by 32 per cent and RWA by 43 per cent[10], and exited/downscaled certain capital intensive business lines. They have also established a non-strategic unit to further accelerate the reduction of capital, leverage exposures and costs associated with non-strategic activities.
    - To facilitate the movement away from high-risk and capital intensive business areas, UBS also set up in Q1 2013 a non-core and legacy division comprising CHF103bn in RWA. 65 per cent of the reductions planned for 2017 had been achieved by July 2014.

---

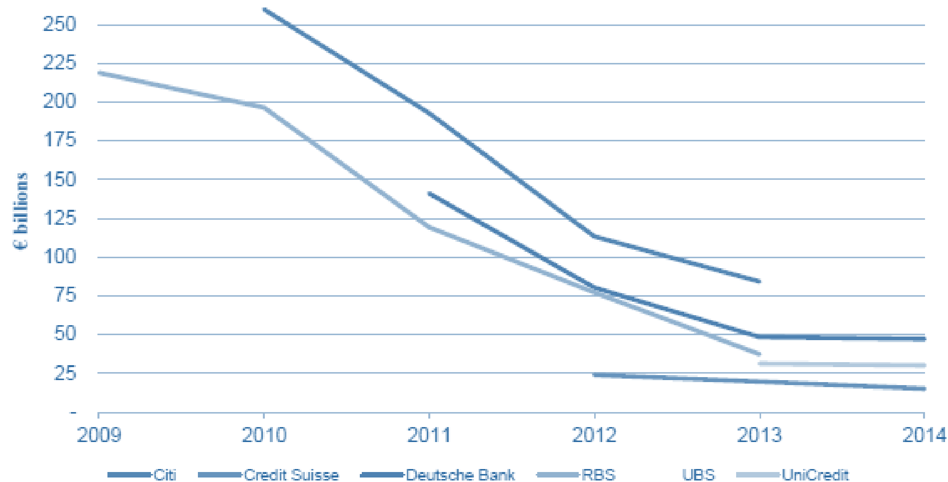
[8] Global Financial Markets Liquidity Study, PwC, August 2015, p.28.

[9] Mark Carney, 2014 Monetary Authority of Singapore Lecture, November 2014. See http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf.

[10] RWA for 2007 are based on estimates which are calculated as if the Basel III framework had been in effect during such period.

- Indeed, this has been a common practice amongst a number of banks facing increased capital requirements, as figure 4 below illustrates:

Figure 4 : Non-core RWAs (adjusted) of six focus banks reporting the metric.(add source)



Source: PwC.

- Similarly both banks have downsized their fixed income businesses, with UBS exiting FICC Asset Securitisation, Complex Structured Products, and Macro-Directional Trading in 2011.
- Finally, the retrenchment has had the impact of leading banks to focus on a smaller number of core institutional investors and clients, withdrawing services from more capital intensive businesses. Thirty per cent of banks sampled by PwC for their report on the impact of bank structural reform said they had already decided to refocus their business in this way.[11] While some aspects of this re-focusing of the client base may partly be in line with policy goals on risk reduction, it may result in certain client segments becoming effectively unserviceable, leading clients such as corporates with less skill in risk management to take risk back onto their own balance sheets.

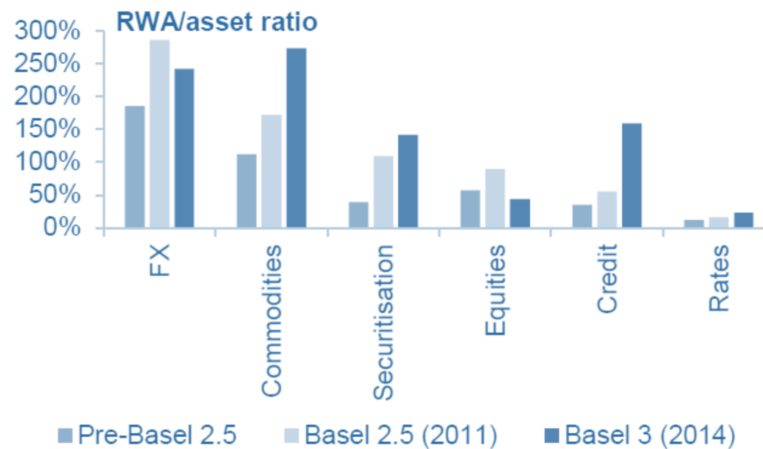
6. Have increased capital requirements affected the market for some categories of assets more than others? If so, which ones and how? Which of the provisions contained in the CRR, apart from those establishing capital ratios, are likely to have created the effects experienced by specific markets and/or exposures?

28. Trading assets have been particularly hard hit by the new prudential requirements, and will further be impacted by the changes to market risk weighted assets envisaged by the FRTB. In addition to the risk weight changes (existing and forthcoming), the LR constrains banks' ability to hold inventory of low risk trading assets (outside the LCR buffer) and the NSFR requires longer-term funding for market making activities. As noted in our response to question 4, this means that banks are less able to support the economy in this way.

29. One of the factors that has contributed to the shrinkage in trading inventories is the significant increase in risk-weighted capital charges across many asset classes, as figure 5 shows.

[11] Structural Reform Study, Supplementary Report 2: Inventory of Bank Responses to Regulatory Change, PwC, November 2014, p.25.

Figure 5: Changes in risk-weighted capital charges due to changes in the capital regime



Source: PwC analysis, Tricumen

As the cost of holding such assets has increased, it has become more difficult to hold trading assets in order to hedge risk and diversify. As shown in figure 3 (see question 4) there has been a corresponding degree of deleveraging in securitisation, commodities, rates and credit.

7. Do you think the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions? If so, please explain how.

30. To the extent that the transitional provisions lead to distortions in the Single Rulebook and undermine a level playing field, then we favour their elimination.

Lending to SMEs

8. To what extent has this provision been effective in supporting lending to SMEs? Could you provide any evidence, preferably quantitative, of the change in lending to SMEs due to the introduction of the supporting factor as from 2014?

31. Consistent with our desire for a risk sensitive capital framework, we are not convinced that the SME supporting factor is necessary to stimulate the provision of finance to SMEs. Based on the EBA's discussion paper on the SME supporting factor, there does not appear to be sufficient evidence to justify a reduction in SME loan risk weights.[12]

9. What specific difficulties do banks face when lending to SMEs, compared to when lending to larger corporates? Are these related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties in other ways than by adjusting rules for SMEs, or do they need to be resolved by some other means? If so, what other means would be adequate?

32. We acknowledge that SMEs were not the counterparties where the majority of counterparty credit risk mark-to-market losses were taken during the crisis, however, as both the EBA and the Basel Committee have recognised there remains a significant counterparty credit risk when lending to them, particularly where exposures are uncollateralised. To that end, we agree with the EBA that a full exemption from the CVA risk charge for SMEs is not warranted. CVA should be applied to these exposures in a way consistent with the evolving Basel CVA framework to ensure international consistency. Given its positive focus on SME lending,

---

[12] EBA Discussion Paper on SMEs and the SME Supporting Factor, European Banking Authority, July 2015. See https://www.eba.europa.eu/documents/10180/1153414/EBA-DP-2015-02+Discussion+Paper+on+SME.pdf.

we would recommend the Commission and EU central banks engage in the Basel level discussions to ensure that the calibration of CVA strikes an appropriate balance between the risks of SME lending and increases in hedging costs, rather than diverging from global standards.

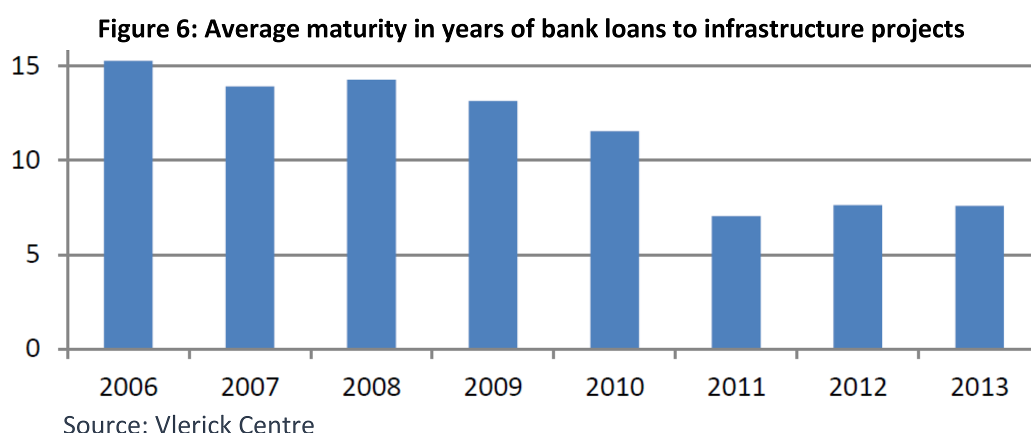
Lending to infrastructure

10. Has the CRR influenced the capacity of banks to provide loans to infrastructure projects? Which provisions are most relevant?

33. The introduction of the new capital framework has certainly affected the capacity of banks to provide loans to infrastructure projects. The NSFR requires long-term lending to be matched to long-term liabilities, which are more expensive as a result of the CRR. Moreover, the fact that the specific calibration is yet to be determined is a source of uncertainty, further deterring banks from long-term investments. A recent study from the Vlerick Centre, based on interviews with lenders noted that "our interviews with ten European banks show that a majority have reduced their allocation towards infrastructure loans."[13]

34. The impact of the increase in capital costs is evident in the market for long-term loans, which has seen a significant reduction in maturities over recent years, see figure 6, which, using a sample of French, Belgian and Dutch banks, illustrates the trend.

Figure 6: Average maturity in years of bank loans to infrastructure projects



Source: Vlerick Centre

11. What are the specific difficulties that banks face when lending to infrastructure projects? Are they related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties or do they need to be resolved by some other means? If so, what other means would be adequate?

35. As noted, to invest effectively in infrastructure projects banks have to match long-term assets with long-term liabilities, however, as a result of changes to the capital regime such liabilities are more expensive, deterring banks from making those investments. The SFC believes a clarification in the NSFR calibration may help to solve the problem.

36. Addressing these difficulties is further complicated by the number of factors banks need to take into consideration when making loans to long-term infrastructure. A list compiled by AFME and ICMA includes:[14]

---

[13] Vlerick Centre for Financial Services, Regulatory impact on banks' and insurers' investments, September 2014.

[14] AFME and ICMA, Guide to Infrastructure Finance, June 2015, p.50.

- Asset type, which should have an economic value beyond the term of the debt, with the term of the financing facilities commensurate with this;
- performance risk, which is much more difficult to gauge for longer-term projects;
- the issuers' financial covenants, which are a critical means of investors monitoring risk and performance of a project, as well as the quality of other documentation;
- degree of third party commitment, including, where public sector involvement is critical, political risks such as tax changes; and
- broader risks affecting the project, including economic risks, such as interest rate and currency risk, as well as environmental and other factors.

12. Should infrastructure projects continue to be treated as loans to corporate borrowers? If not, why? What common features of infrastructure projects or their subsets would justify a separate treatment from loans to corporate borrowers?

37. The SFC believes that there is a strong case for treating infrastructure investments differently to corporate loans, not least to ensure a level playing field with the treatment of such investments by the insurance industry. Indeed, the Commission has recently proposed significant changes to the Solvency II regime by adopting a Delegated Regulation amending Regulation (EU) 2015/35. The aim of this is to create better incentives for insurers to invest in infrastructure projects, in particular, by reducing the amount of capital which insurers must hold against the debt and equity of qualifying infrastructure projects and reducing the requirements both for direct investments and investments into ELTIFs investing in infrastructure. We also welcome the Commission introducing the concept of 'qualifying infrastructure investments', which benefit from a specific treatment and note the proposal that ESMA be given the task of defining such an investment category to guard against the risk of arbitrage and legal form taking precedence over economic substance. We believe ESMA should do so on the basis of the global criteria which are being developed by the dedicated G20 Investment and Infrastructure Working Group.

38. Similarly, the SFC believes that consideration could be given to the treatment of bank loans, and that European authorities could promote such an approach in the Basel Committee. In doing so, we agree with the Bank of England that the criteria for qualifying infrastructure investment *"should be clear, transparent, and focused on the economic risk fundamentals of infrastructure, rather than simply specifying a 'closed list' of qualifying assets, sectors or issuers."*[15] Specifically, a common treatment for infrastructures could contain a common framework for project due diligence and disclosure, as well as a European passport. Likewise ESMA should take account of the same considerations when designing the criteria to apply to the revised Solvency II framework.

39. To complement such measures, we believe that a broader policy approach to infrastructure is needed to attract private money into risky long-term projects, encompassing:

    - Identifying and addressing regulatory disincentives to investment;
    - a list of viable infrastructure projects made available to all actors, including a European infrastructure strategy;
    - more co-operation between the public and private sectors, including the use of public private partnerships (PPPs) where appropriate;

---

[15] Bank of England Response to the European Commission Green Paper on Capital Markets Union, May 2015, p.15.

- facilitating the leveraging capacity of national and European resources, e.g. the structural and cohesion funds, and the EIB 2020 Project Bond Initiative, and
- a stable legal framework facilitated by public sector involvement ensuring transparent procurement procedures, risk mitigation measures and guarantees where appropriate.

40. Finally, we wish to point out that there are also other regulations that prevent a market in infrastructure from developing, such as national restrictions preventing occupational pension funds from investing in long-term infrastructure projects. In 2014, the Commission proposed a Directive (IORPS II) which would, among other things, stop Member States banning occupational pension funds from investing in assets with a long-term profile such as infrastructure, unless the restrictions are justified on prudential grounds; we are supportive of this position. In addition, the use of PPPs should be further expanded within and across Member States (as examples of best practice).

Proportionality

13. Should the provisions contained in the CRR allow for more differentiation in how they are applied to banks of different sizes or with different risk-profiles? How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market? Are there any provisions that could potentially be applied with greater differentiation? If so, what are these provisions? Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application? Are any concrete changes desirable in this context? If so, what are these changes and the associated costs and benefits?

41. The SFC believes that it is important to recall that large and complex institutions are not automatically more prone to face difficulties. We acknowledge that when they do fail the ramifications can be systemic, but it is also the case that a diversified portfolio enables banks to withstand shocks in particular markets and increase their resilience, reducing the likelihood of failure. Moreover, larger banks have a higher degree of interconnectedness and range of exposures, and so are therefore able to act as shock-absorbers, providing a source of stability in times of stress, a role that continuing structural reforms risk undermining. By the same token, small does not necessarily mean safer. During the crisis, it was often smaller, mono-line institutions that found themselves in difficulties which led to systemic consequences. In the UK Northern Rock and other smaller lenders were not diversified enough to cope with rapid changes in wholesale markets, and as the Commission agreed in the subsequent State aid approvals for these and other similar banks, Government intervention was deemed to be necessary to safeguard against systemic contagion. Similarly, Cajas in Spain and Landesbanken in Germany also faced difficulties.

42. Turning to forthcoming regulation the SFC believes that proportionality is a key principle that should be applied when considering all aspects of prudential regulation. With this in mind, the Commission should consider its approach to a number of forthcoming regulatory measures, taking account of the broader changes in the prudential landscape since the crisis, as outlined in our responses to earlier questions. In particular, in the immediate term, the Commission and Member States authorities should consider proportionality when adopting measures on loss absorbing capital, TLAC and MREL. The SFC agrees that bank failure should be possible without requiring public sector bail-outs, and are supportive of the FSB proposal on TLAC and the concept of MREL. However, the EBA currently proposes allowing national supervisors significant discretion in applying MREL at the European level, meaning it is unclear how these requirements will be applied at group level; filter down to the rest of the group, or how supervisors in host and home countries will interact to avoid duplication of standards. Intragroup requirements for TLAC and MREL must be sensitive to the preferred resolution strategy, and any pre-allocation of resources to subsidiaries must be proportionate and take into account the disadvantages for the whole group of excessive

capital and liquidity ring-fencing. We would note that no reduction in the SIFI buffer has yet been contemplated despite the forthcoming implementation of TLAC, the NSFR, LCR and LR. Finally, if the Basel IV reforms lead to a material rebasing of RWA, then prudential requirements calibrated on RWA ratios should also be reviewed to ensure that the obligations remain proportionate to the original policy objectives.

Scope for simplification

14. Which areas of the CRR could be simplified without compromising the Regulation's objective of ensuring prudence, legal certainty and a level playing field? Are there areas that could be simplified, but only for specific types of bank or business models? Would it be useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations? What would be the risks with such an approach?

43. We would caution against the notion that standardised risks weights are an appropriate answer. As we explain in our responses to questions 2 and 3, proposals to shift the emphasis of the capital framework away from the risk-based approach in order to simplify them will make banks' capital allocations less responsive to underlying risk with consequent market distortions further concentrating holdings in assets that best meet regulatory criteria as opposed to being guided by risk assessments. It will also undermine the drive to cement a culture of accurate risk management in internal decision-making, one of the key aspects of the reform process since the financial crisis. A drive towards simple and standardised approaches misses the point that markets are complex, and that calculating risk is not straightforward. Regulators need to give institutions scope, appropriately guided, to bring to bear their understanding of the risks they are taking. Capital floors would add an additional dimension of complexity into capital allocation, reduce risk sensitivity and target a problem that is already solved by several other tools (e.g. tough model validation and eligibility criteria, and a backstop LR).

44. Similarly, the regulators need to consider the unintended consequences of reporting requirements. For example, parallel reporting of risk weightings under both standardised and internally modelled approaches may discourage institutions from using more accurate risk weightings based on internal models. There also needs to be simplification for those that have left the market.

45. Finally, in the context of simplicity, we would like to mention the Level 2 process, that we often find hard to follow and lacking in transparency. Some Level 2 obligations are delivered on time, others seem to get stuck in the development phase, no doubt on the basis of prioritisation that is not made public. Once final draft rules have been submitted to the Commission, there again seems to be no clear way to track the adoption process, and it seems timelines can vary materially. With often short time periods between adoption and implementation, it would be helpful for firms to be able to follow this process more accurately. Constant focus on impact assessments is of course critical to ensuring a better understanding of real economy impacts of new regulations. There have been recent examples of where final rules included some crucial elements that have not been consulted upon, perhaps most notably in the case of the Basel NSFR where a 20 per cent derivative liability gross-up was added at the last minute. In such situations the industry would prefer further consultation, a process which is often shorter than post hoc reviews. In the context of Vice President Timmermans's Better Regulation agenda, the Commission could consider how such matters are best approached in the EU in the future.

Single rulebook

15. *What additional measures could be taken in the area of prudential regulation to further promote integration and enhance a level playing field? Can you indicate specific examples and evidence of discretions that affect the cost and availability of bank lending?*

46. The SFC believes that a level playing field is paramount, both within the EU and between it and the rest of the world. Consistent regulation between jurisdictions is the best way to repair global capital markets and get sustainable investment flowing across borders again. So far, there has been a lot of talk about better co-ordinating global standards, but as we have seen in the derivatives space, this has not always resulted in consistent implementation of regulatory objectives, even when they have been shared at a high level. Combined with regulation in the prudential space – differing approaches to regulatory capital; structural reforms; the forthcoming implementation of TLAC etc. – we have seen the beginnings of fragmentation in global markets. It is essential that this process is arrested, and the SFC believes that the EU can play a key role at the global level to better co-ordinate jurisdictions.

47. In order to achieve this, it is important for the EU to lead by example in three ways.

- First, the EU should not anticipate changes in the international framework, and should implement international standards as they are agreed. Front-running changes to the international framework risks (i) undermining fair and effective competition within the sector, to the detriment of the consumer, (ii) weakening the EU's reputation and ability to influence global standard-setters, and (iii) ultimately setting off a race towards lower regulatory standards, which in turn will undermine financial stability and the achievements to date in the field of regulatory repair.
- Second, the EU needs to play a leading role in international bodies to help set those standards.
- Third, the EU should develop a consistent and coherent framework for decisions on third country equivalence, as called for in the draft report on EU financial services regulation being undertaken by the European Parliament. Timely and predictable determination of the regulatory and supervisory arrangements in place in third countries, supported by enhanced dialogue between the EU and third country competent authorities, is essential to achieve the legal certainty that market participants need.
- Finally, the EU needs to prevent divergences of implementation within the Single Rulebook, enabling the European Supervisory Authorities to tackle national gold-plating, and, crucially, avoiding a divergence of practice between the Banking Union and non-Banking Union countries. In this regard we welcome measures by the ECB to address the issue of within the SSM. However, there is a danger that in doing so, practice between members of the Banking Union and those outside will diverge. We therefore call for a strengthening of the role of the EBA to ensure the integrity of the Single Market across the EU 28.

Swiss Finance Council, October 2015

The Swiss Finance Council was established in November 2013 to engage in dialogue around policy developments in finance at a European and international level. It represents the interests of internationally active Swiss financial institutions and provides a platform to share their experience, expertise and knowledge through a permanent representative office in Brussels, thereby supporting the work of the Swiss Bankers Association in EU-related matters.

The Swiss Finance Council articulates and advocates the common interests of its members, provides a voice for their joint positions and a source of knowledge and experience in finance for policy makers and the industry at large. The organization enables its members to participate in policy discussions regarding European and international finance-related issues and develops positions and contributes on their behalf in the international and EU-level policy-making process.