EUROPEAN COMMISSION

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*Mr Dietmar WOIDKE*
*President of the Bundesrat*
*Leipziger Straße 3 - 4*
*10117 BERLIN*

*Dear President,*

*The Commission would like to thank the Bundesrat for its Opinion on "EU banking regulation – focusing on small and medium-sized banks and for the benefit of the real economy".*

*The Opinion is particularly timely as the current COVID-19 crisis raises questions on whether the EU banking sector can effectively support the EU economy and SMEs in particular within the applicable regulatory and supervisory framework. Similarly, the current challenges provide the Commission with an opportunity to better monitor and assess the efficacy of the current rules.*

*It is important to note that the EU banking sector is currently in a much better position to weather the COVID-19 crisis compared to the previous financial crisis a decade ago. Due to the reforms that were carried out after the financial crisis, EU banks have bolstered significantly their capital, liquidity and stability of their funding. Therefore, EU banks are now not only better prepared to deal with the current situation, but also to maintain their lending to the households and companies, including SMEs.*

*Nevertheless, the Commission remains fully attentive to the economic vulnerabilities in the financial sector, especially as the full economic consequences of the ongoing partial lock-down of economic activities in the EU and its trading partners remain unknown at this stage. The Commission is aware that any prolongation of the COVID-19 pandemic would eventually have an impact on banks' profits and the quality of their assets. To support banks to play their role in helping citizens and businesses weather the crisis and prepare for a swift recovery, the Commission adopted on 28 April a banking package[1] to facilitate bank lending. The package includes an Interpretative Communication on the EU's accounting and prudential frameworks ("Supporting businesses and households amid COVID-19"), as well as targeted amendments to the Capital Requirements*

[1] https://ec.europa.eu/info/publications/200428-banking-package-communication_en

*Regulation (CRR). The Commission is currently conducting a dialogue with the financial industry and businesses and consumers representatives to further develop best practices and support lending to the real economy.*

*Following the decision of 3 April of the Basel Committee on Banking Supervision on its policy-making agenda[2], the Commission has also reconsidered its own timeline with respect to the implementation of the finalised Basel III reforms.*

*In this context, the Commission is pleased to have this opportunity to provide its views regarding the points set out by the Bundesrat in this Opinion.*

*The Commission looks forward to continuing the political dialogue with the Bundesrat in the future.*

*Yours faithfully,*

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| *Maroš Šefčovič*<br>*Vice-President* | *Valdis Dombrovskis*<br>*Vice-President* |

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**For the Secretary-General,**

**Jordi AYET PUIGARNAU**
**Director of the Registry**
EUROPEAN COMMISSION

[2] https://www.bis.org/press/p200403.htm

Annex

*The Commission welcomes the views that the Bundesrat has expressed on this important subject. The detailed work that the Bundesrat has undertaken constitutes an important contribution to the debate that is now underway.*

*Please find below the Commission's views on the points raised in the Opinion.*

***Points 1 to 4****: While the Commission continues with its efforts in developing the Capital Market Union, it is true that bank financing continue to play a crucial role as a reliable source of funding for SMEs in many years to come and that EU banks of different size and business models would remain active in this area.*

*The EU financial regulation introduced in the aftermath of the 2008-2009 crisis have considerably strengthened the banking sector and banks' individual resilience, such as adequacy of their capital, liquidity or stability of funding to deal with crisis event. It is also true that the financial regulation enacted in the aftermath of the crisis have increased compliance costs for EU banks. A 2019 study contracted by the Commission shows that the implementation of financial regulation enacted in the aftermath of the 2009 crisis led to an increase in regulatory costs for all banks. For small banks, one-off costs increased from 2% to 3% while ongoing costs increased from 0.9% to 2.4%. For large banks one-off costs increased from 2.2% to 2.8% and ongoing costs from 0.3% to 2.9%. Most of that increase is justified as the new rules have made the EU banking sector better prepared to deal with stress situations, like the one we are currently experiencing.*

***Points 6 and 7a:*** *The Commission welcomes your suggestion that new regulatory requirement should have its simplified version, which while being less burdensome to implement meets its prudential objectives. Indeed, safeguarding financial stability, and also protection of depositors, are important objectives to consider when designing simplified rules. The Commission notes that CRR already contains simplified rules, such as standardised approaches, that smaller banks can use and does not consider changing them.*

***Point 7b:*** *The European Banking Authority (EBA) has started the review of the supervisory reporting framework and despite a likely delay in the review report due to covid-19 crisis, the Commission expects the EBA to find ways of materially reducing the costs of supervisory reporting. The Commission is also aware of duplicative national data requirements and trusts national authorities to take steps towards removing them and therefore reducing reporting burden.*

***Point 7c:*** *The creation of an integrated reporting platform cannot replace the need of the EU-wide stress tests, organised every two years by the EBA. The EU solvency stress test are based on a constrained bottom- up approach, conducted at the highest level of consolidation in the EU (group level) and are applied to a sample that represents about 70% of EU banks' total assets – thus, mainly large banks are involved in this exercise.*

*The banks' participation is not limited merely to having provided the information needed for the maintenance of an integrated reporting platform. Since the EBA-organised stress tests requires banks to make projections based on a given hypothetical scenario, these banks are not passive providers of information. While following the common agreed methodology, they are allowed to build and run their own models to calculate the impacts of the shocks on their balance sheets and to produce capital figures under stress, developing in this way efficient risk management practices.*

***Point 7d:*** *The case for excluding small institutions from the SREP needs to be considered from the perspective of the latest adjustments to that framework, which enforce proportionality and predictability of the SREP. Thus, Article 97(4) of the CRD embeds proportionality as it provides competent authorities with the possibility to "establish the frequency and intensity of the review and evaluation [SREP] having regard to the size, systemic importance, nature, scale and complexity of the activities of the institution concerned and taking into account the principle of proportionality." This is translated in the EBA SREP guidelines (updated last in July 2018) through a classification of banks in four different categories depending on a set of criteria, in particular their size and complexity. These guidelines propose different frequencies for the SREP assessment for each of these categories (from an annual to a three-years periodicity for the full completion of the SREP), thereby ensuring proportionality in the application of the SREP assessment. More generally, the EBA SREP guidelines frame the SREP assessment ensuring a minimum level playing field, comparability and transparency in the process of determination of the Pillar 2 requirements and the Pillar 2 guidance. In addition, it should be noticed that the current EBA SREP guidelines are under review by the EBA following the adoption in June 2019 of the CRD5, introducing, among other elements, the new category of small and non-complex institutions. Moreover, CRD5 clarifies additional elements of the SREP analysis and substantially frames the discretion of supervisory authorities to impose additional capital requirements by defining which risks may be covered, ensuring materiality of such risks and requiring case-by-case justification for supervisory measures.*

***Point 7e:*** *The risk-based capital framework sets capital requirements primarily in proportion to a historical assessment of risks in each asset class. In contrast, the leverage ratio framework has been designed to guard against an understatement of risks and therefore treats all exposures equally, regardless of their estimated risk levels. Both frameworks therefore work best when they complement each other. For instance, a pure leverage ratio requirement could create incentives for banks to increase investments in high-risk assets as no additional capital would be needed to fund these positions relative to low-risk exposures. This undesired effect can only be mitigated by applying the risk-based capital framework as well. Furthermore, German corporates, typically well equipped with collateral to pledge, could face higher funding costs as collateral does not reduce a banks' capital requirements under the leverage ratio requirement. Consequently, the envisaged introduction of a binding leverage ratio requirement remains appropriate, but as a complementary measure only, while the risk-based capital framework should continue to be the primary instrument of the solvency rules governing all banks in the Union.*

**Point 7f:** *The new Standardised Approach (SA) for credit risk for exposures to multilateral development banks and to banks already embeds an important level of risk-sensitivity: risk weights applicable to exposures of banks having high ratings are much lower than risk weights for those banks with lower ratings. Further, the External Credit Risk Assessment Approach (ECRA) provides that exposures to unrated banks should be treated under the Standardised Credit Risk Assessment Approach (SCRA). Under SCRA, those exposures may receive RWs between 20% and 150% depending on their risks. The Commission will take due consideration to assess whether this framework is sufficiently risk-sensitive for specific cases such as the one Bundesrat mentions in point 7 f) of its Resolution.*

**Point 8:** *The Commission continues to be committed to avoiding unduly burdensome regulatory costs, in particular for small banks, but also for other institutions. The Bundesrat suggestion of achieving this objective by reducing prudential regulation and intensity of supervision for mid-sized banks should be assessed very carefully in light of the features of the European banking market. Comparing merely the size of total assets of institutions in the EU with those in US or Switzerland would not be sufficient to draw conclusions, especially as the EU is composed of Member States whose banking sectors vary in terms of size. In some smaller Member States a majority of banks have total assets lower EUR 30 billion and hold significant parts of the market and have systemic importance in those Member States. For those ones, reducing the rules and the supervision would not be warranted. So far, the Commission has not obtained compelling evidence that would suggest the need to reduce rules for institutions with total assets between EUR 5 and 30 billion, nor which specific rules could be considered. Moreover, it should be recalled that the current proportionality embedded in the rules benefits also this category of banks.*

**Point 9:** *The Commission is committed to faithfully implement the Basel III agreement in the EU in order to complete the post-crisis bank prudential framework, taking into account European specificities and the need to preserve the diversity of the European banking sector, and bearing in mind the objective stated by co-legislators for the reforms not to result in a significant increase in the overall capital requirements for the banking sector.*

**Points 10 and 12:** *The Commission is carefully analysing the different options made available under the final Basel III package for risk weighting exposures to corporates under the SA for credit risk: ECRA vs. SCRA. In order to draw a conclusion on this aspect, the Commission will also have to take into account the potential continued use of the so-called "SME supporting factor", the scope and effect of which have been substantially increased through the recent amendments to CRR brought by the CRR2.*

**Point 11:** *The Commission is carefully considering any possible unintended consequences of the implementation of the new risk weights applicable to equity exposures under the SA for credit risk, especially on specific group business models or other institutional protection schemes, and takes good note of this point made by the Bundesrat in its Resolution.*

***Point 13:*** *A granularity criterion for the retail exposure class under the SA was already incorporated in Basel II rules. The final Basel III package provides additional flexibility for this criterion (see paragraph 55 of Basel III: "unless national supervisors have determined another method to ensure satisfactory diversification of the regulatory retail portfolio"). In this regard, the Commission takes due consideration of point 13 made by Bundesrat in its Resolution and will carefully assess if there would be a need to redraft Article 123(b) CRR.*

***Point 14:*** *The Commission thanks the Bundesrat for its comments. It is carefully assessing both options, the so-called "whole-loan-approach" and "loan-splitting-approach, having also in mind that the transposition of those Basel III rules into the CRR should avoid creating possibilities for regulatory arbitrage.*

***Point 15:*** *Similarly to the initial Basel III standard on CVA risk published in 2011, the final Basel III standards published in 2017 do not exempt whole categories of transactions from the calculation of the capital requirement for CVA risk.*

*By contrast, the CRR provides a number of exemptions from the CVA framework (certain non-financial, sovereign, intra-group and pension fund counterparties), with the aim to prevent a potentially excessive increase in the cost of derivative transactions for those counterparties due to the introduction of the own funds requirements for CVA risk.*

*The final Basel III standard on CVA risk would address the known deficiencies of the initial Basel III standard on CVA risk by better reflecting the real CVA risks banks are exposed to. However, during the ongoing monitoring of the impacts of the final Basel III standard, the Basel Committee on Banking Supervision (BCBS) realised that the calibration of the final Basel III standard on CVA risk did not meet the agreed target. Therefore, the BCBS is currently considering the calibration to the final Basel III standard on CVA risk with the intention to reduce its capital impacts. This review is expected to be concluded during the course of this year.*

***Point 16:*** *As the Bundesrat may already be aware of, due to covid-19 crisis the implementation date of the Basel III standards finalised in December 2017 has been deferred by one year to 1 January 2023 by the BCBS. The accompanying transitional arrangements for the output floor has also been extended by one year to 1 January 2028. The Commission is currently considering how to incorporate this deferral into its own timetable, as well as the appropriate amount of time to be given to banks to implement the new rules*