Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002, Basel
Switzerland

7 September 2016

Subject: BCBS consultation on reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

Dear Mr Ingves,

We are writing to you concerning the recent consultation held by the Basel Committee on Banking Supervision on reducing variation in credit risk-weighted assets. It is our understanding that the proposals could involve important detrimental consequences for non-financial companies as end-users of financial services and we would therefore urge you to consider their impact on the real economy prior to any decision on their eventual endorsement.

The EACT has been and continues to be supportive of most of the post-crisis measures aiming at making the financial system safer, more robust and more transparent. The requirements on capital, leverage and liquidity in Basel III were a necessary change from the past, as non-financial companies need stable, well-governed and appropriately capitalised banks.

However, in the current economic context it is also crucially important to ensure that financial regulatory reforms ensure banks' ability to perform their primary task: to support actors in the real economy by providing them with all the necessary financial products and services needed to conduct and develop their business. The EACT has already expressed concerns on some of the adverse consequences that the regulatory reform has had on non-financials companies' ability to fund themselves, manage their risks and handle their liquidity, and the excessive administrative burden it has created in many instances.[1] Corporates now face difficulties both achieving compliance with requirements from financial counterparties, and also accessing a comprehensive and efficient set of financial services as corporate end-users of the global financial system. The authorities should take appropriate care not to implement any measures that would further deteriorate the situation, and be mindful of the fact that a non-financial

[1] See for instance our recent response to the European Commission's call for evidence on EU regulatory framework for financial services http://www.eact.eu/docs/EACT-Response-EC-Consultation-Cumulative-Impact-Financial-Reform-31Jan16.pdf

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sector unduly compressed by the effects of financial regulation is also a factor of instability for the financial sector.

The Committee proposes generally to limit the use of internal risk models and move back towards the use of standardised models – a model we understand to be very risk-insensitive and arbitrary. These proposals would impact the whole range of banking services that non-financial companies require: loans, credit lines and overdrafts, derivative products, cash management tools etc. The Group of Governors and Heads of Supervision (GHOS) has asserted that the proposed changes should not overall significantly increase the capital required to be held by banks. It is however unclear to us how such an outcome could be achieved, as banks estimate that their risk-weighted capital needs would considerably increase as a result of the planned changes. We fear that this could lead to an important contraction in lending to non-financial companies, an increase in pricing of various banking products and services and a very likely reduction of banks' offer of different banking services and products. If added to the difficulties non-financial companies already face, we feel that the outcome could be more detrimental and destabilising to the economy as a whole than any benefit that can be expected from more capitalised banks.

We are aware that the European banking industry estimates that in order to comply with the Committee's proposals, it would need to either raise an additional 300 billion euros of capital or to cut balance sheets by 25 per cent. If this were to happen, banks would seek to pass on the additional costs as much as possible to their corporate clients, potentially through massive price increases. Some of the estimations we have seen include the following. :

- Depending on the type of counterparty and the type of instrument, the bank capital required for derivative products could increase by up to eight times from the current levels. Non-financial companies are not able to bear the resulting cost increases. Yet derivative instruments are vital for non-financial companies for managing financial market risk linked to their daily business activities, and the resulting contraction in hedging would leave the whole economy – including financial institutions that service these companies – less stable and more prone to volatility.
- Capital required for certain products/services (e.g. specialised financing, lending) is expected to rise at a minimum two to three-fold from current levels.

It is worth noting that any estimation of the cost impact to the real economy sector does not reflect the impact that non-financial companies could face once the interest rate environment normalises.

We note that the proposals would be particularly damaging for large non-financial companies and for those using 'specialised lending', as they would be the most impacted by the removal of internal risk models and would be bluntly given risk weights that do not correspond to the real risk associated with those corporate counterparties. This means that non-financial companies that generally are of the highest credit quality the have lowest default rates would be the most penalised by the proposals. Such a development is counterintuitive and lacks a clear and objective justification – certainly it cannot be argued that such a development would be justified from either a risk or an economic perspective.

Furthermore, the proposal to limit the use of internal models would create a major distortion in competition between EU and US banks and could furthermore possibly also lead to

concentration within the European banking industry, to the detriment of end-users. The proportion of market-based financing is considerably lower in the EU than in the US, which means that any measure impacting banks' ability to fund the economy will disproportionately hit the European economy, and this at a time when it is starting to show signs of slow recovery. Also, market-based financing will not be able to absorb the funding needs of European companies, not to mention all other banking services that are not readily available from non-banking actors. As a consequence the European real economy would be disproportionately penalised – a consequence that is unacceptable to our members.

Lastly, we would like to express our disagreement with the Committee's decision to eliminate the possibility to use internal models for calculating CVA exposures. We believe that such a change would not make the CVA framework any more workable, and instead would make it more risk-insensitive.

We are convinced that more analysis is needed before making final decisions on measures that could have such a far-reaching negative impact on economic activity and growth. It is unclear to us how certain differences within the banking sectors' internal risk models (which should be properly monitored by competent and adequately staffed authorities) would justify such a consequential change in risk weighing and capital allocation. We therefore strongly recommend that the Committee conduct an in-depth analysis on the impact of its proposals on economic activity prior to taking any next steps.

We remain of course open for a dialogue with you, and would be delighted to meet with you or your staff in order to expand on our concerns at your convenience.

Yours sincerely,

Jean-Marc Servat
Chair – European Association of Corporate Treasurers

Cc:

European Commission:

Valdis Dombrovskis, Vice President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union

European Parliament:

Roberto Gualtieri, Chair Economic and Monetary Affairs Committee