**TARGETED CONSULTATION**

**ON IMPROVING THE EU’S MACROPRUDENTIAL FRAMEWORK FOR THE BANKING SECTOR**

**Executive summary**

**Whichever reform is adopted following this consultation, it is of utmost importance that it does not translate into an increase in the overall level of capital requirements.**

* Banks indeed hold “excess capital”, as demonstrated by the results of the 2021 EU-wide stress testing showing that the adverse scenario would have a negative impact of 485 bps on banks' CET1 fully loaded capital ratio, leading to a 10.2% CET1 capital ratio at the end of 2023.
* Very significant amounts of capital are “frozen” because of this accumulation of buffers, while such resources could be usefully invested in the economy.
* It is of no help, from a financial stability perspective, to have elevated buffers, if the consequence is that return on equity and Price to book is low, and therefore the bank has no access to raise capital in the market.
* The existence of implicit market capital requirements that are influenced by – but higher than - the level of capital requirements in normal times and relatively stable compared to the latter tends to reduce the effectiveness of changes in official capital requirements during the cycle or according to specific circumstances. This is a strong argument towards a calibration of official requirements closest to the optimal level and not excessively high in normal times, in order to preserve the ability of the banking system to limit downturns and support recoveries, namely in situations where the capital releases decided by the supervisor would not be totally effective in practice.
* In any case, the EU should avoid increase in buffers in crisis times (in € terms).

We would also like to highlight that the EU buffer framework largely derives from, and gold-plates, Basel standards. This has several consequences on the way this consultation should be handled:

* First, discussions on its design and calibration must be performed not only in the EU but also at global level, given room for maneuver at EU level is limited and does not allow holistic reform of the framework. In addition, the BCBS has initiated a review of the buffer framework, following its report on lessons learnt from Covid-19, as part of its Evaluation Task Force. We suggest that the EU does not reform its macroprudential framework unilaterally, before changes are discussed and adopted at Basel level, which is essential for Europe to be faithful to multilateral standards.
* Second, as new BCBS and EU standards (leverage buffers, output floor, MREL) are being implemented in the EU and many other jurisdictions, it is essential to take into account the changes introduced by these new rules. The most significant change is probably the Output Floor, which substantially modifies the nature and measurement of risks that are addressed as part of Pillar 1.

This is also the reason why we respond to this consultation taking into consideration all the buffers:, i.e. current and future P1 & P2 buffers, as well as so-called “management buffers” or “capital headroom” imposed by supervisors that exist on top of minimum capital requirements, but also the other stacks i.e. leverage and MREL, and not only macroprudential buffers. Importantly, IFRS9 should also be taken into account as part of an overall review of the capital framework, as lifetime provisioning equates to the building-up of a capital buffer. A holistic view is necessary to avoid overlaps between requirements that may address similar risks and “risk drivers” and ensure consistency across the stacks.

While the avoidance of overlaps would require specific definitions of risks to be covered by each buffer, another approach, potentially more pragmatic and which would give more readability to the framework, could be to calibrate the buffers in a holistic way (which also requires a change in governance).

* Indeed, in real-life, there are no different “layers” of capital that are meant to absorb losses stemming from specific risks. On the contrary, banks hold a certain amount of capital and eligible liabilities (CET1, AT1, T2, MREL) that are available to absorb losses, in a fungible way. Consequently, the argument that some layers of capital used to comply with a given requirement should not be used to comply with other, parallel requirements, is not appropriate.
* In real life also, losses do not always stem from one specific risk but from a certain number of risks that can materialize at similar or distinct times and are sometimes interdependent, in particular between micro v. macro-prudential losses and/or idiosyncratic v. systemic risks.
* Every risk should not (and cannot) be addressed by a macroprudential capital charge. We guard against the temptation to establish an (endless) list of risks that banks could be exposed to and that would justify the creation of additional layers of capital requirements.
* All risks are adequately tackled as part of existing Pillar 1 framework and/or via Pillar 2.

We would also like to stress two important considerations on the optimal amount of capital to be accumulated by banks and on the way it can be used in order to absorb losses while supporting lending:

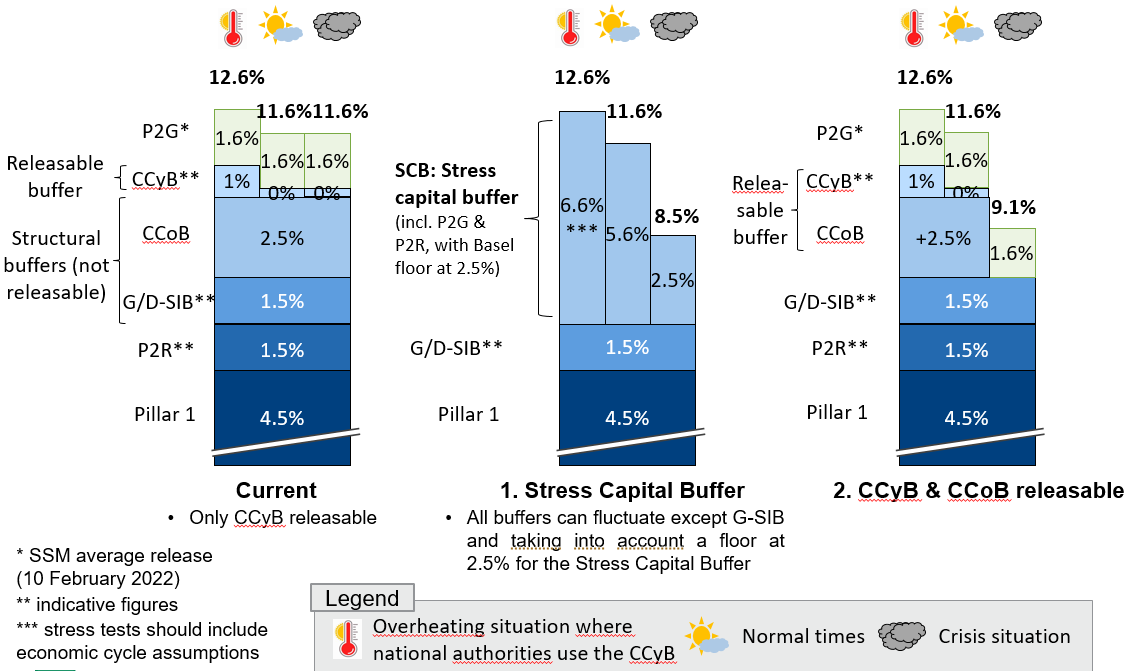
* The consultation paper seems to rely on the basic axiom that financial stability increases linearly with increases in capital requirements. It should be at least recognized that capital accumulation beyond a certain level stifles investments and deteriorates institutions’ revenue generation capacity.A recent ECB [research paper](https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2356~4a9ccc29af.en.pdf) evidenced a 10.9% turning point, meaning that banks’ creditors perceived capital accumulation beyond 10.9% of their RWA as “inefficient and hampering their profitability”. As emphasized by the authors of the ECB,“(…) these results could also inform **the calibration of macroprudential capital policy measures**, such as the countercyclical capital buffer”. [[1]](#footnote-1)
* In addition, as acknowledged by the BCBS, a very important metric to explain banks’ reluctance to use their capital resources in times of stress is not the absolute amount of capital they hold but rather their “capital headroom” i.e. the “distance to the MDA”: “quantitative work regarding a large sample of international banks and more granular analysis in the euro area suggest that banks closer to their regulatory buffers have been more likely to constrain lending”.

**“Usability” does not work: there should be more “releasability” embedded in the buffer framework.** To remedy with the present limited usability of the buffer framework (only CCyB usable), two solutions are described thereafter.

**As European banks will face an increase in their micro-prudential requirements through CRR3/CRD6, it is essential to avoid piling up multiple buffers on top of those increased requirements. EU regulators should revisit the whole framework and design a better articulated, simpler framework, differentiating clearly a micro-prudential requirement and a macro-prudential buffer. Such solution could be similar to the Stress Capital Buffer system, which has proved its effectiveness in the United States and would ensure a better comparability for the major European banks, and market participants.**

* Merging the CCoB, CCyB, SyRB and Pillar 2 components into a Stress Capital Buffer, would entail a strong simplification of a more complex framework, both in terms of buffer architecture and governance.
* A major benefit of this approach would be to replace buffers that are set arbitrarily without explicit reference to risk metrics with a buffer that captures the specific vulnerability of each bank’s balance sheet to a given macroeconomic scenario.
* It is also the option that would provide the greatest “releasability” in the capital framework, while also responding effectively tackling growing risk (in “overheating situations”) via stress tests.
* Importantly, it can be implemented without any deviation from Basel standards, provided a 2.5% floor is introduced.
* It would improve competitiveness of the EU banking sector, as part of the EU strategic autonomy stance.
* For the SCB approach to deliver the targeted releasability, it would be necessary to ensure that regulatory adverse scenarios are designed as countercyclical, in line with the US.
* Given the importance of scenario-setting in this option, the governance of macro-economic stress scenarios should be strengthened.
* In any way, the amount of the SCB should not derive automatically from the outcome of the stress-tests, i.e. a mechanism should be in place so that authorities can exercise supervisory judgment when setting the SCB.

**Another option** would provide more flexibility compared to the current framework thanks to two distinct buffers being releasable in crisis times: the CCoB would be available in case of exogenous shock and/or the CCyB could be released in case the risks associated with excessive credit growth materialize. This solution would also ensure a balance between EU and national authorities. On the downside, this option requires changes in Basel standards.



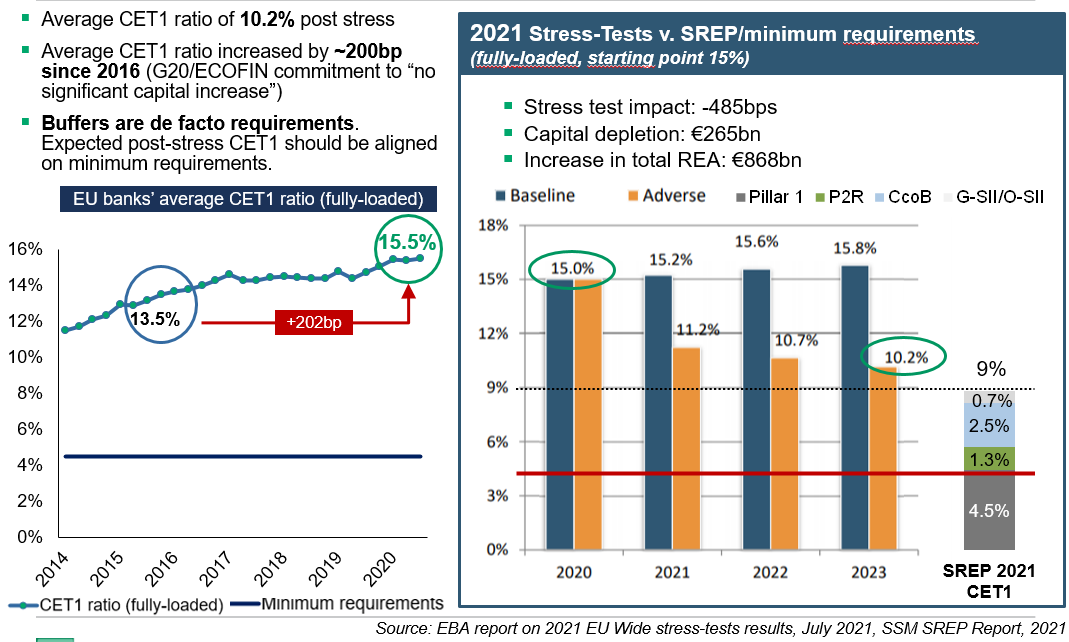
**In any case, the reform should avoid positive CCyB in normal times in accordance with explicit BCBS definition.** Indeed, the CCyB aims to “ensure that the banking sector builds up additional capital defenses in periods where the risks of system-wide stress are growing markedly” […] “this focus on excess aggregate credit growth means that jurisdictions are likely to only need to deploy the buffer on an infrequent basis” [source: BCBS RBC 30.6/30.7]. If a “positive neutral” CCyB were imposed, commensurate offset would be needed to avoid capital increase.

**Importantly, we believe that relief must be granted in a harmonized way and at the same time across the different stacks (risk-based, leverage, resolution). Otherwise, any relief would be tied up by other constraints.**

* Introduction of leverage buffers (G-SIB, P2R-LR, P2G-LR) will make the leverage ratio increasingly binding, hence proportional releasability of leverage requirements will become all the more necessary.
* MREL/TLAC requirements are derived from risk-based buffers and leverage. When buffers are released, commensurate adjustments of MREL/TLAC should be automatic and immediate. When buffers are rebuilt, adequate time should be left to banks to reach MREL targets.

**Additionally, some issues need to be handled:**

* Countercyclical Buffer, which should be neutral in normal situations, should be released promptly when needed and targeted measures should be preferred, in particular to include non-bank business.
* Treatment of new risks (ESG, Cyber risk) should not lead to capital requirements because of the need to avoid double counting as: (i) ESG risks are risk drivers of existing credit, market, and operational risks, (ii) cyber risks are risk drivers of operational risk, (iii) recent reinstalment of Countercyclical and Systemic buffers is premature. Also, proper sequencing between QE tapering, progressive normalization of monetary policy, and implementation of macro-prudential measures is needed. Simultaneous activation of all levers may endanger a still fragile recovery.
* There is no need to modify the MDA framework, but rather to ensure it is implemented. In the COVID crisis, supervisors took distribution restrictions” much above MDA trigger. We welcome EC’s statement that “at the current juncture, the Commission does not see a need for additional supervisory powers to be granted to the competent authorities to impose restrictions on distributions by institutions in exceptional circumstances. Otherwise, the MDA framework should be removed, to reduce complexity of the capital stack, all the more given the spill over on leverage MDA and MREL.



1. See also: Quignon L. (2017), “The economic impact of Basel III: applying the BIS analysis to the Eurozone”, BNP PARIBAS Eco Conjoncture, February. https://economic-research.bnpparibas.com/html/en-US/economic-impact-Basel-III-applying-BIS-analysis-eurozone-2/27/2017,29606 [↑](#footnote-ref-1)