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FBF RESPONSE TO THE BCBS CONSULTATION PAPER ON THE CONSOLIDATED BASEL FRAMEWORK (BCBS d462)

I- General comment

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 340 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 340,000 people in France and around the world, and serve 48 million customers.

The FBF welcomes the opportunity to comment on the Basel Consultation (BCBS d462)¹ on the Consolidated Basel Framework. Please find below our feedback on the specific adjustments subject to consultation (question 2) preceded by additional suggested adjustments (question 1).

¹ Please see: <https://www.bis.org/bcbs/publ/d462.pdf>

Question n°1. Does the framework accurately, clearly and comprehensively set out the policy contained within the published Basel standards?

Although the below items are not specifically subject to the present consultation, the FBF and its member banks think it could be relevant to discuss the opportunity to make additional adjustments to the Basel consolidated framework.

These adjustments could be justified for clarity and consistency reasons (items 1. and 2.) or in order to adequately reflect the evolution of actual capital requirements, including buffers (item 3).

1. Prudential treatment of software assets

Reference to consolidated Basel framework paragraphs 30.7 and 30.8

Our understanding is that the Basel rules relating to intangible assets do not target software *per se* but rather goodwill and other intangible assets that do not generate tangible value and that in any case, it does not reflect today's reality that software is a core asset which could be considered the cornerstone of modern banking. For financial institutions, *"software is as necessary as an asset to produce banking services than a factory to produce cars"*.

Reference is made in Basel capital framework to applicable accounting standards for the determination of the intangible "feature" of banks' assets. Some jurisdictions follow this understanding that software should not be deducted from CET 1 when they approach software as a tangible asset. This is for example the case of the US or Switzerland where software assets can be recognized in accounting items such as "Premises and equipment", "Property, equipment and software" or "other assets" under certain conditions, as observed in the financial communication of banks headquartered in those jurisdictions. In this context, software assets, as tangible assets, receive a 100% risk weight in the Basel capital framework.

On the opposite, the EU implementation of IFRS, for instance, explicitly classifies software as an intangible asset under IAS 38 (except for some marginal cases), thereby leading to the mandatory deduction of its value from the banks' Common Equity Tier 1 (CET 1) capital in accordance with paragraph 30.7.

As a result, the prudential approach to software may be more or less stringent depending on the jurisdiction considered and it ultimately depends on the accounting standards effectively applied rather than on prudential risk considerations on the asset itself.

As there does not seem to be a reasonable rationale for those diverging jurisdictional treatments, we think it would therefore be of general interest that the BCBS clarify the normative prudential treatment of software that the Committee expects its member jurisdictions to implement in the Basel capital framework, namely that capitalised software investments do not have to be deducted from CET1.

This consideration looks important to foster a consistent implementation of Basel rules in all relevant jurisdictions and it would contribute to the objective of international level-playing field, all the more in a context of digitalisation where software has increasingly become a strategic asset for banks and where cyber criminality threat implies massive investment to the benefit of financial stability.

2. Minimum haircut floors framework for Securities Financing Transactions (SFTs)

Reference to consolidated Basel framework Section CRE56

(Reference to “Basel III: Finalising post-crisis reforms (d424)” paragraphs 179. to 188.)

The Basel Committee, in its December 2017 finalised Basel III post-crisis reforms standards, introduces of a new Minimum haircut floors framework financial collateral haircut in SFTs.

Under this new framework the standard specifies that in-scope SFTs (or netting set thereof if applicable) for which the financial collateral haircut does not meet the newly defined haircut floor must be treated as an unsecured loan and subsequently receives a very penalising treatment.

The minimum haircut floors framework for SFTs as defined by the BCBS is not in line with the related framework set by the FSB.

When the FSB issued its regulatory framework on this topic in Oct. 2014 (https://www.fsb.org/wp-content/uploads/r_141013a.pdf), the numerical haircut floor envisaged on financial collateral other than government securities (or cash under conditions) in non-centrally cleared SFTs was intended to target only the transactions where the financing is provided to entities other than banks or broker-dealers : in that case, that financing, although collateralised, should be treated as unsecured loan for capital requirements. The objective of the FSB was to limit the build-up of excessive leverage outside the banking system and to help reduce the procyclicality of that leverage. However, the Basel standard goes beyond the FSB framework when it expands the scope to securities borrowing when the borrower of the securities intends to use the received securities to meet a current or anticipated demand. Indeed, in this situation there is no intention by banks to finance shadow banking but to source securities to perform market making activity.

3. Review of the 1250% risk weight

Reference to consolidated Basel framework: paragraphs 11.5, 20.6, 20.33, 22.10, 22.103, 31.29, 35.10, 40.31, 40.41, 41.10, 42.2, 42.4, 42.16, 42.17, 43.24, 54.42, 60.8, 60.20, 70.12,

A risk weighting of 1250% was equivalent under Basel II to a deduction from regulatory capital when considering a 8% minimum capital requirements. This 1250% risk weight appears to be a legacy from older Basel texts and it is no longer adapted to the level of banks' applicable capital requirement and actual capital base.

This 1250% risk weight is still applied in the 2019 version of the consolidated Basel framework, (i) for equity investments in commercial entities above the materiality threshold, (ii) for certain equity exposures under the PD/LGD approach (iii) in the securitisation framework in the absence of due diligence, when banks cannot use the other approaches or under certain respective specific conditions under SEC-SA, SEC-ERBA and SEC-IRBA, (iv) for credit protections provided in the form of 1st- or 2nd-to-default credit derivatives (v) for exposures to the default fund on non-qualifying CCPs, (vi) for equity investment in funds where neither the mandate-based approach nor the look-through approach are feasible and as a cap for the leverage adjustment and (vii) for failed delivery-versus-payment transactions

Considering the actual level of bank capital requirements including buffers, we are of the view that a risk-weighting of 1250% is over-penalising as the resulting impact on regulatory capital requirements exceeds by far a plain deduction from regulatory capital, which used to be an alternative treatment for some of the exposures concerned.

Thus, for a bank that would be subject to a total capital ratio of say 13,1%, as presented in the below illustration, the risk weight (RW) equivalent to a deduction would be only 763%, meaning the impact on regulatory capital for exposures subject to a 1250% RW is 64% higher than if those exposures were just deducted from regulatory capital.

		Level	Cumulative requirement	RW equivalent to a deduction
	Minimum capital requirements	8,00%	8,00%	1250%
<i>example</i>	+ capital conservation buffer [CET 1]	2,50%	10,50%	
<i>example</i>	+ countercyclical buffer [CET 1]	0,10%	10,60%	
<i>example</i>	+ P2R [CET 1]	1,50%	12,10%	
<i>example</i>	+ SIB buffer (CET 1)	1,00%	13,10%	
<i>example</i>	Total capital requirements	13,10%	13,10%	763%

Question n°2. What are your views on the technical amendments in Section 1?

A. CRE - Calculation of RWA for credit risk

a. CRE52.1 - Products for which no specific treatment

Context: FAQ3 (i.e. “Are banks permitted to decompose certain types of products for which no specific treatment is specified in the SA-CCR standard into several simpler contracts resulting in the same cash flows?”) of CRE52.1 details the options that could be decomposed as a portfolio of various options for calculations. FAQ3 underlines linear instruments can’t benefit from this treatment (i.e. decomposition).

Proposal: We welcome this clarification transposed in the EU legislation (please see Article 274(6) of Regulation 2019/876). Nevertheless, could the Basel Committee confirm complex instruments (i.e. combining linear derivatives and options) can be decomposed in simpler products for calculation purposes (i.e. a linear derivative [i.e. such as an interest rate derivative] + cap/caplet + floor/flooret)?

b. CRE52.74 - Treatment of multiple margin agreements and multiple netting sets

Context: FAQ1 (i.e. “How should multiple margin agreements be treated in a single netting agreement?”) relative to the paragraph CRE52.74 authorizes the netting between margined and unmargined transactions for the calculation of the replacement cost (RC), whereas for the calculation of the potential future exposure (PFE), there should be a distinct calculation for all unmargined transactions and for margined transactions of differing MPoR (margin period of risk).

Proposal: We welcome this clarification and call for an alignment of the EU legislation with these requirements (i.e. as defined in Article 274(4) of Regulation (EU) 2019/876).

B. MAR - Calculation of RWA for market risk

a. MAR50.32 - Floor of MPoR

Context: Market participants have sought guidance as to whether a lower margin period of risk (MPoR) than the “9+N day minimum” (as specified in paragraph 30 (Minimum capital requirements for CVA risk) of BCBS d424²) in SA-CVA may be acceptable in cases where the relevant counterparty credit risk standard permits a lower MPoR.

Although the SA-CCR standard sets the minimum MPoR for derivative transactions to at least 10 days for transactions that are not centrally cleared, SFTs are covered by other methods to determine counterparty credit risk capital requirements (i.e. repo-VaR, Internal Model Method, Comprehensive Approach), all of which set the minimum MPoR for SFTs to 4+N business days.

² Please see: <https://www.bis.org/bcbs/publ/d424.pdf>

The final bullet point of paragraph MAR50.32 **clarifies that the minimum MPoR for SA-CVA is set equal to 10 business days for derivatives and five business days for SFTs in the case of daily margining.**

Proposal: The FBF welcomes the amendment on the definition of the MPoR for the determination of the expected exposures for the purpose of the SA-CVA calculation [MAR50.32(9) – future version] (see BCBS d462 Section 1.6.1). **However, it should be made clear that for clearing member derivative exposures to clients, the MPoR may be set to that of CRE54.12 (current and future versions), i.e. a “margin period of risk of at least five days”.**

Paragraph MAR50.32 should be modified as follows:

“MAR 50.32 [...]

*(9) For margined counterparties, the simulated paths of discounted future exposure must capture the effects of margining collateral that is recognised as a risk mitigant along each exposure path. All the relevant contractual features such as the nature of the margin agreement (unilateral vs bilateral), the frequency of margin calls, the type of collateral, thresholds, independent amounts, initial margins and minimum transfer amounts must be appropriately captured by the exposure model. To determine collateral available to a bank at a given exposure measurement time point, the exposure model must assume that the counterparty will not post or return any collateral within a certain time period immediately prior to that time point. The assumed value of this time period, known as the margin period of risk (MPoR), cannot be less than a supervisory floor. For derivative transactions, the supervisory floor for the MPoR is equal to 9 + N business days, where N is the re-margining period specified in the margin agreement (in particular, for margin agreements with daily or intra-daily exchange of margin, the minimum MPoR is 10 business days). For SFTs, the supervisory floor for the MPoR is equal to 4+N business days. **MPoR may be set at five business days for centrally cleared derivative transactions subject to the daily margin agreements that clearing members have with their clients**”*

C. Operational Risk

a. OPE 25.34 - Inclusion of losses and BI items related to mergers and acquisitions

Context: The amendment proposed by the Committee clarifies the scope of loss and business indicator data that should be included in the standardised approach calculation in case of an acquired business / a merged entity. The original text provided banks with some flexibility on the determination of the “relevant” business and mergers to be included while the proposed revision considers all those acquisitions/mergers in the “relevant” time period.

Proposal:

This proposed amendment represents a “substantial” change, which contradicts the Committee statement in the consultation document (“Such policy changes, which are not substantial (...)). Based on this observation, we consider that at least materiality thresholds should be applied for the inclusion of the Business Indicator (BI) and the Loss Component, in the same vein as for the standard applicable

in particular for divested business which specifies the conditions of losses exclusion from the Loss Component (OPE 25.32).

Going forward, whereas we understand that a pro forma BI component would be needed as a proxy of operational risk exposure, though subject to possible adjustments approved by the competent authority, it must be underlined that when a bank acquires a new business/entity, significant modifications are then applied to its governance and its actual management, meaning that its new operational risk profile is finally disconnected from its past operational risk events. Therefore, the historical loss data related to that business/entity is not representative of the operational risk of the acquirer and its plain and automatic inclusion in the acquirer's Loss Component does not seem relevant.

Therefore, we suggest that the inclusion in the Loss Component of historical loss data of acquired businesses / merged entities be subject to a systematic supervisory review and dialogue (above the materiality threshold) leading to a formal request by the competent supervisor, in a way that would mirror the supervisory approval required for the exclusion of any loss data which "would no longer be relevant to the banking organisation's risk profile" (OPE 25.30).

D. CAP – Definition of Capital

a. CAP 10.11 - additional Tier 1 capital

Context: the new FAQ 7 of CAP 10.11 further details the tax events considered acceptable in the context of redeeming capital instruments.

Proposal: The FBF welcomes this clarification. However, the case where the adverse impact is on the holder should be added. Therefore, FAQ 7 should be updated as follows:

"FAQ7

An Additional Tier 1 instrument can be redeemed within the first five years of issuance only on the occurrence of a tax event or regulatory event. Please advise whether: (a) a tax event must relate solely to taxation changes that adversely affect the tax treatment of dividend and interest payments from the issuer's perspective; (b) a tax event could also include tax changes from the holders' perspective, with or without the issuer seeking to compensate the investors with additional payments; and (c) issuers should be allowed to gross up distributions to compensate the investors with additional payments, or whether this should be regarded as akin to a step up and an incentive to redeem (either under a call option related to the "tax event" (if permitted), or otherwise when the five year call date is reached).

A tax event must relate to taxation changes in the jurisdiction of the issuer that increase an issuer's cash outflows to holders of capital instruments or adversely affect the tax treatment of dividend, interest payments or principal repayments from the issuer's perspective.

Any taxation changes that result in an increase in the cost of the issuance for the bank may be regarded as a tax event where the change in tax law is in the jurisdiction of the issuer and could not be anticipated at the issue date of the instrument. For example, where the issuer is required by a change in taxation law to withhold or deduct amounts otherwise payable to instrument holders, and is also required under the terms of the instrument to make additional payments to ensure that holders receive the amounts they would otherwise have received had no

withholding or deduction been required, such a change in taxation law may be regarded as a tax event. *In the example, such change of law (compiled with the contractual obligation to pay additional amounts to the holders to ensure that holders receive the amounts they would otherwise have received had no withholding or deduction been required) may be regarded as a tax event even if the payment of the additional amount happens, at the time of the change in tax law in the jurisdiction of the issuer, to be prevented by applicable law.* Any redemption on account of such a tax event will be subject to all of the conditions applicable to early redemptions within the jurisdiction. In the example, the contractual additional payments required to make investors whole for withholding taxes or deductions, in effect, represent the adverse impact of the tax change on the issuer.”

b. CAP 10.11 and 10.16 - Additional T1 and T2 capital eligibility criteria

Context: The FAQ 15 of CAP 10.11 on additional Tier 1 capital: new FAQ 15 on additional explanation on the prohibition of a bank funding directly or indirectly the purchase of its own capital instruments. The new FAQ 3 of CAP 10.16 on Tier 2 capital deals with the same topic.

Proposal: The FBF welcomes the clarifications. However, the term “economic terms “ is not defined and the answer is ambiguous. FAQ 15 and FAQ 3 could be modified as follows:

“FAQ15 / FAQ3

Does CAP10.11(13) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (e.g. it was provided for the purpose of holding a diversified portfolio of investments)?

No. Banks must ensure full compliance with CAP10.11(13) taking into consideration the economic objective of the provided funding. Where funding is provided to the purchaser of the capital instruments for any other purpose than specifically funding this purchase (including funding provided for generic purposes), the instruments shall not be excluded from regulatory capital on the grounds of this funding.” in economic terms irrespective of the specific legal features underpinning the transaction.”

E. RBC – Risk-based capital requirements

RBC 30.5 - Capital conservation buffer

Context: RBC 30.5 (previous paragraph 132 of Basel III) is augmented by a sentence of clarification on the declared dividends taking into account in the capital conservation standards.

“The distribution restrictions do not apply to dividends which satisfy all three of the following conditions:

(a) the dividends cannot legally be cancelled by the bank;

*(b) the dividends have already been removed from CET1; and
(c) the dividends were declared in line with the applicable capital conservation standards
(as set out in RBC30.4) at the time of declaration.”*

Comments: The FBF welcomes this clarification and call for an alignment of the EU legislation (i.e. Regulation (EU) 2019/876) with these new requirements.