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European Parliamentary Financial Services Forum
Lunch debate on the Risk Reduction Package

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Does the RRM package strike the right balance between banks' resilience and their capacity to finance the real economy?

- ISP supports the objectives of the Risk Reduction Measures (RRM) package to finalise the post-crisis regulatory reform agenda, that is to strengthen the EU prudential and resolution frameworks for banks.
- At the same time ISP is concerned by the tendency towards an MREL inflation for all categories of banks, as well as by the tendency to increase MREL subordination level up to the levels initially intended for bail-in (in order to have access to the SRF) and not for MREL purposes, levels that could, in some instances, lead to the entire MREL requirement of a bank being expected to be met with subordinated liabilities.
- That said, how can we counterbalance this tendency and at the same time give a robust help to finance the real economy?
    - First, by keeping a level playing field among EU banks themselves and with non-EU financial institutions. So, we encourage the Parliament to set a sound level of MREL total amount and subordination amount, in line with international standards and not above, with sufficient flexibility given to bank's management to steer hard times by using Guidance.
    - Second, by working on the other side of the issue - I mean lowering the leverage and the risk weighted amount and in so doing releasing resources to finance the real economy.
- ISP supports the main aspects of the discussions within the Parliament aimed at fostering growth and innovation, in particular those regarding:
    - the exclusion of some of the guarantees of Export Credit Agencies exposures from the Leverage ratio. In particular, we favor a full exemption of ECA exposures from the application of the leverage ratio. This would be key for the successful continuation of the export finance activity.
    - the downwards adjustment of the risk weight exposure amount for investments in private equity,
    - the extension of the SMEs supporting factor– ISP pays close attention to all the measures to support SMEs financing, given the structure of the Italian industrial framework,
    - the supporting factor for bank lending for infrastructure projects – another point where Italy is in need and where ISP may help the country,
    - the supporting factor for green assets, similar to the one for infrastructure projects – ISP is very active also on this point; ISP won two awards[1] in 2016,
    - the removal of the deduction of software investments from banks' regulatory capital.

[1] 01/12/2016 Industry Carbon Leader 2016 Award to Intesa Sanpaolo; 21/10/2016 Green Globe Banking Award 2016 to ISP.

How can we make sure that the measures take the future competitive environment that European banking sector into account?

- Banks are heavily investing in order to become digital, so as to be better able to serve their clients and compete against GAFAs and to protect themselves from cyber security risks. Against this background, devising an appropriate prudential treatment for investments in software is essential for EU banks. The current framework requiring the deduction of investments in intangible assets (software) from CET1, is extremely penalizing for the banking sector. As you know, this is not the case for US banks, that do not deduct such investments from CET1. Such an asymmetric treatment undermines the level playing field, while fintechs are entering into the financial services space, putting banks at a competitive disadvantage:

  - Banks are still the main source of financing for the real economy in the EU, supporting the creation of growth and jobs. The digital transformation of our societies and economies requires banks to invest in developing innovative and technological capabilities, not least to meet consumer demand and fight cybercrime. One of the key investments is in fact in software.

  - However, we would like to stress that software investments by banks are penalised in the EU, as opposed to the USA. This follows from the fact that such investments are considered as intangible assets not only for accounting purposes (IAS 38) but also for capital requirements, as they are fully deducted from the Core Equity Tier 1. In this respect, the rules differ from those that apply to banks located in some third countries. The consequence of this is that it makes EU banks less competitive than those in some other jurisdictions, such as the United States. EU Banks should in fact be allowed not to deduct software investments from CET1, along the already existing rules of insurance companies (under Solvency II).

- Implementation of the FRTB and the NSFR ahead of the US: possible problem of level playing field; the EU should avoid the front running of the implementation of these two requirements.

- With regard to the FRTB, the BCBS has just opened a public consultation on key elements of the standard (such as the P&L Attribution and Non Modellable Risk Factors-NMRF). The BCBS will finalise the review of the standard by the end of this year, therefore we strongly invite the EU legislators not to introduce in the EU a partial version of the standard, but to carve it out from the CRR2 and to await until BCBS has adopted the finalized the standard. Frontloading by the EU of the FRTB requirement will undermine the competitiveness of EU banks against US ones.

- The introduction of the NSFR as well should be carefully monitored.

  - **Repo and reverse repos**: Under the NSFR, an asymmetric treatment for short-term (less than 6 months) reverse repo transactions compared to repos ones is applied and would additional stress and weaken the effectiveness of the repos and collateral markets in the EU. The repo market has already suffered from the financial crisis and considering the specificities of the European repo market, compared to the US one (tri-party repos vs. repos mainly cleared through CCPs), an asymmetrical treatment could have undesirable negative effects on liquidity management and increase risks and fragmentation in the secondary markets, particularly for government securities, which are the main collateral posted in this kind of transactions.

    The repo market is a key market for exchanging liquidity and its proper functioning is important for the transmission of the monetary policy. Therefore, the proposed treatment

will also go against the Capital Market Union (CMU) Action Plan. ISP supports the removal of the asymmetry, i.e. the exemption of reverse repos from the NSFR (0% RSF).

- **Add-on for derivatives liabilities**: The BCBS has now allowed jurisdictions to set a lower add-on for derivatives liabilities (from the original 20% to the minimum of 5% RSF), as no agreement has been reached on more risk sensitive alternative approaches. Therefore, taking into account that the idea of an add-on is already questionable as it is a kind of tax imposed on derivatives liabilities, without any real economical reason behind it, ISP believes that at least in this case we should stick to Basel, adopting the minimum allowed, i.e. the 5%, without any further revision to avoid uncertainty in the market.
- **Factoring and reverse-factoring** are an essential source of funding for European enterprises, especially SMEs. The Factoring products reflect the underlying trade of goods and services, helping companies in their day to day needs, thereby creating economic growth. It covers around 60% of global turnover in Europe, that's around €1.37 trillion euros, or 10% of European GDP. Therefore, for NSFR purposes factoring products should receive a preferential treatment as the one applied for trade finance, which is another important source of funding.

- Brexit agreements are being discussed but while adopting RRM we should keep in mind that there might be some funding issues for EU banks, once London would be outside the EU. ISP believes that all existing securities (whether issued under UK law or not) should remain MREL eligible and in general that at least a grandfathering is needed for already issued MREL eligible instruments. Should a grandfathering not be granted, the main consequence would be an over-supply of securities issued by EU banks under the EU legislation, to be placed in the EU market. with disruptive effects for EU issuers.

Can we claim that a sufficient proportionality dose has been introduced to match with less-significant institutions concerns about raising constraining requirements given their size or their activities?

- ISP supports the proposal to limit reporting requirements for small banks which have a less sophisticated business model, but not the idea of reducing capital requirements. If small banks are less capitalised, they will fail to attract interest from investors, since these banks will be perceived as being more risky. In case of crisis, they will rather be put into liquidation, thus destroying value.

[***Are there interlinkages between the Risk Reduction package and the Non-Performing Loan reduction plan?***

- Both plans are deeply interconnected and pursue the same objective, the risk reduction within the EU banking sector.

- The opinion of the Commission is that the excessive build-up of NPLs has to be prevented in the future, given the interconnectedness of the EU's banking system. According to the Commission, there are potential spill-over effects from Member States with high NPLs levels to the EU economy as a whole, both in terms of financial stability and economic growth. Therefore, a prudent management and reduction of NPLS goes hand in hand with the overall new prudential and resolution rules contained in the RRM package (CRR II and BRRD II).

- However, our view, also supported by important studies (Bank of Italy, April 2018), confirms that existing NPLs do not prevent *per se* new lending to the real economy.

    - On the contrary, excessive requirements, especially for secured loans, can affect lending.

- Moreover, it is worth nothing that lending to SMEs is often unsecured. Therefore, penalising unsecured loans can lead to cherry picking practices and in the end it will penalise lending and affect growth.

Are the Single Rulebook and the Banking Union sufficiently recognised in the RRM package?

ISP has always been of the opinion that achieving regulatory harmonisation across the EU is essential for a Single Market in financial services as it contributes to promoting a level playing field amongst institutions and reducing the administrative burden incumbent on institutions providing financial services on a cross-border basis.

Moreover, legislators should always keep in mind that banks are often organised in cross-border groups, which pursue a group strategy and they are not the mere aggregate of different subsidiaries.

However, the current regulatory framework and the possible amendments that you are considering are not conducive to a Single Rulebook. I shall provide here some examples:

- **Options and discretions granted to national competent authorities:** Despite the harmonization effort undertaken by the ECB, options and discretions granted to National Competent Authorities (NCAs), especially for capital requirements, can still jeopardise the single supervisor's powers, especially for cross-border groups.

- **Intragroup transactions**: here also considerable powers rest in the hands on NCAs. The rules proposed by the Commission are not satisfactory for cross-border banking groups. In our view – at least within the Banking Union area – intragroup transaction should benefit from a preferential treatment. This means that the liquidity subgroup status should automatically be granted and not subject to supervisory discretion. However, unfortunately, the Commission and the co-legislators want to adopt stricter conditions (or no waiver at all [Council) for capital and liquidity waivers. This is an obstacle for an efficient allocation of capital and liquidity within a banking group.

- **The Internal MREL (I-MREL)** requirements should be set according to the resolution strategy for the group, and not by other factors. Excessive pre-positioning of resources increase fragmentation and are detrimental to the ability of a group to successfully implement its resolution strategy.

Eventually, is "risk reduction" a never-ending process? Is there a risk to move towards a permanent "risk aversion" environment instead?

Risk reduction should be ensured, but there is a risk that it becomes the main focus of legislators. Risk reduction alone would not support the real economy and allow growth and jobs creation. It can't become a never-ending process, as banks and the market as a whole need legal certainty, but of course it should evolve as the economic cycle and market conditions evolve, with an eye on the right timing for revisions and implementation.

In particular:

- It should not hamper further banks' profitability (for instance introducing penalizing standard calendar provisioning systems for NPLs),

- It should also focus on other risks which have not been thoroughly addressed so far by EU legislators

- It should be accompanied by measures aiming also at sharing risks, in particular by establishing the third pillar of the BU (EDIS).