

- Re-assesses the impact on Tier 1 (T1) Minimum Required Capital (MRC) relative to the size of IMM CCR RWA.

Calibration of the alpha factor

EBA impact analysis of setting alpha equal to 1 under SA-CCR for the Output Floor

The report published by the EBA on 30 May 2023⁶ was mandated in the CRR2 (Article 514). This includes recommendations for policy options which are linked to the outcome of the CRR3 negotiations. Furthermore, this report could also inform the calibration of the alpha factor after 2029 (Article 514 in the latest CRR3 Draft Agreement (DA)).

The report indicates that compared to the older Mark-to-Market Method (MtM, also known as the Current Exposure Method), SA-CCR reduces bank exposure by -7.3% on average. However, the report also indicates that compared to IMM, SA-CCR increases exposure values on an average by 60% as measured on a sample of 9 out of the 22 IMM banks in the EU. Additionally, the European Commission has proposed to change the alpha factor applicable to exposures under IMM when considered in the output floor calculations for the transitional period from 1.4 to 1 which has found support in both the European Council and Parliament. The EBA states that this proposal only reduces the Output Floor impact for all risk types by 0.3% and the aggregate industry Minimum Regulatory T1 Capital by 0.2%.

The industry highlights that the added value of the Internal Model Method (IMM) is meaningful, thanks to its capacity to assess the exposure value over time and under a large span of scenarios. The use of IMM allows institutions to better anticipate and manage their exposures. Furthermore, we believe that banks should continue to be incentivized to develop internal models under the supervision of the ECB, versus standardized approaches which are less risk sensitive and not necessarily suitable for the netting sets found in large institutions and their underlying portfolios. Currently for the exposures under IMM when considered for output floor calculations (i.e. using SA-CCR for OF), the alpha factor is set to a punitive 1.4 which, combined with the Standardized Approach for Credit Risk (SA-CR) risk weights, will jeopardize the benefits internal models bring and disincentivise the use of IMM.

In the report on standardised approaches under CCR, it is noted that the EBA had previously assessed the change in total T1 MRC from implementing the Basel III package, considering two scenarios (with or without EU specificities). This change in T1 MRC is expressed as a weighted average on a sample of 160 banks.

The EBA has rerun the above analysis, setting alpha = 1 for exposures under IMM when considered in the output floor RWA calculations (i.e. using SA-CCR for OF), to produce a revised change in T1 MRC, expressed again as a weighted average on the same sample of 160 banks.

The impact of setting alpha = 1 is then assessed as the delta of the change in total T1 MRC, as shown below:

Impact of alpha set to 1 = change in T1 MRC due to Basel III (alpha = 1.4) – change in T1 MRC due to Basel III (alpha =1)

Change in total T1 MRC (Weighted average)	Alpha=1.4 for IMM exposures in the OF	Alpha=1 for IMM exposures in the OF	Delta
Without EU specificities ⁷	15.0	14.8	-0.2
With EU specificities ⁸	10.7	10.6	-0.2

⁶ [EBA Report on standardised approaches under counterparty credit risk.pdf \(europa.eu\)](#)

⁷ Table 21 (p46) of the EBA report

⁸ Table 22 (p47) of the EBA report

The EBA concludes from the above that a change in the alpha factor carries only a marginal impact (0.2% reduction).

The EBA has chosen to provide an impact relative to the total T1 MRC (i.e. overall risk types) across the whole banking sector. This means any conclusion will be heavily driven by the choices regarding the scope of the analysis. Among these, the following two are critical:

- a) The sample of banks (160 banks)
- b) The metric (delta of the change in average weighted total T1 MRC)

a) Sample of banks:

The EBA uses the same sample of banks that contributed to the Q4 2021 Basel QIS and this population contains 160 banks that submitted the minimum required data to perform a Basel III output floor analysis. According to the EBA report, only a minority of banks (22 credit institutions) use an IMM model⁹, meaning most banks in the sample do not see any impact from a change in the alpha factor. For banks that do use IMM however, IMM exposure values (EV) or RWA equates to half the total RWA under Counterparty Credit Risk.¹⁰ Banks using IMM are typically the larger EU Corporate and Investment banks.

Therefore, the industry is of the view that including non-IMM banks in the sample significantly reduces by design the relative impact of a change in the alpha factor and understates the impact this will have on those banks that have permission to use IMM.

b) Metric:

The EBA uses the change in the total T1 MRC. While we understand that this is required to run a meaningful output floor analysis to allow for a comparison between the solvency ratio and the leverage ratio, this has the side-effect of significantly diluting the impact of a change in the alpha factor.

Indeed, a change in the alpha factor for SA-CCR in the output floor will only affect IMM exposures, which are a limited subset of total RWA. The EBA report states that IMM exposures represent roughly half of Counterparty Credit Risk RWA (CCR RWA)¹¹, and CCR RWA represent on average 3.4% of Credit Risk RWA¹². In addition, Credit Risk RWA represent on average 83% of total RWA¹³. This means CCR RWA from IMM exposures account for roughly 1.4%¹⁴ of total RWA.

Therefore, considering the impact at total RWA level irrespective of the share of IMM CCR RWA is highly misleading and again reduces by design the relative impact of a change in the alpha factor.

Industry impact study

In support of the arguments outlined in this letter, the industry has conducted a survey on European banks/European entities of non-European banks. In order to align with the EBA report and provide for a better comparison, ISDA collected data using a more recent date (COB 31 December 2022). ISDA and AFME

⁹ Para 27 (p20) "...IMM is only used by a few of the largest banks (22 credit institutions)"

¹⁰ Para 26 (p20) "...50.9% of the total counterparty credit risk RWA correspond to exposure values determined by the standardised approaches (...) and 49.1% by the IMM."

¹¹ Para 24 (p19) "On average, it [CCR] accounts for 3.0% of the total credit risk EV and 3.4% of the total credit risk RWA."

¹² Here Credit Risk RWA include CCR RWA in addition to "pure/traditional" Credit Risk RWA of the banking book

¹³ EBA Dashboard Q4 2021 – table RWA composition p46 in the Statistical Annex

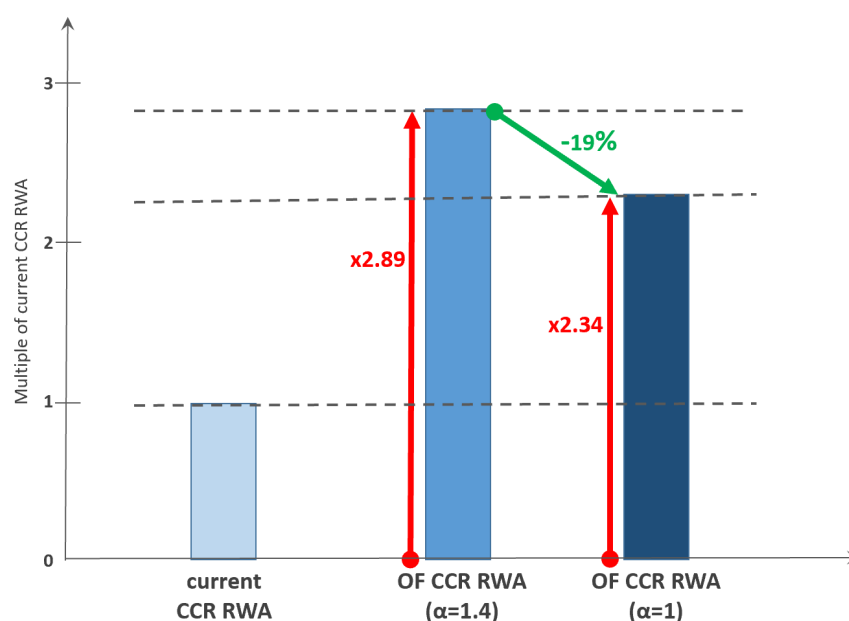
¹⁴ $50\% \times 3.4\% \times 83\% = 1.4\%$

members¹⁵ submitted data on total risk weighted assets (RWA) and RWA for counterparty credit risk (CCR). Firms were required to provide current production data for Total and CCR RWA as well as two sets of output floor CCR RWA¹⁶, setting the alpha factor to 1.4 and then 1 for derivative trades capitalised using IMM for risk-based capital calculations.

For each bank, we compared the output floor CCR RWA with alpha set to 1 and set to 1.4 for IMM derivatives positions, and assessed the relative impacts as compared to the production figures of total RWA and CCR RWA. The results were then aggregated by taking the weighted average across the sample. Similar to the EBA report conclusion, it is observed that lowering the alpha factor from 1.4 to 1 results in a rather limited reduction of 2.2% in the total output floor when assessed relative to total RWA (this compares to the output floor impact of a reduction of 0.2% in T1 MRC as stated in the EBA report). However, when focusing on capital market activities only, where EU banks compete globally with international peers, our analysis gives a different view.

We observe that OF CCR RWA (where alpha is 1.4 for all exposures)¹⁷ is 2.89 times as compared to the current CCR RWA¹⁸. Even after the alpha factor is reduced to 1 for exposures under IMM when considered in the output floor calculations, the OF CCR RWA is 2.34¹⁹ times as compared to the current CCR RWA. Reducing the alpha factor to 1, results in a 19% decrease of the output floor CCR RWA as is shown on the figure below.

Impact of changing the alpha multiplier



Impacts shown in graph:

¹⁵ 7 banks participated who have either fully or partial IMM permissions to calculate CCR RWA

¹⁶ using only standardised approaches and considering a 72.5% scalar (i.e. fully phased-in)

¹⁷ OF CCR RWA ($\alpha = 1.4$) is the CCR RWA calculated for the purpose of output floor with alpha set at 1.4 for all exposures

¹⁸Note that current CCR RWA, i.e. those under the current applicable CRR rules, are different from CCR3 RWA before output floor. Indeed, though the derivatives exposure approaches do not change, the exposures of repo style transactions in the standardised approach and the applicable risk weights will.

¹⁹ OF CCR RWA ($\alpha = 1$) is the CCR RWA calculated for the purpose of output floor with alpha set at 1 for all IMM derivative exposures and 1.4 for all other exposures

- **x 2.89:** The impact on OF CCR RWA (calculated with alpha of 1.4 for all exposures) when assessed against the current CCR RWA
- **x 2.34:** The impact on OF CCR RWA (calculated with alpha of 1 for exposures under IMM when considered for OF purpose and 1.4 for all other exposures) when assessed against the current CCR RWA
- **-19%:** Reduction in the increase in OF CCR RWA due to reduced alpha for exposures under IMM when considered for OF purpose when assessed against OF CCR RWA with alpha of 1.4 for all exposures

These impacts show a stark contrast with the figures shared in the EBA report due to the arguments put forward earlier in this letter.

Recommendation

The industry remains concerned on the analysis performed by the EBA on the proposed change in the alpha factor in calculating the output floor.

Based on the sample of banks and the choice of metric, the industry believes the impact assessment is significantly under reported²⁰ in the EBA's report, where the impact of the reduced alpha factor for exposures in IMM before flooring is presented at the industry level.

Indeed, the report dilutes the impact of the alpha factor as the figures presented are largely driven by institutions that do not have permission to use IMM for the computation of their CCR own funds requirements, and by other types of risks. This can also be seen from the survey conducted by the industry where the impact of reducing the alpha factor from 1.4 to 1 resulted in a decrease in total output floor RWA of only 2.2% when assessed relative to current total RWA. However, the survey shows a much larger decrease in output floor CCR RWA of 19%.

We remain at your disposal to support any further discussion on the issues highlighted above.

Yours sincerely

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²⁰ Paragraph 83 (p46) of the EBA report