BANKING STAKEHOLDER GROUP

Post-crisis Basel III reforms finalization
Opinion paper

This Opinion Paper is a high-level document summarizing discussions held within the BSG Capital and Liquidity Working Group, across banks, academics, and end-users. These discussions took place in particular at a workshop organized on Dec 6th hosted by CEPS. The present document should be seen as a first high-level feedback, while the BSG will continue to work to deepen its analysis as the European implementation of the package progresses.

Overall remarks

The Banking Stakeholder Group (BSG) supports the implementation of the December 2017 Basel Committee on Banking Supervision (BCBS) package in the EU, given the essential goals of finalising the post-crisis reform agenda and supporting multilateralism. At the same time, the BSG recommends that the transposition of Basel III final reforms duly takes into consideration the European specificities, in particular the risk profiles of the European banking industry, and avoids any "gold plating" that would structurally weaken the competitive position of the EU banking sector and ultimately the European economy, vis-à-vis other jurisdictions such as the United States, amidst low to negative interest rates environment.

We warn against the fact that Basel III final requirements, depending on how they are interpreted in Europe, may be leading to a disproportionate increase in capital requirements considering on one hand the current business models and balance sheets composition of most European banks, and on the other hand the increase in capital requirements already implemented post financial crisis.

We concur with the European Commission’s view that EU policymakers should strike the right balance between prudential soundness and ensuring adequate financing of the economy. As such, the evaluation of economic benefits of the finalization of Basel III reforms should not be overly optimistic and unintended financial stability issues should carefully be taken into account in overall macroeconomic and monetary assessments.

While it is a challenging task to reconcile risk sensitivity and simplicity with regards to the calculation of own funds requirements, we acknowledge that multiple initiatives of the European institutions including the European Banking Authority (EBA) have substantially improved the reliability of internal models and the comparability of risk weighted assets across banks within and outside the EU.

The BSG further recommends that European specificities be effectively taken into account, notably with regards Small and Medium-sized enterprises (SMEs), infrastructure, mortgage lending, equity
investments and risk hedging, in order to minimize the negative impact of Basel III final reforms on the European real economy.

In parallel of the Basel III final reforms implementation, we urge EU policymakers, to create the necessary conditions for appropriate adjustments of the EU financial services industry in a broader context including a functioning Capital Market Union (CMU) and to give the consideration to the desired level of risk-taking in the EU financial system, notably to finance innovation, growth and climate risk mitigation.

**Detailed remarks**

1. **Challenges ahead for the implementation of the final Basel III reforms**
   
   **a. The trade-offs between risk sensitivity and simplicity**

   The final BCBS accord is a trade-off between the risk sensitivity and the simplicity of own funds requirements calculation. On the one hand, risk sensitive capital requirements are desirable, reflecting bank’s risk profile and providing an incentive for banks management to measure, assess and manage risks; however, complex Internal Rating Based (IRB) models may lack transparency and comparability across banks and countries. On the other hand, a flat capital requirement is more simple and transparent, but is does not adequately reflect individual banks’ risk profiles.

   We acknowledge that it is challenging to strike the right balance between risk sensitivity and simplicity. While a stated objective of the Basel III finalization was to improve the risk-sensitivity of the standardized approaches, it should be recognized that only limited improvement has been achieved, and that the Standardized Approach continues to lack risk sensitivity, while having introduced, at the same time, a unwelcome/unwarranted level of burden, not only for standardized approach (SA) banks but also for the IRB banks, which will have to run two sets of capital requirements in parallel¹.

   **b. TRIM and IRB Repair have enhanced the reliability of internal models**

   The BSG welcomes the multiple initiatives and studies performed by the European Banking Agency (EBA) and the European Central Bank (ECB) since 2015 and recognises that they have played an important role in enhancing the reliability of European internal models and explaining the variability of own funds requirements resulting from the application of IRB approaches. The BSG encourages these initiatives to continue enhancing the reliability of internal models.

   In December 2015, the ECB launched the Targeted Review of Internal Models (TRIM), a multi-stakeholder, multi-year project aiming to ensure the adequacy and appropriateness of approved models as well as their consistent implementation by banks.

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¹ The 2 systems are based on different parameters (LGDs, different rules to assess eligibility of collateral, different assumptions for maturity, different rules for market risks, counterparty credit risks etc.). All banks’ systems have to be adapted to capture a dual set of parameters, and 2 different capital requirement calculation engines will have to be built and run in parallel to compute the output floor. This will lead to an increase in the implementation cost for IRB banks whatever their size.
TRIM is a one-off project that came on top of two business-as-usual processes: model reviews and ongoing model monitoring. According to the ECB, its achievements (around 200 models have been reviewed by 2019) have improved the reliability of the surveyed European banks’ internal models and will certainly enhance the ongoing validation and monitoring of models in the future.

Second, based on a 2013 study evidencing some level of unwarranted risk weight variability under IRB approaches, the EBA launched an “IRB repair” program in February 2016 with the explicit aim to restore trust in the use of internal models.

As part of this roadmap, the EBA performs an annual assessment of the consistency of internal model outcomes. According to the last assessment dated January 2019, the EBA came to the conclusion that 50% of the difference in variability is explained by the proportion of defaulted exposures in the portfolio and the portfolio mix. In a second step, the EBA divided the portfolios between low-default portfolios (LDP) and high-default portfolios (HDP). It came to the conclusion that, as relates LDP, when substituting the risk weight with that of the median institution, the resulting deviations would generally be below 10%; with regards to HDP, the report presents evidence that the majority of institutions have conservative estimates (PD, LGD), when compared with the observed values.

2. Uncertainties on the macroeconomic impact of Basel III finalization

We concur with the European Commission’s view that EU policymakers should strike the right balance between prudential soundness and ensuring adequate financing of the economy. “An economy that works for the people” is the second objective of the new Commission and banks, which have a major role to play in this regard, should not be pushed to excessively reduce risk-taking, which is rather inherent to the banking businesses.

a. Transition v. steady state costs

According to the EBA/ECB macroeconomic impact study published December 4th, 2019², the finalization of Basel III would entail transition costs: the EU GDP growth would fall by 0.2 pp during the first four years following the implementation of the reforms.

Although these costs are coined as “modest” in the December 2019 EBA/ECB assessment report, the BSG believes that the occurrence of a 0.2 pp GDP loss each year over four years should be a real concern given the current European context of subdued growth, high uncertainty and less supportive external environment.

The BSG questions the expectations shared by the EBA and the ECB that these implementation costs will necessarily fade over time. It should be reminded that higher level of capital requirement for a given loan might be a permanent feature of the new regime, which weighs on credit costs for households and corporates as long as the revised Basel framework are in place. The increase in capital requirements would translate into higher funding costs that ultimately would be passed on to banks’ customers and giving rise to a potential decline in GDP. Ample literature provides evidence that investors pass

additional costs to customers as they cannot be expected to accept lower earnings resulting from more stringent financial regulation.  

b. **Uncertainty on macroeconomic benefits**

The BSG cautions against uncertain and possibly over-optimistic evaluation of the benefits of the reforms in terms of financial stability.

First, this evaluation may not take enough into account the “law of diminishing returns”, which has been demonstrated in many studies, including from the BCBS: beyond a certain level of capital, the marginal impact on financial stability obtained by a further increase in capital reduces and may even become negative. European banks may well have already exceeded that level, with CET1 capital ratios having more than doubled since the crisis.

In addition, it does not recognize that financial stability is truly enhanced only when banks have more capital buffers above the minimum requirements. Increasing the minimum capital requirements reduces this buffer and makes banks actually more vulnerable, as they are more likely to breach their (higher) minimum capital threshold. More research is encouraged to bring more evidence to this relationship.

We note that other assessments, such as the Copenhagen Economics “Final Basel III Evaluation” study commissioned by the European Banking Federation (EBF), estimate that the benefits of Basel III finalization would be equivalent to 0.1% of GDP, compared to an estimated GDP reduction of 0.5% of GDP, leading to a permanent net cost of 0.4% of GDP for society.

Finally, the evaluation of benefits of the Basel III framework does not take into consideration other macro-economic factors such as the level of private debt which may weigh, when reaching critical levels, on the borrowing appetite of some economic actors, independently of the prudential framework in place.

c. **WACC adjustment to Basel III finalization**

While the capital shortfall is a useful measure to assess the adjustment effort during the transition phase, the BSG is of the view that, at the steady state, an additional measure should be considered and used: the weighted average cost of capital (WACC). By imposing a funding mix with more equity and less debt (deposits), Basel III reform can lead to a permanently higher WACC for banks.

In the view of equity analysts, the uncertainty about the finalization of Basel III and about how much capital will be needed means that the cost of equity is higher. If the return on tangible equity falls below the cost of equity (notably given prolonged low/negative rate environment), banks become so value destroying that investors will no longer be willing to invest in banks’ shares, compared to other more profitable sectors. On the debt side, while in theory the senior debt spreads should adjust given the higher cushion that protect senior investors, the increase in subordinated debt requirements through Total Loss-Absorbing Capacity and Minimum Requirement for own funds and Eligible Liabilities (TLAC/MREL) has actually increased the weighted average cost of debt. The subordinated debt markets


can even stop funding a troubled bank, putting even more pressure on equity given higher risk of bail-in. Overall, these market dynamics might lead to an overall increase in WACC for banks, despite the Modigliani Miller theory that states that the mix of debt and equity has no impact on WACC. More research on this issue should provide more evidence.

Indeed, according to the EBA/ECB December 2019 impact study, the increase of capital requirements is expected to yield limited advantages with regards to the cost of debt (imperfect Modigliani-Miller effect). As such, the WACC should be expected to increase following the implementation of the final Basel III reforms from current levels.

The BSG advises that the EBA/ECB macro-economic impact studies should be further expanded, to provide answers to important questions such as the extent to which the WACC could increase; the expected impact across banks/business models; and the implications for bank lending.

d. Capital requirements and profitability

The BSG recalls that the impact of introducing additional capital requirements on profitability should not be ignored, as it is of paramount importance with regards to financial stability. We stress that while a profitable banking sector builds more capital and can be more resilient, insufficient profitability makes the sector actually vulnerable, as noted in recent EBA Risks and vulnerabilities reports.

More capital does not necessarily reassure the equity market because at a certain level, this may create vulnerabilities. According to bank equity analysts, the listed European banks generate today c. EUR 100 bn of Net Earnings, same as pre-crisis, but it has EUR 1,100 bn of Tangible Equity vs EUR 500 bn at the time. Conversely, the market capitalization used to be around EUR 1,100 bn vs currently EUR 800 bn. The equity market is thus saying that the sector is much worse off than it was pre-crisis despite holding more than twice the same account of equity. This is not linked to specific or general fears on excessive risks, but rather to lower return expectations (through net earnings, dividends and share buy-backs). Such low valuations may turn to be problematic for financial stability, as they significantly reduce the financial flexibility of banks, notably limiting their capacity to raise fresh capital.

e. Frontloading v. phasing

The BSG believes that a phasing period is not sufficient to smooth out the impact. Analysts and investors are likely to fully frontload the 2027 impact and banks may thus not be given time to adjust: banks with a perceived deficit in 2020 or 2021 will continue to trade at a discount, and are likely to engage in accelerated deleveraging strategies.

3. Need for considering European specificities and priorities

a. EU v. US business models and risk profiles are very different

We would like to recall that in a broader global context, EU and US banks show a very different profile in terms of balance sheet exposures and capital framework. The capacity to off-load “low risk exposures” either to government sponsored entities, in the case of residential mortgages, or through truly functioning securitization and Asset-Backed Securities (ABS) market makes US banks’ balance sheets and risk profiles very different from their European peers. As such, we believe that the application of simple, non-risk sensitive measures such as the Output Floor or the Leverage Ratio applied in both jurisdictions cannot be directly proportionate.
Additionally, different prudential and accounting treatments across the Atlantic, such as the ones of software investments, also raise questions around the level playing field on capital requirements.

b. SMEs

We share the European Commission stance that SMEs are the backbone of Europe's economy, as they represent 99% of all businesses in the EU, have created around 85% of new jobs and provided two-thirds of the total private sector employment in the EU during the past five years.

The BSG also recalls that banks are essential to SME financing. As a result, regulations that impact bank lending have very significant consequences on SMEs and more generally on the real economy. It is thus essential that prudential rules strike the right balance between increasing financial stability and supporting companies’ financing needs for investment and business activities, with a specific attention to long term financing and equity investment.

Future changes to those rules (following Basel III finalization) should not significantly increase capital requirements overall in order to maintain a framework able to support companies’ need for capital for investment and trade (bank loans, equity investment, trade finance), preserve equity investments in companies by financial institutions, and ensure access to risk management products at competitive terms.

Two issues are of particular importance with regards to SME financing. First, the output floor would negatively affect the lending capabilities for well-performing but “unrated” companies, with solid business models and therefore low credit risk profiles. Hence the design of the output floor should be set with a view to minimize undue impact on the European economy. Second, as the SME Supporting Factor reduces the cost of lending to SMEs, it is vital to maintain it in order to mitigate the disadvantaged position of such lending due to the combined effect of enhanced capital requirements and liquidity rules.

c. Infrastructure and ESG factors

European banks have also developed a recognized expertise in the field of specialized lending, an area particularly penalized in the revised Basel framework. The BSG is of the view that banks have a key role to play in tackling climate change and mitigating its effects. We caution against imposing excessive capital requirements on this exposure category as it would hamper banks’ sustainable finance capacity.

We would rather encourage the regulators to commensurately reflect the structural effect of the risk mitigation tools embedded in such transactions.

It should be noted that the CRR2/CRD5 package has already provided a number of mandates to explore how to integrate sustainability considerations (particularly Environmental, Social and Governance – ESG – risks) in the prudential framework (i.e. disclosure requirements for large institutions; inclusion of ESG

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5 The risk weight for those corporates would be 100% rather than 65% for equivalent companies in the US. This is in the Basel rule and in the EBA report.

6 This is relatively risk sensitive because the Basel 2/3 capital does not take into account portfolio diversification. At equivalent average PD, a granular SME portfolio gives rise to a lower unexpected loss than a less granular large corporate portfolio. The SME supporting factor is a simple (and arguably arbitrary) way to address this. See notably recital (59) of CRR 2 (Regulation 2019/876).

7 We can cite the ~30% RW increase expected on Specialized lending (see EBA report fig 42) mostly due to LGD floors (same, fig 52). Note that the EBA report is unfortunately almost silent on this, which triggered a further request by the Commission.
risks in the supervisory review and evaluation process – SREP; assessing the possible differentiated treatment of assets on the basis of ESG criteria – green/brown factors).

In this respect, it will be essential to preserve the “infrastructure supporting factor” that has been introduced in the CRR2 (and which also takes into account the climate dimension of projects for instance), while EBA is arguing for its removal in its policy recommendations. This is even more relevant in the context of supporting specialised lending activities of EU banks, which have developed skills and a track record of successful lending in the area of project financing.

While it is too early to foresee the impact that such measures would have overall, it seems clear that the new Commission would be even more ambitious in providing capital incentives for green assets, notably through the implementation of a green supporting factor. Additional assessment and research is certainly needed on this area.

d. **Home loans**

The BSG believes that the finalization of Basel III reforms should take into due consideration the very significant structural differences that exist between Europe and other jurisdictions, as well as within the European Union, on mortgage lending.

Typically, average mortgage default rates between 2000 and 2014 vary from 1.1% in France to 2.9% in Portugal and up to 5.2% in the US. Within the European Union, Nordic countries show persistently very low default rates: since the 1970s, the mortgage default rate in Denmark has been close to 0% and has never exceeded 0.7%.

In addition, substantial differences in structuring in the EU and in the US warrant the use of lower LGDs in Europe: dual recourse loans (for which the creditor has recourse against the collateral but also against the debtor) are predominant in the EU, and reduce the dependency of banks to potentially volatile house prices.

As such, the BSG stresses that the Basel “one-size-fits-all” approach does not properly take into account EU mortgage lending specificities and entails a unwarranted significant increase in capital requirements in many European countries as shown in the EBA report, with negative consequences for the households, the construction sector, and the economy as a whole.

e. **Equity**

The BSG believes that at a time where the Capital Market Union (CMU) reflections identify a need to boost equity investments, notably to scale up European tech firms, mobilizing more capital to support already adequately capitalized banks is a waste of the scarce European equity investment pool. The proposed risk weights seem rather to act as a disincentive for equity investments.

It is also of the view that equity exposures should be further differentiated, for instance when pertaining to equity holdings of financial institutions, dependent on whether they are within an institutional
protection scheme (IPS), or towards a counterparty which is a parent undertaking, a subsidiary or a subsidiary of its parent undertaking.

f. Credit Valuation Risk (CVA)

The BSG supports the view expressed by European businesses associations that it is essential, in order to avoid negative side effects on business operations, to exempt hedging transactions engaged by non-financial clients from a CVA risk capital charge.

At the public hearing organized on November 12, 2019 by the European Commission, a representative of Airbus provided a concrete illustration of its reliance on strong EU banks. With 90% of the staff located in the EU, EU sales account for only 20% of the global turnover and almost 100% sales are denominated in USD. In this context, Airbus heavily relies on foreign exchange (FX) risk hedging. The finalization of Basel III raises concerns not only for Airbus, but also for their suppliers - generally unrated corporates that are also significant consumers of risk hedging instruments - and their clients (airlines and leasers) which need new financing to the tune of USD 130 bn per year.

g. Proportionality

The BSG recalls that the original Basel standards are originally designed for large internationally active banks. A recent survey of the Basel Committee has revealed that many jurisdictions have simplified these rules in order to make them more suitable for smaller credit institutions. Without hampering a level playing field, the implementation of the final part of Basel III should avoid to impose overly complex rules on smaller and less risky institutions and consider adjustments, where the new set of rules would create an inadequate administrative burden for smaller and less risky institutions.

4. Financial stability issues

The BSG advises taking into consideration a number of concerns linked to a significant increase in capital requirements, notably as a consequence of the output floor, before implementing the final Basel III reforms.

First, we remind that financial stability is enhanced when banks hold more capital buffers above the minimum requirements. Increasing the capital requirements reduces this buffer and makes banks actually more vulnerable, as they are more likely to breach their (higher) minimum capital.

Second, the growing gap between regulatory capital and economic risk creates substantial threats to financial stability. Contrary to common sense, the most penalized assets are the low-risks portfolios, which give a very unwelcome incentive to banks. The overall loss of risk sensitivity, linked to the reduction of use of internal models and to the output floor, combined with existing constraints on size (leverage, Global Systemically Important Institutions (G-SII) and Other Systemically Important Institutions (O-SII) buffers, liquidity ratios) will incentivize banks to increase, not decrease, the risk profile of their balance-sheet. Such increase in risk profile may also play against the interests of consumers and SMEs, as banks may thrive to absorb the capital shock by increasing prices and grant high yield loans to high-risk clients, leading to over-indebtedness and bankruptcies.

Third, as European regulators and supervisors do not consider that any buffer in the capital stack can be “usable”, the whole stack is perceived as “unbreachable”, which goes against the nature of some buffers and contributes to making the European banking sector more vulnerable. With the implementation of Basel III final reforms, as the thermometer (i.e. measuring the risks) changes, the graduation (capital
requirement, notably Pillar 2) should be changed accordingly, and a clear message should be delivered, consistently with the recent BCBS newsletter, that capital (and liquidity) buffers are designed to absorb losses, including in the stress-testing framework. In case capital buffers are used, the BCBS clarifies that banks should “seek to rebuild their capital strength in a timely manner”\(^{11}\). Applying this framework in the EU, notably in the context of the current discussion around 2022 new stress testing framework, would be a major step to restore flexibility, and comparability with the US framework, where the explicit exit point of stress-tests is the minimum 4.5% Pillar 1 requirement, excluding all additional buffers.

Fourth, in our view the interplay between the different regimes from micro and macro supervision, resolution and deposit insurance is in general not appropriately considered. The interlinkages between the different pillars of the regulatory framework need to be addressed to avoid double counting or overlaps, and we support recent speeches by A. Enria\(^{12}\) to that effect.

5. Cross-border issues

The evidence seems quite conclusive that, after five years of Banking Union, and almost a decade of ESA’s being in place, there has been very little impact on the banking industry structure, especially in terms of cross border operations.

The lack of cross border consolidation in Europe is interpreted as the main symptom of an incomplete Banking Union, and policy measures are needed to encourage, or at least not restrict, cross border consolidation. There are several regulatory impediments that may be acting as deterrent for cross-border banking consolidation in Europe.

Large and internationally active banks are imposed higher capital requirements due to their complexity and systemic footprint, while on the other hand regulation does not recognize the positive prudential effects of international diversification. Likewise, there are other examples, such as the new operational risk framework, where size is also penalised.

The most important impediment has to do with the need to satisfy capital and liquidity requirements at a consolidated level but also at the level of each subsidiary in any European country. The case for those requirements lies behind the recognition of an incomplete European integration whereby, absent a single deposit guarantee scheme, potential problems at local subsidiaries of a foreign bank must be borne by the local authorities and ultimately by domestic taxpayers.

On the other hand, the obligation to meet capital and liquidity requirements at both levels (consolidated and local subsidiary) reduces considerably the flexibility of banks to allocate resources within the group, which is a clear impediment for cross border expansion of European banks.

The removal of those impediments, through waivers to meet capital and liquidity requirements at subsidiary level, is a necessary condition to encourage a much needed wave of cross border banking consolidation in Europe.

\(^{11}\) BCBS October 31 2019 Newsletter on buffer usability.
\(^{12}\) Refer for example to Keynote speech by Andrea Enria, Chair of the Supervisory Board of the ECB, at the European Commission’s DG Financial Stability, Financial Services and Capital Markets Union conference on the implementation of Basel III, Brussels, November 12, 2019.
Conclusion – the way forward for the EU

The BSG is of the opinion that Basel III final requirements may lead to a disproportionate increase in capital requirements compared to the current business model and balance sheet composition of most European banks.

The implementation of the Basel III final set of reforms should be seen in context with the wider impact of reforms on the overall EU economy. Financial stability considerations and the need to support both continued growth and the transition to a green economy cannot be decoupled from the increase in capital requirements that the reforms might trigger. The EBA most recent impact assessment of the reforms sets at EUR 124.8 billion the capital shortfall for EU banks, and a 23.6% the average increase in capital requirements, which corresponds to 2.8trn€ increase in RW assets. If the Output Floor is introduced in the EU at different levels and not only consolidated, the impact would further increase.

Given the need to address the capital shortfall, while at the same time maintaining a sustainable profitability level and meeting supervisory capital demands, it appears that the resources needed to finance an EU green new deal would be significantly constrained.

However, the fair implementation of the final Basel accord by the EU and other jurisdictions is an essential element of international cooperation. While the consistent international implementation of the Basel III framework is an important objective, such consistency should be anchored on a global framework that remains appropriately structured and calibrated for the risks being addressed.

The answer of this dilemma may not be in assessing to what extent Europe can adjust or diverge from agreed international standards, but to what extent public authorities can enable a real transformation of the EU Financial Services industry while addressing at the same time currently growing fragmentation.

If the foundations for a truly functioning CMU were to be on the table and differences in accounting and prudential treatment of critical aspects vis a vis the US were reduced, the EU banking sector would be operating in a more adequate framework to comply with the agreed international standards and also be more competitive in the global context.

This would require being innovative and ambitious both from the legislative front and from the private side. Finalizing a Banking Union, confronting the "big tickets" for a real CMU would not only pave the way to better absorb the impact of the Basel Accord, but also reinforce EU banking and financial system as well as foster Economic and Monetary (EMU) resilience. Financial services fragmentation would be reduced, further channels for private risk sharing would be in place and shock absorption capacity in the euro area would be reinforced.

The EU policymakers are giving increasing attention to EU’s sovereignty and financial independence, which have become stated objectives of the Banking Union and the Capital Markets Union. The BSG recalls that ultimately, the implementation of Basel III is a geopolitical issue and the EU transposition of Basel III final reforms has to take this reality into consideration.

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13 Eurogroup HLWG December 2019 Roadmap for political negotiations “Further strengthening the Banking Union, including EDIS”
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