



European Commission
publishes CRR III and
CRD VI

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Introduction

On 27 October 2021, the European Commission (EC) published its legislative package implementing the Basel 3 Reforms, also known as Basel 4. This fires the starting gun on the last leg of the journey to deploy the changes to capital standards in the region through the Capital Requirements Regulation (CRR) III and the Capital Requirements Directive (CRD) VI.

With this announcement, the European Union (EU) is attempting to balance two objectives: implementing the proposals of the Basel Committee on Banking Supervision (BCBS) to enhance financial stability and supporting EU institutions' ability to continue financing the economy.

The EU package mainly follows the Basel proposals, and the majority of the capital changes track the Basel Committee's guidelines. The EU has - so far, at least - resisted some of the industry proposals to depart significantly from Basel: for example, by having an alternative "parallel stack" approach to Basel's output floor. But some changes to the Basel proposals are incorporated to reflect specific EU interests, either by tweaking approaches or by providing for a transition period to adjust to specific changes. CRR III and CRD VI also implement the market risk capital changes in the Fundamental Review of the Trading Book (FRTB), although the amendments include a provision that allows the EC to amend the market risk approaches if there are any major discrepancies with other major jurisdictions. And the EU

has taken the opportunity to include additional regulatory change in this package, including (i) requirements relating to environmental, social and governance (ESG) (ii) the introduction of a new framework and classification system that will require reauthorization of all existing third-country branches, (iii) amendments to the bank crisis management framework impacting the Bank Recovery and Resolution Directive (2014/59/EU) and the CRR, and (iv) further measures to harmonize supervisory powers and tools, and require the European Banking Authority (EBA) to centralize the publication of annual, semi-annual and quarterly institutional prudential information for the largest institutions in the EU.

Although the Basel timetable calls for the Reforms to be implemented on 1 January 2023, the EU announcement indicates an application date of 1 January 2025, with transitional arrangements applying over a further five-year period. This seems to confirm speculation of a further delay from the Basel timetable and fits with the typical EU (and country-level) legislative processes.



Overview

On 27 October 2021, the EC released the awaited proposed CRR III and CRD VI. This represents the implementation in the EU of the finalization of Basel 3 agreed in December 2017 (Basel 4).

The scope of CRR III and CRD VI incorporates changes to:

- ▶ The standardized approach for credit risk
- ▶ The internal ratings-based (IRB) approach for credit risk
- ▶ The calculation of credit valuation adjustment (CVA)
- ▶ The operational risk framework
- ▶ An output floor, limiting the capital benefit from risk models

The EC has also incorporated amendments to the market risk framework referred to as the FRTB, initially implemented in CRR II. The EC reserves the right to further amend this, at a later date, in order to maintain a level playing field internationally.

In addition to the Basel generated changes, the EC has incorporated a number of other developments into the revised rules (CRR) and directive (CRD), namely:

- ▶ Amendments to CRR and CRD to incorporate ESG requirements
- ▶ A new framework for regulating and supervising third-country branches (TCBs) in the EU

- ▶ Adjustments to Pillar 2 Requirement (P2R) and the Systemic Risk Buffer (SyRB) accompanying the introduction of the output floor
- ▶ Enhanced definitions of entities to be included in the scope of prudential consolidation, capturing FinTech ownership and engagement in financial activities
- ▶ EBA is given authority to centralize the publication of annual, semi-annual and quarterly institutional prudential information for the largest institutions in the EU
- ▶ Provisions regarding independence of competent authorities and addressing conflicts of interest
- ▶ Expansion of supervisory powers to competent authorities in the EU to create a common standard
- ▶ Implementation into law of a requirement to conduct fit and proper assessments of directors to a common standard
- ▶ Clarification of the interplay between the failing or likely to fail declaration
- ▶ Amendment to the approach of supervisory benchmarking of expected credit risk losses for purposes of calculating own funds requirements

Finally, the EC has introduced some amendments to the bank crisis management framework impacting the Bank Recovery and Resolution Directive (2014/59/EU) and the CRR. These relate to the internal total loss absorbing capacity (TLAC) deduction regime recommended in the EBA draft regulatory technical standard (RTS) and address some other resolution-related issues concerning the regulatory treatment of G-SII groups with a multiple point of entry (MPE) resolution strategy.

The EC says it is expected that the proposed amendments “will start entering into force in 2023 at the earliest.” However, the date of application of the CRR is currently shown as 1 January 2025. The next steps in the EU legislative process require the EC, the European Council and the European Parliament to agree the published text following a trilogue procedure. There is not a defined time period for this procedure but, following its completion, the Directive shall come into force on the 20th day following its publication in the Official Journal of the European Union. This phrase is somewhat misleading, as it will not

actually apply until it is transposed into national law by each EU Member State. The CRD allows an 18-month period for this transposition, after which it will apply to all credit institutions. If we assume that the CRR and CRD come into force on the same date (January 2025), the EU has built in a period of 20 months for the trilogue procedure. If it takes less time, the CRD can apply before the CRR.

The EC states that the impact of implementing the proposed Basel 3 Reform options and considering all the measures in the proposal is expected to lead to a weighted average increase in EU banks’ minimum capital requirements of +6.4% to +8.4% in the long-term (by 2030) after the envisaged transitional period. In the medium-term (in 2025), the increase is expected to range between +0.7% and +2.7%. This could lead to a limited number of large EU banks (10 out of 99 banks in the test sample) having to raise collectively additional capital of less than €27b in order to meet the new minimum capital requirements.





Implementation of the Basel 3 Reforms

Output floor

Establishing an output floor has proved to be one of the most controversial Basel proposals. The output floor limits the capital benefit arising from the use of risk models across all risk types by establishing minimum risk weighted assets (RWAs) at 72.5% of the standardized (i.e., non-modeled) level. The output floor is incorporated in CRR III and CRD VI at 72.5%, but is confirmed to operate primarily at the consolidated EU level only.

Although individual group entities below the EU parent are not subject to the output floor, there is an approach specified to apportion floored RWAs at the consolidated level to subsidiary parent companies in each EU country. This will result in the impact of the consolidated floor being distributed across the countries in which an EU group operates.

In a further concession, the EC notes that Pillar 2 Requirement (P2R) and the Systemic Risk Buffer (SyRB) can be used to address risks that are similar in nature to those addressed by the output floor. Consequently, there is a possibility that certain risks (e.g., model risk) could be double counted once the floor starts to apply. They refer to the EBA's advice on this issue and call on authorities to reconsider the appropriate level of P2R and the SyRB once the floor is implemented.

Standardized credit risk

The Basel proposals provide for various changes that make standardized approaches more risk sensitive. Generally

speaking, the changes tend to add more tiers, categories and requirements, thereby making standardized approaches more complex.

The EC incorporates the Basel changes to standardized credit risk approaches for institutions, corporates and specialized lending. However, two EU specificities are included. These recognize concerns arising from the fact that many EU corporates and specialized lending exposures are unrated. Accordingly, for unrated corporates with a probability of default (PD) of less than 0.5%, the standardized risk weight is set at 65% rather than 100% for a transition period. And unrated object finance exposures that are assessed to be high quality will also benefit from a relatively favorable capital treatment. In addition, the current EU infrastructure supporting factor is retained.

The EC also incorporates the Basel changes to standardized credit risk for retail exposures. However, there is an EU-specific concession in real estate lending. Instead of the proposed Basel approach of requiring the value of the property to be based on the value at the time of the loan origination, the EC approach permits the property value to be adjusted upward, but only to the average of the property's value over the last three (for commercial) or six (for residential) years.

Under the Basel changes, equity exposures can only be treated as standardized, and the risk weights are set at levels up to 450%. The EC incorporates these changes but proposes two concessions: the first sees intra-group equity exposures remain at a 100% risk weight, and the second provides for a transition period of adjustment to the new Basel risk weights.

Internal ratings-based credit risk

The EC incorporates the Basel changes to remove the Advanced-IRB (A-IRB) approach option for exposures to large corporates and financial institutions, and remove all IRB approach options for equity. However, in an EU-specific change, exposures to public sector entities, regional governments and local authorities are exempted and can remain on the A-IRB approach.

Basel proposes input floors to establish minimum levels of PD, loss given default (LGD) and exposure at default (EAD) within the IRB framework. Further changes include the removal of the 1.06 scaling factor and a reduction of the LGD component in Foundation-IRB from 45% to 40%. The EC incorporates these changes to IRB; however, for specialized lending and leasing exposures, the input floor is subject to a transitional phase-in.

Credit valuation adjustment

The EC incorporates the Basel changes to CVA to remove the use of internal modeled approaches and require a standardized approach or a basic approach.

Operational risk

The Basel changes to operational risk remove the advanced measurement approach (AMA) and replace it with a non-modeled standardized approach. This is based on a business indicator component (BIC) that the EC incorporates. However, the EC approaches do not further consider historical operational losses. Hence, as a much-anticipated development, the operational risk internal loss multiplier (ILM) element is effectively set at 1.



Full implementation of FRTB

The EC had originally planned for inclusion of binding FRTB standards as part of CRR II. However, following the revision of the standards published by the BCBS in 2019, combined with updated timelines, FRTB was only included in CRR II for reporting purposes. The CRR is now amended to reflect the revised FRTB standards from 2019, with a proposal to move to binding capital requirements for market risk and CVA, which would come into force on 1 January 2025. This timeline diverges with the BCBS proposal of 1 January 2024.

Additionally, the amendments include a provision that allows the EC to amend the market risk capital calculation approaches if there are any major discrepancies with other major jurisdictions, by 31 March 2024. Depending on the level and magnitude of such amendments, this could be introduced as late as nine months prior to when the regulation will come into force, which may make it difficult for financial institutions to meet the 1 January 2025 capital binding date.

The specific amendments to the CRR are generally in line with the BCBS's revised market risk framework. However, some of the core components of the rules are still to be further defined in a series of draft regulatory technical standards (RTS) to be set out between 9 and 18 months from the publication of the CRR. We note that EC refers to the FRTB-introduced standardized approach (SA) and internal model approach (IMA) as the alternative standardized approach (A-SA) and alternative internal model approach (A-IMA) respectively.



Highlights of other CRD/CRR amendments

ESG requirements

CRR III and CRD VI include considerable new ESG requirements for banks and require the EBA to accelerate the publication of recommendations on capital requirements to June 2023. In addition, the suitability of the macro-prudential framework for dealing with these risks will be reviewed by 2022.

The introduction of these requirements and the acceleration in timelines align with comments from the ECB when reviewing EU banks' self-assessment against ECB guidelines: "... the preliminary results show that banks have made some progress in adapting their practices, but it is still too slow. If it continues at this pace, many banks will not meet the supervisory expectations any time soon."

New articles in the CRD require banks to build ESG considerations into their strategies and processes for evaluating internal capital needs and adequate internal governance. This includes requirements to monitor and address the risks arising in the short-, medium- and long-term from the misalignment of the business model and strategy of the institutions with EU policy on development of sustainable economies. In addition, the regulators and supervisors are required to ensure that institutions have, as part of their governance arrangements and risk management framework, robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of ESG risks incorporating stress testing with at least 10-year horizons.

The EBA is required to publish guidelines by June 2023, including (i) standards and methodologies for the identification, measurement, management and monitoring

of ESG risks; (ii) timelines and intermediate targets and milestones to monitor the business model and strategy of institutions against EU policy objectives; and (iii) criteria for stress testing scenarios and methodologies.

The CRR is amended to introduce new harmonized definitions of the different types of risk in the ESG risk universe aligned with those proposed by the EBA and to require institutions to report their exposure to ESG risks to their competent authorities.

Third-country branches

The EC has introduced a new framework incorporating a classification system and accompanying requirements for the authorisation, regulation, reporting and supervision of TCBs in the EU. The materiality in some cases, and the lack of harmonization and consistency of approach and standards, has made this necessary. Although the EBA reported on this matter only recently, in June 2021, concerns were sufficient to introduce this framework in a short time frame to avail of the legislative opportunity. In anticipation of this, a joint letter from an association of bank bodies in September 2021 expressed concern, in particular, regarding subsidiarization and application of CRR rules on a branch basis. It seems that most of these concerns have been heard, with only three branches potentially impacted by subsidiarization, and CRR rules are not being applied from a capital perspective.

In the framework, branches are defined as Class 1 (with assets > €5b or receiving retail deposits, or from a country that does not qualify as equivalent) or Class 2 (all others). Where assets of all TCBs in the EU of a third-country group are over €30b, risk to financial stability of the Member State or the EU will be assessed and, if regarded as systemic, the

branch(es) may be required to (i) subsidiarize, (ii) restructure activities or (iii) apply Pillar 2 capital requirements to the branches or related subsidiaries in the EU.

The framework incorporates an authorization process that requires all existing branches to reauthorize, and regulations that require all branches to maintain endowment capital based on their classification (1 or 2) and Class 1 banks to maintain liquidity coverage ratio. They are also required to meet certain governance, internal control and record-keeping requirements. National supervisory authorities are required to undertake regular reviews of branches to ensure compliance with requirements, including AML.



Other provisions

The CRD and CRR introduce numerous other changes, some of which impact banks directly and others indirectly as a result of further strengthening of the roles and obligations placed upon the EBA and supervisory authorities. Most notable among these changes are (i) provisions to ensure that financial groups that are headed by FinTech companies, or include other entities that engage directly or indirectly in financial activities, are subject to consolidated supervision; and (ii) introduction into national law, by way of the CRD, of provisions regarding the fit and proper assessment of directors. Additionally, the EBA is required to centralize the publication of institutions' annual, semi-annual and quarterly prudential disclosures, making information publicly available through a single electronic access point.

Updates to bank crisis management and deposit insurance framework

The EC proposal incorporates some technical elements related to the resolution regime, aimed at clarifying some aspects of the TLAC/minimum requirement for own funds and eligible liabilities (MREL) regime both under a single point of entry (SPE) and a multiple point of entry (MPE) resolution strategy.

These reforms relate to technical issues that do not alter the essence of the approach to resolution but, rather, contribute to operationalizing the implementation of TLAC. A further review of the resolution regime is expected in the near future since the EC released a public consultation in January 2021 related to topics such as differences in the national insolvency regimes, predictability of the public interest assessment or the role of the deposit guarantee schemes in resolution.

1. A “deduction regime” is introduced for internal MREL channeled indirectly from a subsidiary to the resolution entity through an intermediate company (the “daisy chain”). It requires intermediate parents to deduct from their own internal MREL capacity

the amount of their holdings of internal MREL instruments issued by their subsidiaries belonging to the same resolution group. This deduction provides for an outcome equivalent to that of a full direct subscription by the resolution entity of instruments issued by their ultimate subsidiaries.

2. The regulation is clarified to make it clear that, with regard to the TLAC of MPE groups, the resolution authority will act to address the eventual inconsistencies between the sum of the actual TLAC requirements of each resolution entity and the TLAC requirement that the group would have if it was SPE, and to clarify that the requirements will consider the subsidiaries in third countries.



Summary

As the first major jurisdiction to show its hand, the EU has started the Basel 4 endgame. Other leading regulators, notably the US and the UK, will need to respond, both with their versions of the Reforms and views on the timing of implementation.

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