Box 8.2
FINAL PHASE OF BASEL III IMPLEMENTATION IN THE EUROPEAN UNION

The Committee of Permanent Representatives of the Governments of the Member States to the European Union (Coreper) and the European Parliament's Committee on Economic and Monetary Affairs (ECON) have approved the amendments to Regulation (EU) No 575/2013 (CRR-III) and Directive 2013/36 (CRD-VI).[1]

The main aim of this reform was the implementation in the EU of the final amendments to the Basel capital framework (Basel III), with two distinct documents:

— Amendment of Regulation (EU) No 575/2013 (CRR-III). This is the fundamental part of the reform, including changes to the calculation methods for own funds requirements.

— Amendment of Directive 2013/36 (CRD-VI). While this incorporates changes relating to implementation of Basel III, its fundamental purpose is to enhance the way institutions address environmental, social and governance (ESG) risks, as well as enhance the supervisory framework for institutions and harmonisation of divergent national laws.

CRR-III will enter into force on 1 January 2025. Turning to CRD-VI, Member States will have 18 months from its publication to transpose it into national legislation. In December 2023 the European Banking Authority (EBA) published a roadmap[2] on strengthening the prudential framework, ensuring an international level playing field and providing the industry with clarity on how the EBA will develop the mandates to implement the legislation and how it expects to finalise the most significant components prior to the application date. All of the above will facilitate banks' implementation of the package.

I Main changes introduced by CRR-III

One of the aims of Basel III[3] is to mitigate the variability and lack of comparability of banks' risk-weighted assets (RWAs) entailed by the use of internal models. To this end, a series of measures is introduced that CRR-III incorporates into EU legislation. The adoption of Basel III in the EU is, broadly speaking, complete and consistent with the international framework, although it introduces some European specificities not covered by the Basel framework.

The most significant changes introduced in CRR-III for the EU-wide implementation of Basel III are as follows.

— Output floor: it sets a lower limit for overall RWAs for any bank at 72.5% of RWAs calculated using the standardised approach. In the EU, the output floor will apply at all levels of consolidation, although each Member State may derogate from the individual or subconsolidated level for banking group entities within its jurisdiction. Certain transitional arrangements have also been introduced (in addition to those set out in Basel III) to phase in the framework, so that the output floor will only be fully applicable by 2032.

— Credit risk: the new regulation enhances granularity and sensitivity to certain classes of exposure in the standardised approach (e.g. retail or equity exposures). Internal models are no longer permitted for certain exposures (equity), the advanced internal ratings-based (A-IRB) approach is no longer an option for other exposures (financial institutions and large corporates) and new restrictions are placed on institutions' estimates of parameters. In addition, various transitional arrangements have been agreed in the EU that go beyond Basel III so that banks can gradually adapt to the new rules, e.g. the application of valuation haircuts on leased assets.

— Operational risk: as set out in the Basel framework, internal models may no longer be used in the EU to calculate own funds requirements for this type of risk, but legislators exercised the option provided in Basel III to disregard historical losses when calculating requirements. As such, capital needs will be determined solely by the "business indicator component", which measures an institution's volume of business. At this point, it should also be noted that CRR-III goes further than Basel III to introduce the possibility of the supervisor allowing a bank to calculate the interest component (which is part of the business indicator) separately for each subsidiary in a group, under certain conditions.

1 On 6 December 2023 in Coreper and 11 December 2023 in ECON.
2 *EBA Roadmap on strengthening the prudential framework.*
3 Finalising Basel III. In brief.

Box 8.2

FINAL PHASE OF BASEL III IMPLEMENTATION IN THE EUROPEAN UNION (cont'd)

— Market risk: Basel III's new market risk calculation approaches are introduced (the alternative internal model approach, the alternative standardised approach and the standardised approach), but the European Commission is empowered to adopt a delegated act to modify the framework or postpone its application if differences are observed between the EU's adoption of international standards and that of third countries.

— Credit valuation adjustment (CVA) risk: internal calculation models are eliminated and new calculation methods based on Basel III are introduced (standard, basic and simplified alternative – the latter on the basis of proportionality).

With regard to the impact of the reforms, a recent EBA study, carried out in September 2023, assessed the burden the new regulation would place on EU banks, showing that, in general, European banks' minimum Tier 1 capital requirements would rise by 9.0%. This impact would be around 12.6% if the European specificities other than the Basel III's allowed options were not considered, although most of this discrepancy is the result of particularities that already exist in the current version of the regulation, such as the SME supporting factor or EU exclusions from CVA calculations.

Lastly, bearing no relation to the adoption of Basel III, CRR-III introduces transitional arrangements for the prudential treatment of banks' exposures to crypto-assets, which will remain in force until the Commission delivers its legislative proposal (to be published by 30 June 2025 at the latest), implementing at EU level the framework agreed by the Basel Committee. CRR-III also regulates the information that institutions must disclose about their crypto-asset exposures.

II Main amendments brought about by CRD-VI

The amendments introduced by CRD-IV have two key objectives. First, to strengthen the treatment of ESG risks and, second, to harmonise supervisory powers within the EU.

The banking package seeks, among other things, to strengthen the focus on ESG risks in the prudential framework with a view to addressing the possible impacts of climate change and other ESG risks on credit institutions. New developments notably include the inclusion of ESG risks in the supervisory review process (SREP) and the possibility of using the systemic risk buffer to address climate-related risks. In addition, CRR-III extends the application of ESG disclosure requirements to all credit institutions, taking into account the principle of proportionality, and introduces new requirements for reporting ESG risks to the supervisor.

Finally, regarding the harmonisation of supervisory powers, three aspects should be noted.

a) Third-country branches: the current regime applied to these branches is subject to national legislation and is highly divergent. CRD-VI, first of all, establishes the obligation for foreign banks wishing to engage in deposit-taking or lending activities in a Member State to request authorisation to set up a branch. Moreover, it establishes minimum capital and liquidity requirements for these branches and recognises the minimum supervisory powers that competent authorities should have, including the power to require the transformation of a branch into a subsidiary, in certain circumstances.

b) Additional harmonisation of the fit and proper framework: "large" institutions (assets exceeding €30 billion) must request a "suitability assessment" from their supervisor when planning to appoint a new member to the management body. This is so that the supervisor, in the event of doubt regarding the suitability of the proposed candidate, may engage in an "enhanced dialogue" with the institution to address these concerns and ensure that the candidate meets the suitability requirements when they take up the position.

c) New supervisory powers: institutions must notify the supervisor of any acquisition or sale of investments in any type of entity when the amount thereof exceeds 15% of the acquiring entity's total assets. Following assessment of the transaction, the supervisor may decide to oppose it. In addition, the supervisors must approve all mergers and divisions of entities.

4 The full EBA report can be found here.