Financial Risk&Regulation

The full implementation of Basel III is approaching: The proposal to revise CRR and CRD is published

Newsletter – November 2021

The Basel III International Standards were developed in several steps by the Basel Committee on Banking Supervision to strengthen the banking system following the 2008 financial crisis, and it was finalised in 2017. The EU has already implemented some of these measures through the creation of the CRR and CRD, as a result of which the EU banking sector proved resilient during the Covid 19 crisis and helped to restart the economy by lending to economic agents. With the CRR3 and CRD6 proposals, the last major phase of the Basel III finalization package has arrived. The main elements of the package are the application of new credit risk weights, the limitation of the IRB, the phasing out the AMA, the introduction of the FRTB, the incorporation of ESG risks, and the fine-tuning of the supervisory framework.

The Basel III framework

With the adoption of the final Basel III framework in 2017, previous negative experiences with the financial crisis and supervisory practices have been addressed. Previous studies have observed a large difference in the capital requirements of banks calculated using the internal model, which could not be explained by the different risk profiles of the portfolios alone. Therefore, the Basel Committee revised the standardized approach to make it more risk-sensitive, and imposed new limits (input and output floor) on calculations based on internal models. The framework also contains changes regarding the calculation of credit, operational, CVA and SFT risks.

The proposal package for the implementation of regulatory reforms not addressed in CRR2 and CRD5 was published by the European Commission in October 2021, which is scheduled to be applicable for EU banks from January 2025, but the final package may deviate from the proposal.

During the implementation of the global Basel III recommendations in the EU, the specificities of the EU banking system and the economy had to be taken into account. For example, EU banks finance many small and medium-sized enterprises, for which no external rating is available, and the role of low-risk mortgages is significant. Accordingly, the allowances brought forward by CRR2 quick-fix, such as the multipliers applied to SME and infrastructure investments, remain unchanged. A further departure from the Basel recommendations under the CRR3 proposal is that the relevant risk weight for long-term strategic equity investments in EU banks would remain at 100%. Thus, during the design of the package regulators have taken into account that the new regulations do not lead to an excessive increase in capital requirements.

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Previous changes in CRR were summarized in our August 2019 newsletter at the introduction of CRR2 and CRD5, and we presented the CRR2 quick-fix package in our July 2020 newsletter, which was introduced due to the coronavirus crisis. We wrote in the January 2021 newsletter on the Basel III impact assessment, which was made during the preparation of the current package of proposals.

The CRR3 / CRD6 package specifies additional measures to address ESG ("Environmental, Social and Governance") risks, which have already been included in the CRD2 / CRD5 package. The MNB's recently issued management circular, its green recommendation and the international ESG regulations were addressed in our newsletters of March, and April 2021.

The package also affects supervisory practices, in particular the penalties. We wrote about the topics examined by the MNB and the fines imposed on multiple occasions, most recently in the December 2020 newsletter.

Fine-tuning risk weights in the standardized approach to credit risk

In the case of **retail exposures secured by residential real estate**, the proposal provides a more sophisticated approach instead of the current 35% risk weight.

Exposures are differentiated according to whether the underlying collateral is residential or commercial property, and whether the repayment of the loan depends on the income-generating capacity of the collateral. The standards introduced the concept of Income Producing Real Estate (IPRE), which are considered to be more risky exposures (with a higher risk weight) than the case when the repayment of a loan depends primarily on the ability of the debtor.

Banks may either assign the above weights to the whole loan exposure or have the option of using the previous loan splitting approach, in which case the exposure may be divided into secured and unsecured parts. Thus, in accordance with the Basel III standards, banks may apply rates of 20% and 60% respectively (in the case of residential and commercial real estate) up to a value equal to 55% of the value of the collateral, above this limit banks must take into account the debtor's risk weight. Unlike Basel III, the proposal breaks down risk weights according to ETV (Exposure-to-Value) values for exposures that are not subject to the loan splitting method instead of LTV (Loan-to-Value).

In the case of **credit card products** within regulatory retail exposures, transactor debtors who pay back debt in time, and revolver debtors who rollover their debt, are differentiated. A transactor may be assigned a lower risk weight of 45%, otherwise the risk weights of unsecured retail exposures are the same.

In the case of **corporate exposures**, loans for externally rated debtors with a BBB+ to BBB- ratings are assigned a 75% weight instead of the previous 100%. The 100% weight on unrated loans will remain. However, until 2032, as a transitional arrangement, a risk weight of 65% may be applied if the debtor's risk corresponds to an investment grade. This may be applied if a large company has a PD of no more than 0.5% and is able to meet its financial obligations on time, even in times of crisis.

In the case of institutional exposures, the risk weights of loans to banks with a rating between A+ and A- and between BBB+ and BBB- will decrease from 50% to 30% and from 100% to 50%, respectively. The weights of short-term exposures do not change (ECRA methodology). Unrated institutional exposures, as a departure from CRR2, where the central government rating was authoritative, are assigned risk weights based on ratings assigned by banks. Under the SCRA approach, banks classify exposures into categories A, B, and C on the basis of quantitative and qualitative criteria, where exposures are assigned weights between 20 and 150%.

Under Basel III, **exposures subject to 'specialized lending'** are also assigned separate risk weights depending on whether an external rating is available and whether the loan is for project, object, or commodity financing.

For **CVA risk**, risk weights are modified in accordance with Basel III and internal models are withdrawn. The minimum haircuts applicable to SFT transactions will be outlined by the EBA at a later stage.

Change in application of IRB methods

When using Internal Ratings Based Approaches ("IRBs"), a lower limit ("input floor") will be set to ensure a minimum level of conservatism for PD, LGD and CCF parameters, thus avoiding a capital requirement that is too low and to limit model risk.

Furthermore, the **"output floor" is introduced**. According to this, banks are required to apply a certain percentage of the capital requirement calculated in the standardized approach as an effective requirement, even if the internal models would result in a lower value. At the time of the

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introduction, there would be a multiplier of 50%, which would increase by 5 percentage points per year and reach a final value of 72.5%. However, it is also possible to apply an upper limit until 2029, based on which the effective capital requirement is at most 125% of the capital requirement calculated without restriction (using internal model methods). With the introduction of the output floor in the case of the pillar 2 capital requirement (P2R) and the systemic capital buffer, certain risks may be taken into account twice (e. g. model risk), which the CRD proposal addresses by allowing supervisors to review these two amounts of capital requirement.

In accordance with the Basel standards, the multiplier of 1.06 is deleted from the IRB capital function for risk weights. It is also worth noting that the CRR3 proposal restricts the use of the advanced IRB method which only applies to asset classes for which a robust parameter estimation is possible.

Market risk: FRTB is introduced

CRR2 has previously introduced data provision for the market risk capital requirement calculated under the FRTB (Fundamental Review of the Trading Book) standard approach published by the BIS in 2016. The CRR3 proposal introduces an alternative internal model approach (A-IMA) according to the FRTB and the standardized approach is separated into an alternative and a simplified approach (A-SA and S-SA). According to the S-SA, the capital requirement will be the sum of the previous market risk capital requirements multiplied by a conservative factor: for equity, interest rate, foreign exchange and commodity risks, a multiplier of 3.5, 1.3, 1.2 and 1.9 will be applied respectively.

In addition, the requirements for structural foreign exchange positions taken to stabilize capital adequacy ratios have been amended.

In order not to put EU banks at a competitive disadvantage in the global market in case the major non-EU regulators deviate from the Basel III standards, the European Commission is authorized to publish delegated acts amending the capital requirements for market risk and its date of entry into force in accordance with the international developments. The FRTB is a more risk-sensitive methodology, but due to the conservative approach and higher risk weights reflecting the stress period, it is likely that banks will have a higher capital requirement when the rules are finally implemented.

Operational risk: SMA cannot take loss data into account

As for operational risk, the SMA (Standardized Measurement Approach) method envisaged in Basel III has been introduced, in which case the required capital requirement will be the value of the BIC (Business Indicator Component) indicator based on accounting data. Unlike the Basel III standards, internal loss data (ILM indicator) cannot be taken into account in the capital requirement. With regard to internal loss data, the proposal imposed detailed requirements on banks regarding data collection, data quality and disclosure. In parallel, previous methods, including the internal model methodology, will be revoked.

There is a greater emphasis on ESG risks

The topicality of the ESG in European banking regulation is indicated by the recently published Taxonomy Regulation and the EBA guidelines on lending processes, which addressed the integration of ESG factors into lending processes. This time, the CRR3 proposal extends the requirement of ESG risk disclosure to all institutions. In addition, the Commission empowers supervisors to integrate ESG risks into their SREP processes. These risks can also be integrated into supervisors' stress tests or those which are required of banks, and the CRD6 proposal has given the EBA a mandate to develop guidelines in relation to this. The proposal also calls for stricter risk management measures and specific plans regarding ESG risks.

Changes in CRD: a broader set of tools for supervisors

The CRD6 proposal has extended and standardized the tools of national supervisors in the regulation / authorization of prudentially significant economic events (purchase of significant holdings, transfer of assets or liabilities, mergers and divisions).

The CRD proposal introduces periodic penalty payments to encourage institutions to quickly comply with the rules and to standardize the range of sanctions for member states in order to create a level playing field between them. The proposal distinguishes between administrative and criminal fines, in which case the list of infringements has been extended to include prudential requirements. The EBA will also develop processes and controls in the future to prevent multiple fines for the same infringement.

Third-country firms providing financial services in the Union will in any case be required to establish a branch in a member state in order to avoid falling outside of the scope of prudential regulation and supervision, thereby jeopardizing the financial stability of the Union. The regulation of third country branches is also tightening as their numbers in the EU are growing with a relatively significant asset value. Under the directive, branches should meet minimum requirements for establishment, as well as a minimum level of capital, good liquidity ratios and internal governance and risk management standards, taking into account the size of the branches.

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Supervisors should examine whether branches are systemically important institutions, these ones could be forced to restructure their portfolio, or be required to hold additional capital under the second pillar.

Impact assessment

According to the impact assessment of the EBA, the implementation of the Basel III reforms would increase the capital requirement of 10 banks out of a sample of 99 European banks by a total of 27 billion euros, while 89 banks already comply with the new rules. The weighted average minimum capital requirement for EU banks would increase by 6.4% to 8.4% in the long run, taking into account the impact of the transitional arrangements, while it would increase by 0.7 to 2.7% in the medium term. Although there would be a number of one-off administrative and operational costs with the new rules, restrictions on internal methods would reduce these types of costs overall. The regulations do not affect negatively the access of SMEs to loans and with lower compliance costs, the cost of funding would be lower. Overall, regulations would make EU banks more resilient to future economic shocks. This would improve investor confidence in the banking system, which could lead to lower funding costs and thus improved competitiveness.

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