Financial Risk&Regulation

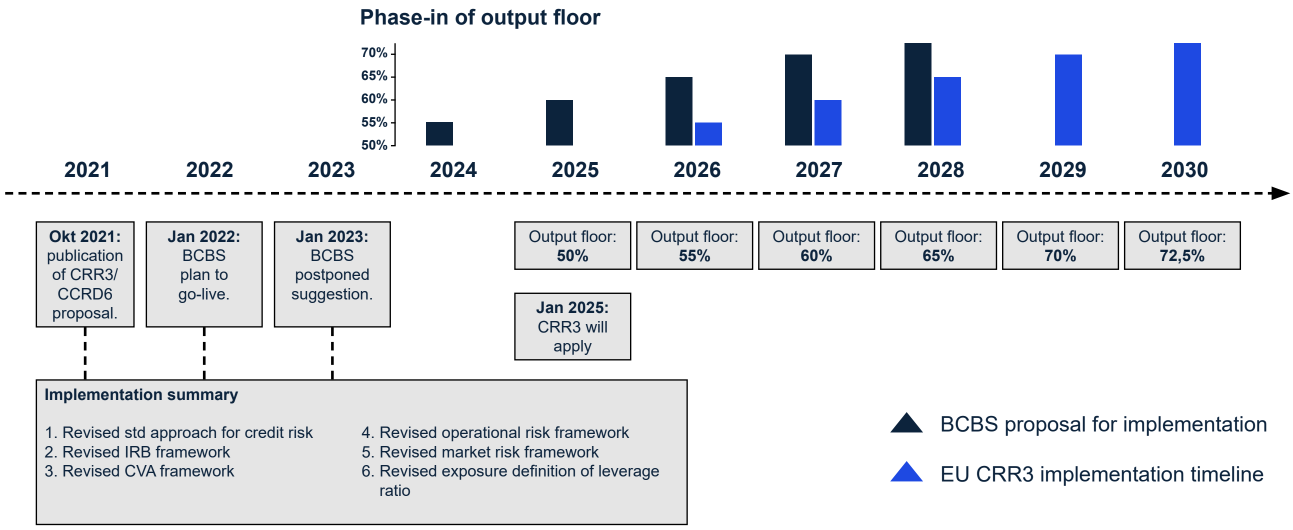
Basel III finalization – Slow progress in implementation of CRR3

Newsletter – 2022. September

Almost a year has now passed since the European Commission published its 2021 banking package, which reached the last major implementation phase of Basel III with the CRR3 and CRD6 proposals. In the time that has passed, the legislators have worked on the final legislative material and both the ECB and the ECON Committee have issued a detailed opinion, which highlights the legislative points that are still in question. These primarily affect the output floor, certain parts of the credit risk framework, the consideration of operational risk loss data, and the regulation of market risks by the Commission. In this newsletter we present these opinions of the two institutions. We last wrote about the details of the planned regulatory changes in November 2021, but previously we also covered the topic in our January 2021 and September 2020 newsletters.

The EU implementation is slower than expected

The journey to implementation has not been fast so far, as the Basel Committee on Banking Supervision (BCBS) first postponed its planned initial implementation date by one year, to January 1, 2023, as a result of the pandemic. The draft EU implementation legislation was also completed later than expected, so the package would largely apply from January 1, 2025, but in many cases, temporary and simplified rules must be complied with for another five years, until January 1, 2030. Thus, this implementation schedule fits well with the jurisdictional and EU legislative processes common to previous Basel implementations, which can also be seen in the illustration below.



The purpose of the Basel III finalization package is to strengthen the sector's resilience against future crises, so its focus is on capital requirements, and its detailed rules were able to be refined from the recent feedbacks of the previous reform package, thanks to the fact that the banking risk management frameworks have gone through go-live tests during the Covid-crisis.

After the publication of the proposal the ECB and the Economic and Monetary Committee of the European Parliament (ECON Committee) expressed their position regarding the proposed amendments. In March 2022, the ECB issued an opinion on the [CRR]() and [CRD]() proposals, while the [ECON Committee]() formulated a public position only in connection with the CRR amendment.

The current status of the legislative process is presented visually in the figures below.

Figure 1 CRR amendment process steps taken so far

Figure 2 CRD amendment process steps taken so far

ECB opinion

Output floor (OF)

Several elements of the OF proposal were highlighted by the ECB in its opinion, according to which the current proposals lead to lower risk weights than those specified in the Basel standards in specific areas, including residential real estate exposures with low historical losses, exposures to unrated corporates and the calibration of counterparty credit risk related to derivative exposures.

The ECB supports the option for the „single stack" approach, according to which banks can only measure their risk-weighted assets in one way. However, it does not agree with the redistribution mechanism proposed by the European Commission, which should be applied to banking groups operating in multiple countries. In ECB's opinion, this mechanism could encourage banking groups to reorganize their activities in order to minimize the impact of the output floor. This can have a negative impact through a misalignment of organizational structures or the less effective risk management, and it can freeze more capital at the local level, which is contrary to the objective of free capital movement necessary for financial integration. The ECB would rather support the solution of applying the capital floor only at the highest level of consolidation.

Credit risk framework

According to ECB, the standardised approach contains several new deviations from the final Basel standards that, together with some existing deviations (e.g. for SMEs), may reduce the consistency and security of the new standardised approach and leave certain risks uncovered.

The ECB recommends that the co-legislators also re-evaluate the current deviations, paying particular attention to the methods of collateral evaluation of exposures secured by special lending exposures, equity exposures, residential exposures and real estate.

Operational risk

The ECB disagrees with the European Commission's proposal which does allow the recognition of historical losses for the calculation of the operational risk capital requirements. According to the ECB, taking losses into account would increase risk sensitivity and the loss coverage of capital requirements, providing institutions with a greater incentive to improve their operational risk management.

Market and CVA risk

The CRR3 proposal allows the European Commission to change the calibration of capital requirements based on the new market risk framework and postpone its implementation by two years. This could result in lower capital requirement, which differs from Basel standards. The ECB recommends limiting these powers, highlighting the importance of implementation by 2025. With regard to CVA risks, the ECB emphasizes that the proposal does not review the existing exemptions, which is unjustified from a prudential point of view, as institutions may be exposed to unhedged risks during derivative transactions with exempt counterparties.

IRB-approach

The ECB predominantly welcomes the proposals for changes to the IRB-approach but highlights some areas for improvement. Certain concepts, such as turnover, revenue and sales, are not sufficiently clarified, which can lead to inconsistent practices. Coherence must also be ensured between the definition of default and the estimation and implementation of risk parameters, for example, in the case of retail portfolios, regarding the terms of default at transaction and customer level.
The proposal also introduced a number of new requirements for PD estimates, where the ECB recommends simplification in certain cases.

Pillar III disclosures and reporting

The ECB believes that the quantitative disclosure approach for small and non-complex institutions (which uses supervisory reports to compile appropriate quantitative public disclosures based on a pre-defined mapping) could be applied to all institutions regardless of size and complexity in order to reduce the reporting burden on institutions.

CRD opinion

According to the ECB's opinion, the ESG risk monitoring toolkit should be expanded and banks should be encouraged to develop their risk management framework in this direction. In connection with the output floor, it welcomes the fact that avoiding double consideration of risks is specifically included in the proposal. The ECB highlighted the importance of a uniform assessment of bank managers and employees performing special functions. It also supports the harmonization of branch rules and the acquisition of controlling interests, the transfer of assets or liabilities and the mergers or spin-offs.

European Parliament opinion

The ECON Committee also published a draft report on the CRR3 proposal with the following amendments.

- Removal of the new 122a. termination of preferential treatment for “high-quality” specialised lending exposures (80% reduced risk weight for non-rated special loans if they are defined as “high quality”). Instead, a 100% risk weight would be applied to all exposures.
- 100% risk weight for retail exposures above EUR 1 million instead of the proposed 75%.
- Rejection of the proposed reduction in the risk weight of exposures from institutions and corporates with a short-term credit assessment. Instead, the actual values would be maintained.
- Exclusion of unrated corporates with an annual turnover of over EUR 500 million from the scope of the temporary regulation on the application of a 65% risk weight until 2032.
- Elimination of the possibility of increasing the value of the property used as collateral for the exposure above the existing value of the loan.
- According to the proposal, the Commission has the power to amend the rules and the date of entry into application of the market risk capital requirements, the ECON Commission does not support this.
- Limiting the application of transitional arrangements for exposures secured by immovable property. The property must be certified at A or A+ energy efficiency level.

Summary

The opinion of the ECB and The ECON Committee and the protracted debates accompanying the finalization of the package may lead to a significant reduction in the time available for banks to prepare, if the European Parliament does not accept the European Commission’s proposal within a short period of time. At the same time, it is clear that the Commission was under considerable pressure, as the date of entry into application of the finalization of Basel III is expected to have a significant capital impact on some institutions, and at the same time, the partner organizations also expressed different opinions on many topics.

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In accordance with the international regulatory environment and domestic practice, the MNB is further expanding and clarifying the resources that concerns materially financial market participants and their legal requirements meet. KPMG has the expertise to interpret, implement and provide relevant professional advice on supervisory expectations and to develop appropriate practices.

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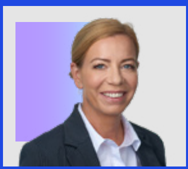

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