The Future of Banking in the EU: Understanding CRR III and CRD VI

Regulatory Update

KPMG Ireland

Banking regulation in the EU has reached a pivotal juncture with the latest amendments to Regulation (EU) No 575/2013 (the Capital Requirements Regulation 'CRR') and Directive 2013/36/EU (the Capital Requirements Directive 'CRD').

Background

The global financial crisis of 2008-2009 served as a catalyst for a comprehensive overhaul of banking regulations. The crisis highlighted the need for a more robust regulatory framework to prevent future financial system failures. The Basel III reforms, developed by the Basel Committee on Banking Supervision (BCBS), laid the groundwork for the amendments encapsulated in CRR III and CRD VI, aiming to enhance the stability of the financial system on a global scale.

The new amendments were published in the Official Journal of the European Union on 19 June 2024 and will take effect on the twentieth day after publication.

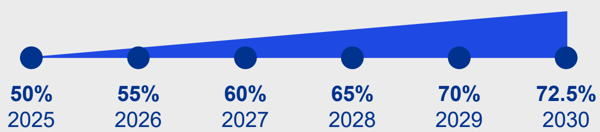
Key highlights

- **Standardised Approach for Credit Risk**: The amendments update the methodology for calculating credit risk using the Standardised Approach (SA), making it more risk-sensitive and aligned with the Basel III framework. The amendments impact the exposure value, risk weights, and treatment of various types of exposures, such as those to institutions, corporates, specialised lending, real estate, equity and defaulted assets.

- **Internal Ratings Based Approach for Credit Risk**: The amendments revise the methodology for calculating credit risk using the Internal Ratings Based (IRB) approach. The new changes restrict the use of the Advanced IRB approach for certain asset classes as well as seeing the introduction of minimum levels for certain input parameters.

What is the output floor?

1. Banks using internal models will not be able to reduce the overall risk-weighted exposures below 72.5% of the risk-weighted exposures that would have applied using the SA.
2. The output floor applies only at the aggregate level, not risk-by-risk or exposure-by-exposure.
3. The output floor will be introduced gradually over a transition period of five years to reduce its immediate impact.



- **Standardised Approach for Operational Risk**: The amendments introduce a new methodology for calculating the capital requirements for operational risk, based on a business indicator that combines the size of the business of an institution with an indicator which takes into account the loss history of the institution.

- **Output Floor**: A significant new feature is the establishment of an output floor, which sets a minimum level for capital requirements, thereby standardising risk assessments across the EU banking sector.

- **Market Risk Framework**: CRR III introduces the new Basel III standards for market risk as binding capital requirements, replacing the existing methodologies with more risk-sensitive and prudent alternatives. The CRR III also harmonises the rules for assigning instruments to the trading book and banking book and gives the European Commission the power to adjust the implementation date of the new framework.
- **CVA Risk Framework**: The amendments update the methodology for calculating the capital requirements for Credit Valuation Adjustment (CVA) risk. The amendments introduce a more risk-sensitive and granular approach based on fair value sensitivities, as well as a simplified approach for institutions with less involvement in derivatives activities.
- **Supervisory Practices**: The amendments seek to harmonise supervisory practices for third-country bank branches, promoting a level playing field and enhancing supervisory convergence within the EU.
- **Adaptation to Emerging Risks**: The inclusion of provisions for crypto assets and Environmental, Social, and Governance (ESG) risks reflects the EU's proactive approach to adapting to emerging risks in the banking landscape.

Future outlook

With the regulations set to be in force from 1 January 2025, and Member States given 18 months to transpose the Directive into national legislation, banks will need to adjust their frameworks to comply with the new requirements. As the banking sector prepares for the implementation of CRR III and CRD VI, it also faces a series of additional challenges and developments driven by Competent Authority and Supervisory initiatives. The cyber risk stress test in 2024, and the top-down climate risk stress test planned by the ECB, are both indicative of the proactive measures being taken to ensure the sector's preparedness for future risks.

Conclusion

The CRR III and CRD VI amendments mark a significant step forward in the EU's regulatory response to the financial crisis, emphasising the importance of resilience, sustainability, and global alignment. As the banking industry embarks on this regulatory journey, it is imperative to maintain a collaborative approach, leveraging the collective expertise and experience of all stakeholders to ensure a smooth and successful transition.

How KPMG Can Help?

- **Regulatory Gap Assessment & Impact Assessment**
- **Benchmarking, Industry Insights, Regulatory Updates**
- **IRB Model development, review & validation**
- **Balance Sheet and RWA Optimisation**
- **Cyber and Climate Risk Stress Testing**

Contact Us

Ian Nelson
Head of Financial Services
Head of Regulatory Consulting
t: +353 87 744 1989
e: ian.nelson@kpmg.ie

Adrian Toner
Managing Director
Financial Risk Management
t: +353 87 050 4894
e: adrian.toner@kpmg.ie

Kankana Banerjee
Associate Director
Financial Risk Management
t: +353 87 111 7963
e: kankana.banerjee@kpmg.ie

Tamas Balazsi
Manager
Financial Risk Management
t: +353 86 136 1814
e: tamas.balazsi@kpmg.ie

kpmg.com/socialmedia