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PART 2/4

COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT REPORT

Accompanying the documents

Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor

Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, environmental, social and governance risks, and amending Directive 2014/59/EU

{COM(2021) 663 final} - {SEC(2021) 380 final} - {SWD(2021) 321 final}

ANNEX 1: PROCEDURAL INFORMATION

1. LEAD DG, DECIDE PLANNING/CWP REFERENCES

This legislative proposal (CRR III/CRD VI) was prepared under the lead of DG FISMA in association with DG JUST. Within the Agenda Planning of the European Commission, the project is referred to under item 21. In the Adjusted Commission Work Programme for 2020, the Commission committed under the header "An Economy that Works for People" to review of the CRR and the CRD and adopt a legislative proposal by Q2 2020.

The Decide Planning references are:

- REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR) as regards risk-based own funds requirements

  PLAN/2019/5320

- DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/36/EU (Capital Requirements Directive - CRD) as regards risk management and review processes

  PLAN/2019/5321

In light of the COVID-19 pandemic, the preparatory work has been delayed, reflecting the BCBS' decision of 26 March 2020 to postpone the previously agreed implementation deadlines for the final set of Basel III reforms by one year[154]. This delay has allowed the Commission services to focus their attention on the response to the COVID-19 crisis. It has also allowed them to reassess the impact of the planned reforms in light of the potential consequences of the crisis.

2. ORGANISATION AND TIMING

DG FISMA work on this legislative proposal started in spring 2018 with the publication of the first public consultation requesting inputs from external stakeholders on the implementation of the final elements of the Basel III reform (see Annex 3).

An Inter-services Steering Group assisted DG FISMA in the preparation of this Impact Assessment report. The Steering Group was set up on 11 September 2019 and included colleagues from DG ECFIN, DG GROW, DG JUST, DG COMP, and DG TRADE.

Two additional Steering Group meetings were organised on 2 December 2019 (with colleagues from the same DGs as in the previous meeting) and on 23 January 2020 (with colleagues from the same DGs as in the previous meeting, as well as colleagues from the

[154] See https://www.bis.org/press/p200327.htm.

Legal Service). At each occasion, the members of the Steering Group were given the opportunity to provide comments in writing on the draft versions of the documents presented.

A final Steering Group meeting took place on 12 February 2021 (with colleagues from the same DGs as in the previous meeting, as well as colleagues from DG CLIMA and DG ENV) to discuss the revised text before its submission.

All the meetings were chaired by the Secretariat General.

The contributions of the members of the Steering Group have been taken into account in the content and shape of this impact assessment.

3. CONSULTATION OF THE RSB

A first version of the Impact Assessment report was submitted to the Regulatory Scrutiny Board (RSB) on 12 February 2020 and discussed during a physical meeting with the RSB on 4 March 2020. The RSB gave a negative opinion on 6 March 2020, pointing to several shortcomings in the report (see left column of *Table 1* for the list).

The Impact Assessment was modified to address the identified shortcomings (see right column of *Table 1* how they were addressed) and was re-submitted via written procedure to the RSB on 22 June 2021.

Table 1: Summary of RSB comments in its 4 March 2020 opinion

RSB comments about the first version of the IA	How these comments have been addressed in the present version of the IA
(1) The report should present a clear and non-technical narrative for the main issues at stake. It should present available evidence of current problems with the resilience of European banks and the banking system, and compare against other jurisdictions implementing Basel III. If relevant, it should differentiate between types of banks.	The narrative of this impact assessment has been clarified and simplified to highlight the main problems that this legislative initiative is addressing. In Section 2, four main problems have been identified and are now all included in the main body of the impact assessment for better readability. The different problems related to the outstanding deficiencies of the calculation of the risk-based capital requirements in the current prudential framework have been merged into one overall problem which will make it easier to present the implementation of the Basel III reforms as a global policy option to address this problem. In addition, more factual evidence has been provided to illustrate the problems.

	The context section now includes information on the state of play of implementing the final elements of the Basel III reform in other jurisdictions and provides more evidence on the current situation of EU banks. The specific impact on the competitiveness of EU banks (now Section 2 of Annex 6) has been improved to provide a comparison of the impacts of the final elements of the Basel III reform across EU banks, depending on different banks' profiles, but also between EU banks and their international peers.
(2) The narrative should also show the overall trade-offs involved in the decisions. This would help to clarify the key issues to non-expert policymakers and prioritise elements of the report, adding structure to the more technical analysis of components	The assessment of the different policy options in Section 6, as well as the summary of the assessment of the preferred policy options in Sections 7.1 to 7.3, offers a better understanding of the different trade-offs in the decision making process.
(3) The report should consolidate in one place all relevant policy objectives, some of which are now only referred to or hinted at later on in the report (e.g. relating to financing of the economy and sustainable finance). The definition of the objectives should allow a systematic analysis of the relevant trade-offs in the impacts sections.	All objectives, general and specific, are presented in one place, namely Section 4. They have been updated to take into account the COVID-19 crisis.. The links between the general and specific objectives as well as the identified problems have been clarified and presented graphically.
(4) The operational meaning of 'level playing field' and other specific objectives should be made clear, including what success would look like. The problem description might also clarify what the problems are that relate to an unlevel playing field. The report should explain to what extent and how the proposal will result in a level playing field in the EU in line with the objective and with other jurisdictions. The explanation should ideally be in terms that can later be tested against outcomes.	The notion of level playing field has been specified across all the sections and put into the appropriate context. Section 2 of Annex 6 offers a clearer analysis of the differences in the impact of the final elements of the Basel III reform could affect the internal (i.e. between EU banks) and external (i.e. between EU banks and non-EU banks) competitiveness of EU banks and how the preferred policy options would address the level playing field.
(5) While it is an important objective to contain administrative and compliance costs, it is less clear whether this is different from	The specific objective has been refined (focusing on banks' administrative costs related to public disclosures) to better

cost-effectiveness used to select the preferred option. The initiative would not appear to deliver significantly lower costs, and cost efficiency is in any case among the assessment criteria. The report should apply uniform definitions of cost-effectiveness and efficiency. The objective on legal clarity also requires better justification	correspond to the problem (of inefficiency in the disclosure of banks' prudential information) identified and to ensure they do not overlap with the assessment of the cost-effectiveness criteria to identify the preferred policy option.
(6) The report should present an intervention logic that describes the channels through which policy measures would contribute to better final outcomes. This would help to better structure the report around the relative importance of various measures and their impacts on different elements of the EU banking ecosystem. The logic should connect actions to specific objectives that relate clearly to the general objectives.	The link between the general and specific objectives has been clarified in Section 4. Sections 5 and 6 describe how the policy options connect to the specific objectives and deliver on them against the assessment criteria (effectiveness, efficiency, coherence), respectively.
(7) The report needs to be clearer on impacts that do not map onto the objectives. This includes the likely reactions from those banks, which will need to significantly raise capital. The report should explain the available means for them to do so (e.g. through retained profits, sale of equity, sale of assets, mergers) and the likely impacts of the different choices on the sector and on different Member State economies.	Section 6.1 clarifies the views of the EU banking sector on the different policy options to implement the final elements of the Basel III reform, the advantages/disadvantages of different approaches that EU banks can use to comply with an increase in capital requirements resulting from the reform, and their chance to succeed for each policy option. Section 2 of Annex 6 provides the impacts of the various elements of the reform, grouping banks by size, business model and Member State of establishment.
(8) Other relevant impacts to explore may include the impact on competitiveness of banks and sectoral consolidation. For example, different ways of calculating the output floor have direct impacts on large banks and indirect impacts on small banks. By contrast, changes to the standardised approach directly affect small banks. The impact on venture capital may also be worth exploring.	Section 2 of Annex 6 provides the impacts of the various elements of the Basel III reform, grouping banks by size, business model and Member State of establishment.
(9) The report should expand the analysis of the limits to supervisory powers in controlling banks' discretion in using	Sections 2.2.1., 2.2. and 5.1. better explain the current powers of supervisors to address the variability observed across EU banks

internal models to calculate capital requirements. Any reduction of discretionary authority of national and ECB banking supervisors needs to be presented transparently, including feedback from those supervisors regarding the proposed changes. The report should explain what the proposal would mean for the internal market and for the competitive situation between small and large banks, public banks, and large or complex banks whose failure would involve systemic risk. It should explain the reason for more pronounced impacts on banks in some Member States, and whether this is likely to affect these economies more broadly.	internal models, including the EU-wide initiatives conducted by the EBA and the ECB in that respect, and their limitations. Section 6.1. and Annex 2 provide the view of supervisors on the proposed changes. See also elements of replies to comments (4) and (8), for what concerns impacts on competitiveness and impacts on different types of banks, respectively.
(10) The report should thoroughly analyse the effect of the proposed measures on SMEs. It should assess the effects of the introduction of a higher risk weight for credits to unrated companies under the standard approach. This measure is likely to affect SMEs in particular as most SMEs are unrated and as they receive more credits from smaller banks that apply the standard approach to credit risk. If the analysis assumes that a substantial part of SMEs will use the transition period to obtain a credit rating, it should incorporate the cost of doing this. The possible positive effects of the SME supporting factor should also be developed.	Section 3 of Annex 6 on the specific impacts of this legislative initiative on lending to SMEs describes which policy options are specifically related to SMEs and how they would impact banks' financing of SMEs. Annex 1 provides further explanation, on top of Section 3 of Annex 6, on the EU specific adjustments proposed in the preferred policy options to mitigate the impact of the reform on banks' lending to SMEs, including the treatment of unrated corporates and the existing SME supporting factor.
(11) The report should better justify why it proposes to maintain the existing supporting factors for SMEs and for infrastructure investment. It should integrate stakeholder views, including the recommendation of the EBA to abandon these supporting factors. The performance of the existing supporting factors should be at the basis for the proposed introduction of a new green supporting factor. The report should bring more convincing evidence that the two types of exposure that would benefit from it have unique features that justify their preferential	Further justification has been provided for the decisions involving the different supporting factors.

treatment.	
(12) The impact assessment should be more transparent about data and model limitations. For example, inferences from the EBA sample of banks on the sector as a whole may be more reliable for large banks than for small ones. Estimates of the negative impact on growth in the short and medium term are more robust than estimates of long-term benefits that are based on decreased risk of full-blown banking crises over longer time horizons. The report appears to overplay analytical support for the hypothesis that 'green' investments are relatively lower risk, and that lower capital requirements on certain loan types are an effective way to stimulate more lending. The report should discuss the EBA calculations' robustness and relevance for assessing the impacts of the preferred options, given the modifications introduced after the calculations.	Section 6.1 and Annex 7 better explain how to interpret the estimated impacts from the EBA and ECB respective analysis. Annex 5 provides more details about the sample used in the EBA and ECB analysis and the limitations of their methodologies. The analysis related to environmental, social and governance (ESG) risks and the corresponding policy choices have been updated.
(13) Some options need further clarification or explanation why they have been discarded. For instance, the report should better explain why supervisory bodies cannot be strengthened and why this option has been discarded. This holds in particular for the ECB, which is responsible for supervision of the larger banks and should have the capacity to assess and control banks' use of internal models to assess portfolio risks. On credit valuation adjustment risks, the justification for discarding the option of postponing the introduction of a revised framework until BCBS has finalised its ongoing review should be strengthened.	In Section 6, the assessment of the pros/cons of each policy option to address the problem it aims to address identified has been improved, as well as the system to score those options. These clarifications allows the reader to understand our choice of preferred policy options and why the other policy options have been discarded.

4. EVIDENCE, SOURCES AND QUALITY

A number of inputs and sources of data were used in the preparation of this impact assessment, including the following:

- advices from the EBA, delivered to the Commission in August and December 2019 and December 2020, and other reports of the EBA referred to in footnotes to this impact assessment;
- information supplied in the context of the public consultation described in Annex 2;
- publications of the ECB, the ESRB, the FSB and the BCBS referred to in footnotes to this impact assessment;
- newspaper articles, scientific journal articles, and other sources referred to in footnotes to this impact assessment.

The vast majority of the data underpinning the quantitative analysis contained in this impact assessment was provided by banks. Given that the data used in the EBA, ECB and BCBS analyses underwent quality checks by those organisations, the data quality can be considered reasonably good. Nevertheless, the figures provided by banks are (more or less accurate) estimates based on assumptions made by banks. As such, they need to be interpreted with caution.

ANNEX 2: STAKEHOLDER CONSULTATION

1. Public consultation

As part of the implementation process of the final elements of the Basel III reform in the EU, the Commission services gathered stakeholders' views on specific topics in the areas of credit risk, operational risk, market risk, CVA risk, securities financing transactions as well as in relation to the output floor.

Beyond these topics related to the Basel III implementation, the Commission services have also consulted on certain other subjects with a view to ensuring convergent and consistent supervisory practices across the Union and alleviating the administrative burden.

The public consultation carried out between October 2019 and early January 2020[155] had been preceded by a first exploratory consultation conducted in spring 2018[156], seeking first views of a targeted group of stakeholders on the international agreement. The results of the two consultations have fed into the preparation of the legislative initiative accompanying this impact assessment.

Stakeholder groups

There were 119 responses to the public consultation. As illustrated by

[155] See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12015-Alignment-EU-rules-on-capital-requirements-to-international-standards-prudential-requirements-and-market-discipline-/public-consultation_en.

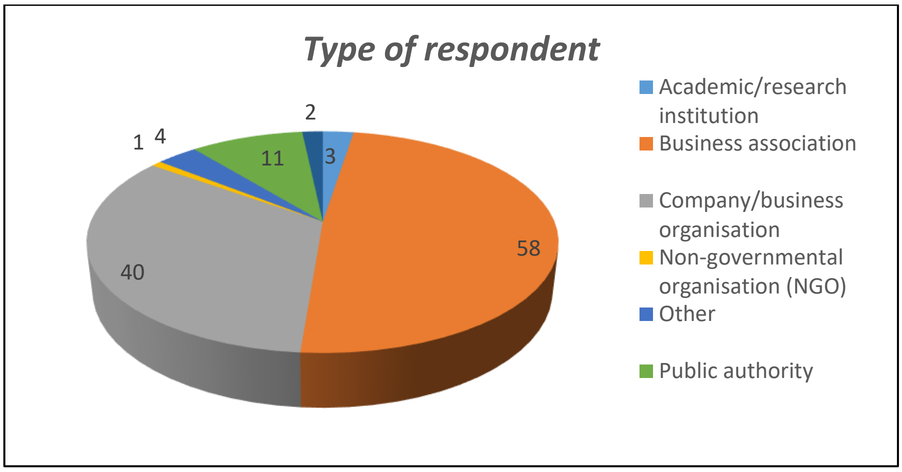
[156] See https://ec.europa.eu/info/consultations/finance-2018-basel-3-finalisation_en

Figure **1** and *Figure 2*, most responses came from the financial industry (i.e. individual banks, banking associations and) and half of them came from respondents established in three Member States (Belgium, Germany, France and the United Kingdom).

Results

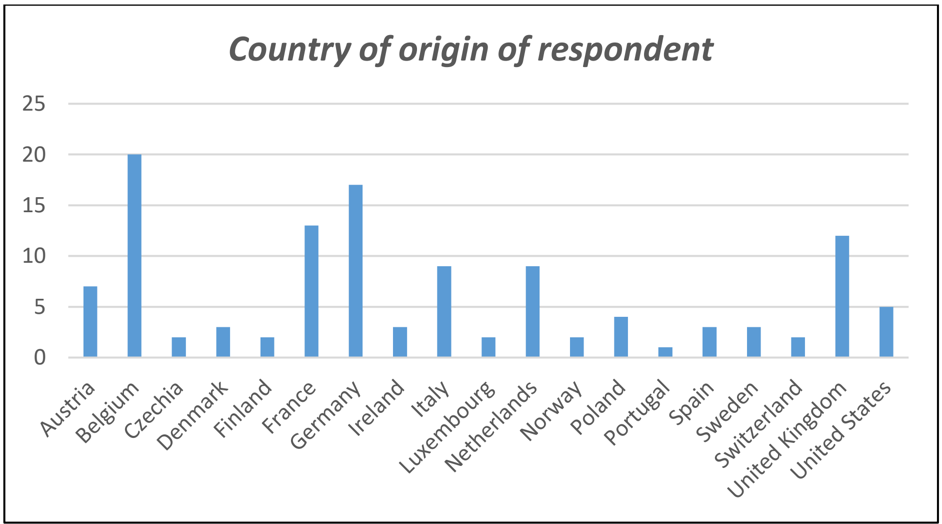
Stakeholders overall agreed on the necessity to complete the implementation of the Basel III framework in the EU. While the financial industry called for several adjustments and additional transition periods, supervisors and public authorities took a more conservative approach and preferred an implementation of the remaining reforms closer to the international standards.

Figure 1: Nature of respondents to the public consultation



Source: Commission, DG FISMA

Figure 2: Country of origin of respondents to the public consultation



Source: Commission, DG FISMA

The feedback received on the individual elements of the reforms can be summarised as follows:

- Regarding the **output floor** the financial industry asked to limit the scope to the requirements explicitly listed in the corresponding Basel standard by applying it as a "parallel stack" and at consolidated level only. In contrast, a majority of supervisors were in favour of a "single stack" implementation of the output floor at all levels of consolidation.
- As regards the treatment of **unrated corporates** in the credit risk framework, supervisors and the financial industry have expressed different views. Industry advocated for a so-called "hybrid approach" while supervisors prefer to implement

the Basel standard. Views were divided among supervisors on the option to remove the SME supporting factor from the risk framework, while the financial industry was in favour to keep it.

- On **specialised lending**, views were mixed between Member States and supervisors. Some showed openness to introduce more granularity in particular with regards to object finance than it is envisaged under the final Basel III standards. This approach was supported by the financial industry.
- Supervisors and the industry also expressed different views on the **treatment of equity exposures.** Supervisors preferred to apply the Basel treatment without modifications while the industry and some Member States argued for a more granular treatment for long-term equity holdings in unlisted entities, and notably a more favourable treatment for intragroup and IPS exposures.
- There was consensus among Member States and supervisors in favour of the continuation of the "loan splitting approach" (instead of implementing the "whole loan approach") for **real estate exposures**. The financial industry preferred to provide flexibility for banks to choose its approach. Industry's plea to continue allowing for the upward revaluation of property values after origination found some (conditional) support with Member States and supervisors.
- Several stakeholders from industry were in favour of not fully applying the **new constraints for the use of internal models** for credit risk. This option found only little support from Member States and supervisors.
- The industry favoured a delay in the implementation of minimum haircut floors for **securities financing transactions**, or, as a second best, an implementation via market regulation. Member States and supervisors were mostly silent on the issue.
- Member States and supervisors were largely in favour of taking historical losses into account to compute large banks' capital requirements for **operational risk**, while the majority of stakeholders in the financial industry favour neutralising the impact of past losses or taking them into account only when they have a beneficial impact.
- The consultation showed no opposition against the implementation of the simplified standardised approach for market risk in line with the Basel calibration. Also, the financial industry unanimously supported the need for more **flexibility in the treatment of CIUs** while Member States and supervisors were mostly silent on the issue.
- Industry and supervisors were in favour of delaying the implementation of the **CVA risk** rules until the Basel standard is finalised. The industry unanimously favours keeping the existing exemptions. MS and supervisors are split on this issue.

Apart from questions on the implementation of the final elements of the Basel III reform in the EU, the consultation included some questions regarding supervisory reporting and public disclosure as well as the fit-and-proper assessment.

Views are all in all cautiously positive on the initiative to centralise **supervisory reporting and public disclosure**. A majority of industry players supported the approach but raised some doubts as to the size of the potential reduction in their administrative costs. Supervisors pointed to the need to address concerns about wrong expectations that the EBA would be responsible for the quality of the information disclosed by banks.

The views of Member States and supervisors on potential changes to the **fit-and-proper assessment framework** were largely correlated with their current practices. Doubts regarding the need for changes were mainly expressed by those Member States that currently do not assess key function holders and/or assess members of the management body after their appointment, while others were more supportive. Similarly, industry representatives in Member States applying only ex-post assessments were particularly concerned about potential difficulties in terms of administrative procedure and burden that could arise under an-ex ante system. Those industry representatives that already had experience with ex-ante assessments of members of the management body and of key function holders and/or with accountability regimes, generally reported a positive impact in terms of reducing risks for the sector and creating a level playing field.

2. Public conference

On 12 November 2019, DG FISMA held a public conference to discuss the impact and challenges of implementing the finalised Basel III standards in the EU.

More than 500 representatives of public authorities (Members of the European Parliament, Member State governments, bank supervisors and international organisations), the financial industry, non-financial companies, think tanks and non-governmental organisations physically attended the conference and 618 additional representatives watched the discussions online on that day.

The conference was comprised of three keynote speeches, delivered by staff of the European Commission, the chair of the EBA and the chair of the Single Supervisory Mechanism, as well as four panel discussions[157]: “Basel III in a global context”, “The impacts of Basel III on the EU economy”, “A proportionate implementation of Basel III” and “Basel III – are we done now?”.

Panel discussions took place on Basel III implementation in a global context, on its impact on the European economy as well as in view of proportionality. Panel discussions included also a regulatory outlook beyond the Basel reforms, chaired by officials of the European Commission, members of the European Parliament (ECON chair) and representatives of the Council (Financial Services Committee chair).

3. Ongoing exchanges with stakeholders

Since 2018 the Commission services have repeatedly consulted Member States on the EU implementation of the final elements of the Basel III reform and other possible revisions of the CRR and the CRD in the context of the Commission Expert Group for Banking, Payment and Insurance (EGBPI).

During the preparatory phase of the legislation, the Commission services have also held hundreds of meetings (physical and virtual) with representatives of the banking industry as well as other stakeholders.

ANNEX 3: WHO IS AFFECTED AND HOW?

The purpose of this Annex is to set out the practical implications for stakeholders affected by this initiative, mainly banks, governments at the national and European level and the general public (namely companies and consumers acting as borrowers). The initiative aims to achieve the following objectives:

- Objective 1: strengthen the risk-based capital framework, without incurring in a significant increase of capital requirements;
- Objective 2: enhance the focus on Environmental, Social and Governance ("ESG") risks in the prudential framework;
- Objective 3: further harmonise supervisory powers and tools;
- Objective 4: reduce administrative costs related to public disclosures and improve access to banking prudential data.

In order to "**strengthen the risk-based capital framework, without incurring a significant increase of capital requirements"** (objective 1), the preferred option would implement the final elements of the Basel III reform in Union law, subject to a set of adjustments. The proposed adjustments are intended to prevent an undue disruption of banks' lending capacity during the (expected) post-COVID 19 pandemic phase.

The aim of the Basel III reform is to make banks more resilient and restore confidence in the banking system in response to the GCF. A more robust banking system has significant long-term benefits for the economy of the Union as a whole. Better capitalised banks will be more capable of withstanding future financial shocks and continue lending through economic downturns, which is likely to make those future downturns shorter in length and less severe. Hence, achieving the purpose of better capturing risks sought by the Basel III reform will directly benefit banks and, indirectly, all other stakeholders concerned. For instance, bank bail-outs and the recourse to governments to fund them in the event of a crisis can be expected to be less likely. At the same time, a steadier flow of credit may reduce the likelihood of failure for borrowers (namely businesses and households) that rely on bank lending as an essential source of funding.

Objective 1 will be achieved by various amendments to the current prudential framework contained in the CRR):

a) *standardised approach for credit risk*: changes to the regulatory capital treatment of rated exposures to banks, exposures to corporates, real estate exposures, retail exposures, subordinated debt and equity and off-balance sheet items;

b) *internal ratings-based approach (IRBA) for credit risk*: the use of internal models is either limited or precluded for certain portfolios that cannot be reliably modelled. Where models may be used, their parameters become subject to certain minimum values ("input floors");

c) *market risk (FRTB)*: the current reporting requirements based on the FRTB are transformed into substantive capital requirements;

d) *credit valuation adjustment (CVA)*: the use of internal models for CVA is precluded and replaced by a revised standardised approach;

e) *operational risk*: the use of internal models is precluded and replaced by a single new standardised approach;

f) *output floor*: capital requirements that result from a bank's internal models are floored at 72.5% of the requirements that would result from applying the corresponding standardised approaches.

The net effect of these changes in the CRR is an overall increase of regulatory capital requirements on banks. The effect mainly depends on the magnitude of the use of internal models, insofar as banks may be impacted by the output floor and/or become subject to the corresponding (normally more conservative) standardised approach or relevant regulatory input. As estimates show (see Section 6.1), the unfettered implementation of the final elements of the Basel III reform would lead to an average increase of 18.5% in banks' capital requirements by the end implementation date (January 2028). The implementation would be phased in during a five-year period and the increase of capital requirements at the start of that period (January 2023) would be 11.8% on average. The impact on regulatory capital, at both the end and start dates of the standards' implementation, would be significant and have considerable potential to reduce bank lending in the short term[158]. This would be particularly undesirable in the context of a post-Covid scenario when lending will be needed to fund the economic recovery.

In order to address this concern, it is suggested to mitigate the proposal's impact through a set of substantive adjustments to the standards, namely:

a) **provisions to cater for the "specificities" of the EU banking sector and its economy**: these provisions would adjust the Basel III standards to the distinctive features of the EU banking sector. In particular they aim at maintaining the flow of lending to EU businesses in general, and SMEs in particular. These include:

- *maintaining certain existing preferential treatments and exemptions for key exposures* - the "SME supporting factor" and the "infrastructure supporting factor", which lower capital requirements for these exposures compared to the corresponding Basel III standards, or the exemption for derivative transactions with certain qualifying parties from the CVA requirements;
- *providing a transitional period for the implementation of the OF in relation to lending to unrated corporates* – Basel III standards increase capital requirements on lending to unrated borrowers. However, most corporates in

[158] Faced with higher capital requirements, banks may choose to raise new capital to increase their ratios and/or reduce their exposures (i.e. reduce lending) to meet the new requirements.

the EU (namely SMEs) are currently unrated. During the proposed transitional period and while solutions aimed at increasing the coverage of external ratings are rolled out, lending to unrated corporates by banks using the IRBA would be subject to a more favourable treatment than the one provided for in the standards (i.e. a lower risk weight under the OF);

- *maintaining the existing treatment for certain types of equity exposures* –the treatment of banks' strategic holdings of equity issued by entities within the same banking group or covered by the same IPS would be left unchanged, and existing strategic participations in non-financial companies where banks exercise influence would be grandfathered. Hence, these particular equity exposures would remain subject to the capital requirements currently applicable under the CRR and, thus, exempted from the higher capital requirements on equity exposures that will result from implementing the Basel III standards;

- *providing an ad hoc preferential treatment for certain exposure types under the new market risk rules* - these comprise exposures to collective investment undertakings and financial products based on EU emission trading schemes; and

- *postponing the implementation of the FSB's recommendation of a minimum haircut floor for non-centrally cleared SFTs*, awaiting a joint report on the matter by the EBA and ESMA;

b) **the application of certain discretions contained in the Basel III standards**:

- apply the OF on the consolidated level of a banking group taking into account all the risk-based capital requirements contained in EU law and require the relevant authority to adjust the individual bank's Pillar 2 requirement (P2R) or the systemic risk buffer (SyRB) in case double-counting of risks already covered by the OF would be detected;

- set the Internal Loss Multiplier ("ILM") at 1 as part of implementing the new standardised approach for operational risk. The calculation of capital requirements for operational risks of EU banks would, thus, be based on their Business Indicator Component ("BIC"), which takes into account the main elements of a bank's income and expenses. However, the banks' historical operational losses would be disregarded for these purposes, which would significantly mitigate the impact of the new approach for calculating the capital requirements for operational risk.

c) **safeguards related to banks' trading activities**: in order to preserve the international playing field for EU banks, the Commission would be empowered to delay the entry into force of the capital requirements based on the FRTB and/or to make certain adjustments to the framework. The Commission's decision should, for instance, consider whether major jurisdictions failed to implement the FRTB. Similarly, it is suggested to temporarily lower the calibration of the current standardised approach for counterparty credit risk ("SA-CCR") for all derivatives for the purpose of calculating the OF, taking into account international developments in this field (for instance, one major jurisdiction has lowered the calibration of the SA-CCR for certain derivative exposures). This would afford extra time to discuss the calibration of the SA-CCR at international level;

d) **a delayed phase-in period** for the new rules, relative to the phase-in period envisaged in the Basel III standards (from January 2023 to January 2028), as further explained below.

The adjustments to the Basel III standards referred to in points (a) to (c) would significantly lower the expected increase in banks' capital requirements that results from implementing the Basel III standards. Capital requirements would go up on average between +0.7% to +2.7% at the start of the phase-in period (in contrast to the 11.8% increase without the adjustments), and between +6.4% and +8.4% at the end of the phase-in period (in contrast to the 18.5% increase without the adjustments). In this modified scenario, bank lending would not be impeded and the prudential benefit of the reform would be preserved.

While the quantitative impact at the beginning of the phase-in period may be moderate per se, the market may exert pressure on EU banks to start building up capital from early on to anticipate future capital requirements. This may coincide with the recovery phase from the COVID-19 crisis and have short term negative effects on bank lending and the wider economy. Accordingly, it is suggested as part of the preferred policy option for Objective 1, that the phase-in period of the new standards' implementation in the EU would be delayed by two years. The starting date of the phase-in period would be January 2025 (instead of January 2023 under the Basel III scenario) and the new standards would only be fully effective from January 2030 (instead of January 2028). This additional two-year period would give banks enough time to start building up capital without compromising their short-term lending ability. At the same time, the completion of the bank reforms, albeit delayed, would give all market players certainty about the final shape of the regulatory landscape.

Objective 2 of the proposal is to "**enhance the focus on ESG risks in the prudential framework"**. This objective seeks to address, among others, the emerging risks that climate change and the resulting economic transformations pose to banks, primarily in the form of transition risk. The transition to a sustainable economy may lead to substantial shifts in the value of assets. At the same time, more frequent and /or more severe weather events will present new physical risks.

As explained in Section 6.2, the preferred policy option would introduce in the CRD a general requirement for banks to manage their ESG risks. At the same time, competent authorities would have to supervise compliance with that requirement as part of the supervisory and review assessment process. In addition, the CRR's requirement to disclose ESG risks related information would be extended beyond large banks. This means that, at this stage, banks would be subject to behavioural obligations in relation to ESG risks (that is, management, governance and disclosure) as opposed to a pre-determined minimum amount of capital to cover unexpected losses arising from those risks within the framework (i.e. no Pillar 1 capital requirements). The introduction of ESG-targeted Pillar 1 capital requirement could be decided at a later stage, following the publication of an EBA Report providing quantitative evidence on the appropriate treatment of ESG risks under Pillar 1.

The above-described policy option presents a number of benefits for all stakeholders concerned without imposing significant costs on banks in the short term. Under the preferred approach, banks would be obliged to adapt their risk management systems and incorporate the ESG dimension before Pillar 1 requirements are introduced. As a consequence, they would be better prepared once Pillar 1 requirements are introduced The prudential framework's better capturing of ESG risks would also have positive effects for governments and the general public as banks would be less exposed to shocks that may result from transition and physical risks and be more likely to continue lending to the economy under these circumstances. The proposal would also contribute to the general public policies by facilitating a smooth transition towards a more sustainable economy.

By contrast, the costs associated with this policy option would be relatively contained and limited to administrative costs that banks would incur to adapt their risk management, governance and disclosure policies. Such costs should not materially affect banks' lending capacity.

Objective 3 of the proposal is to "**further harmonise supervisory powers and tools of banking competent authorities"**. In order to achieve this objective, it is suggested to make various amendments to the CRD to harmonise the supervisory and sanctioning powers of those authorities as follows:

a) introduce ex-ante notification requirements for banks on "material" events with prudential relevance, namely acquisitions of holdings, transfers of assets and liabilities and mergers and demergers;

b) enhance the disciplinary framework whereby the list of breaches for which competent authorities would have explicit powers to impose sanctions would be expanded;

c) introduce harmonised requirements on the assessment of the fitness and propriety of members of banks' management boards and key function holders before taking up their positions.

The preferred policy option would ensure a more consistent application of the prudential framework across the EU in general, and within the Banking Union in particular, than currently the case. Enhanced consistency in regulatory and supervisory processes and outcomes would be beneficial for all stakeholders concerned, namely banks that would be able to operate across much more harmonised legal frameworks within the EU. This would reduce the compliance costs that currently arise from the need to deal with diverse and potentially inconsistent requirements. While some banks may initially incur some costs to meet the new requirements (in particular if the national rules they are currently applicable are less stringent than those under the preferred policy option), it is not expected that those costs would be significant enough to offset the preferred policy option's benefit. It should be noted, in particular, that the most impactful set of amendments, i.e. those referred to in point (a), would be subject to a materiality threshold.

The preferred policy option would also assist competent authorities to discharge their legal duties in a more effective manner than they currently do, as they all would have access to the same full set of supervisory powers (which some competent authorities currently lack) and a more harmonised supervisory framework would mitigate the risk of regulatory arbitrage or the existence of loopholes that banks could potentially exploit. This would, in turn, contribute to fostering the general public's confidence in the EU system of banking supervision.

Lastly, Objective 4 aims at "**reducing administrative costs related to public disclosures and improve access to banking prudential information".** It would be achieved through the creation of a single electronic access to EU banks' quantitative information that the EBA would source from its EUCLID platform (which will be fed through the existing periodic reporting made by banks), and qualitative information that the EBA would source from banks (see Section 5.2.4).

The preferred option would eliminate disclosure costs for small and non-complex banks, which are only required to disclose quantitative data. For all the other banks, the preferred option would entail neither additional costs nor cost savings.

For other stakeholders, namely market participants who are users of information disclosed by banks, this proposal would bring about material benefits in the form of greater market transparency and lower costs to search for and to access prudential data.

OBJECTIVE 1 – STRENGTHEN THE RISK-BASED CAPITAL FRAMEWORK FOR CREDIT INSTITUTIONS

Preferred Option – Implement Basel III reforms with EU-specific adjustments and transitional arrangements adapted to the COVID-19 crisis

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
	Direct benefits	
Implement in EU law the set of reforms to the risk-based capital framework for banks agreed at international level (the Basel III framework or Basel III standards)	- The revisions to the standardised approach for credit risk (SA-CR) will improve the robustness and risk sensitivity of the existing approach; - The revisions to the IRB approaches for credit risk will reduce unwarranted variability in banks' calculations of RWAs; - The minimum haircut floors for non-centrally cleared securities SFTs will limit the pro-cyclicality of these transactions and the build-up of excessive leverage in the financial system; - The revisions to the CVA risk framework as well as revisions to the standardised approach for CVA (SA-CVA) will enhance the risk sensitivity, strengthen the robustness and improve the consistency of the framework; - The new standardised approach for operational risk (SA-OR) will simplify the framework and increase comparability; and - The output floor (OF) will limit the unwarranted variability in the regulatory capital requirements produced by internal models and the excessive reduction in capital that a bank using internal models can derive relative to a bank using the revised standardised approaches.	- These enhancements of the prudential standards will make banks more resilient and restore confidence in the banking system and, thus, make the financial system more stable as a whole. - Better capitalised banks will be less likely to fail as a result of financial crisis and more able to continue lending through economic downturns. - A steadier flow of credit to the economy will reduce the likelihood of borrowers failing due to a shortage of bank funding. - Bank bail-outs and the recourse on governments to fund them can be expected to be less likely in future financial crisis. - Economic crisis following future financial crisis (and the political instability and social hardship caused by those) can be expected to last less and be less severe.
Adjust to the Basel III revisions to take into account the specific features of the EU banking system	- The proposed adjustments will more than halve the average Basel III standards-induced capital increase from 18.5%to between 6.4% and 8.4% by the end of the phase in period.	- The adjustments are designed to cater for the distinctive features of the EU banking system and economy, namely the significant reliance by SMEs in bank lending as key source of funding. - The reduced impact on capital requirements should be regarded as a

		proportionate measure that adequately balance the primary objective of enhancing the banking prudential framework while maintaining a sufficient flow of bank lending to the EU economy. - Hence, the proposed adjustments do not compromise the overall purpose or negate the stated benefits of the Basel III reform.
Delay the starting date of application of the new rules by two years. Starting date would, thus, be set on 1 January 2025 with a 5-year transition period.	- No impact on banks' capital requirements until 1 January 2025. Full impact on capital requirements delayed to January 2030.	- The suggested delay of the phase-in period would prevent material disruption of bank lending in the short-term. - Hence, banks' flow of lending would not be materially affected during the economic recovery phase that is expected for following the current COVID 19 pandemic crisis.
Indirect benefits		
- Implementing the Basel III reforms would meet the EU international commitments and help improve the confidence in European banks across international markets.		

II. Overview of costs – Preferred option						
	Citizens/Consumers/non-financial corporates		Banks		Administrations (including competent authorities)	
	One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Direct costs			Costs to adapt banks' systems to incorporate the changes made to the prudential framework	Increased cost of capital for exposures that would be subject to higher capital requirements compared to the current rules	Costs to adapt current supervisory practices and processes to the new standards	Costs for running the new procedures (depending on magnitude of change compared to current procedures)
Indirect costs		Increase in the costs for bank loans/financial products which are subject to higher capital requirements compared to the current rules (depending on the size of the increase in the capital requirements for				

		the bank loan and the level of competition in the market)				

OBJECTIVE 2 – INCORPORATE SUSTAINABILITY RISKS IN THE PRUDENTIAL FRAMEWORK.

Preferred Option – Introduce measures for a better management of environmental risks by banks

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Requirements for banks to manage ESG risks	- Banks would integrate ESG factors in day-to-day decision-making.	- ESG-targeted risk management provisions will contribute to a more robust and resilient banking system in the face of transition and physical risks. - A more resilient banking system will, in turn, help to reinforce overall financial stability in the EU.
Reinforced supervisory powers over ESG risks	- Improved supervisory monitoring of individual banks' exposures to ESG risks.	
Ad hoc disclosures of ESG risks by banks	- Enhanced market discipline. - Stakeholders concerned about ESG risks and/or ESG-related externalities may incentivise credit institutions to better manage ESG risks and take externalities of their actions into account.	
Indirect benefits		
Better availability of finance for sustainable exposures	- To the extent that sustainable activities may be less risky than non-sustainable activities, this difference may be better reflected in banks' credit decision-granting and, as a result, lead to an increase in the availability of finance for sustainable activities.	- Increased bank funding of sustainable activities would help the EU reach the target of the EGD.

II. Overview of costs – Preferred option							
		Citizens/Consumers/non-financial corporates		Banks		Administrations (including competent authorities)	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Reinforced requirements for banks to manage ESG risks	Direct costs			Cost of adjusting risk management systems and processes to the new requirement.			
	Indirect costs		Cost of providing				

			additional information to banks.				
Reinforced supervisory powers for ESG risks	Direct costs					Cost of setting up new supervisory processes and systems.	Costs of running the new processes and systems.
	Indirect costs						
Reinforced disclosure of ESG risks by banks	Direct costs			Changes to systems to accommodate new disclosure templates.	Costs of preparing the new information for disclosure.		
	Indirect costs		Cost of providing additional information to banks.				

OBJECTIVE 3 – FURTHER HARMONISE SUPERVISORY POWERS AND TOOLS

Preferred Option – harmonise the supervisory powers and tools of banking competent authorities to the greatest possible degree between two available options

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Harmonise the supervisory powers of banking competent authorities to the greatest possible degree between two available options in relation to: (i) ex ante notifications of events of prudential relevance; (ii) assessment of board members and significant function holders (iii) sanctions and penalties	- A more consistent application of the banking prudential framework across the EU in general, and within the Banking Union in particular. - Less scope for regulatory arbitrage and loopholes that limit the effective and consistent application of the prudential framework across the EU. - Reduced compliance costs for banks, as they will be able to operate across similar legal frameworks within the EU.	- More effective and consistent application of sanctions may contribute to fostering confidence in the EU system of banking supervision and reduce the incidence of rules breaches in the future.
Indirect benefits		
-		

II. Overview of costs – Preferred option						
	Citizens/Consumers/non-financial corporates		Banks		Administrations (including competent authorities)	
	One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Direct costs			Administrative costs to adjust internal processes to meet new requirements.	Administrative costs to comply with new ex ante notification and assessment requirements. Scope limited to "material" events for ex ante notifications.	Costs to change current supervisory procedures or to set up new procedures to meet the new requirements.	Costs to deal on an on-going basis with new ex ante notification and assessment requirements.
Indirect costs						

OBJECTIVE 4 – REDUCE ADMINISTRATIVE COSTS RELATED TO PUBLIC DISCLOSURES AND IMPROVE ACCESS TO BANKING PRUDENTIAL DATA

Preferred Option – centralise the disclosure of both quantitative and qualitative prudential banking disclosures

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
EBA to disclose on a single on-line platform the prudential data and information of all EU credit institutions.	- The suggested centralised provision of prudential data and information will significantly improve market transparency and the comparability of that information, and will reduce the costs for market participants to access information that is currently scattered. - Reduced information costs.	- Enhanced transparency would result in more effective and efficient market discipline of banks.
Small and non-complex credit institutions exempted from the obligation to disclose prudential information (replaced by EBA disclosures)	- Costs of disclosure reduced to zero.	
Indirect benefits		
-		

II. Overview of costs – Preferred option							
		Citizens/Consumers/non-financial corporates		Credit institutions		Administrations (including competent authorities)	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
	Direct costs					EBA to incur costs to build up the systems, processes and get the necessary resources to provide the centralised disclosures.	There will be increased on-going costs for the EBA to maintain and operate the disclosure platform.

ANNEX 4: EVALUATION

As described in Section 1, this prudential framework applicable to banks in the EU has been significantly revised through two waves of reforms to address a number of issues observed following the GFC: the first wave of reforms, introduced by the CRR and the CRD IV, was adopted in June 2013 and the second wave, introduced by CRR II and CRD V, was adopted in May 2019.

This new legislative initiative aims to complement and finalise the above reforms with the implementation of the final elements of the Basel III reform adopted by the Basel Committee in December 2017. The initiative addresses the outstanding deficiencies in the prudential framework that have not been addressed by the previous rounds of reforms.

The vast majority of the changes proposed in this legislative initiative stem from changes to the international standards developed by the BCBS. The latter changes were adopted to address the deficiencies that the BCBS identified when it carried out an evaluation of the existing international standards. A number of supervisory initiatives performed at EU level, notably the EBA benchmarking exercises (see Section 5.1), the EBA work on IRB repair and the ECB TRIM exercise (see Section 5.1), confirmed the findings of the BCBS.

Given the reliability of the abovementioned evaluations, the Commission decided to rely on their findings instead of carrying out its own evaluation.