EUROPEAN COMMISSION

22/7/2021

SEC(2021) 380

REGULATORY SCRUTINY BOARD OPINION

Review of the capital requirements legislation (Basel III)

COM(2021) 663, 664
SWD(2021)320
SWD(2021)321

EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
RSB

Opinion

Title: Impact assessment / Amendments to the Capital Requirements Regulation and the Capital Requirements Directive

Overall 2nd opinion: POSITIVE WITH RESERVATIONS

(A) Policy context

To ensure a resilient banking system that supports the real economy, the EU requires banks to meet capital standards. These standards have evolved in multilateral talks in Basel following the financial crisis. The Commission has committed to implement these standards, known as Basel III rules, taking into account European specificities.

The Parliament and the Council have expressed concerns about further increases in overall capital requirements for the banking sector.

This impact assessment examines changes to capital requirements, management of environmental, social and governance risks, the enforcement of prudential rules and the access to prudential information.

In light of the COVID-19 pandemic, the implementation of the Basel III rules was postponed by one year in March 2020. This allowed the Commission to reassess the reform in view of the crisis and to resubmit a revised report.

(B) Summary of findings

The Board notes the changes to the report reflecting the new political and econonomic context. The report is now less technical, the analysis has been updated and the preferred option adapted.

However, the report still contains significant shortcomings. The Board gives a positive opinion with reservations because it expects the DG to rectify the following aspects:

(1) The report fails to present evidence that confidence has yet to be sufficiently restored in the EU banking sector.

(2) It is not clear why supervisors' approval is not an option to tackle the problems with internal models. The report does not demonstrate that the lack of harmonisation in supervision is a problem.

(3) The comparison of options does not take into account the macroeconomic costs

This opinion concerns a draft impact assessment which may differ from the final version.

and benefits and the impact on SMEs, competitiveness of EU banks and administrative and compliance costs. Furthermore, the SME analysis does not include the costs of obtaining company credit ratings after the transition period.

(C) What to improve

(1) The problem description should demonstrate better the need for the initiative by providing evidence that confidence in the EU banking sector has not yet been sufficiently restored. In particular, it should show how the risk-based capital framework in place is affecting trust in the EU banking system. It should clarify the nature of the EU commitment to implement the final elements of the Basel III reform.

(2) The report should clarify better why supervisory approval of internal models is not sufficient to ensure their appropriateness. It should explain why the European Central Bank, which is responsible for supervision of the larger banks, would not have the capacity to assess and control those banks' use of internal models to assess portfolio risks. It should justify why there is no option on strengthening of supervision on internal models.

(3) If the report considers that more harmonisation is needed between the capital requirements of different types of banks and in supervision across countries, it should more clearly demonstrate that there is a problem. It should include harmonisation in the objectives and in the monitoring framework.

(4) The report should explain why not having a credit rating is considered a problem and how it increases the credit risk of EU SMEs.

(5) The report should justify better some of the proposed options. On equity exposure, it should explain why it differentiates between existing and future strategic equity investments in counterparties outside the banking sector (including in insurance undertakings). It should also better argue why it proposes to maintain the existing supporting factors for SMEs and for infrastructure investment, taking into account their level of effectiveness. On sanction powers, greater clarity is needed on the role and impacts of materiality thresholds. Concerning environmental, social and governance risks, it should clarify how and when the Taxonomy would cover all these risks and would be able to identify unsustainable activities.

(6) As regards the options aiming to improve the current framework for calculating risk-based capital requirements, the report presents possible EU specific adjustments in an 'all-or nothing' manner, leaving no policy choice. It should explain why a more incremental approach, for instance starting with the most important or beneficial adjustments, was not considered.

(7) The main report should include the impacts of the options on macroeconomic developments, competitiveness of EU banks, SMEs and on administrative and compliance costs. It should also integrate these impacts in the comparison of options, to clarify policy trade-offs of the initiative and of individual options.

(8) The report should elaborate more clearly the effect of the proposed measures on SMEs. It should assess the impacts of the introduction of a higher risk weight for credits to unrated companies. 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. If SMEs would only obtain credit ratings after the transition period, this should be included in the analysis.

(9) The report should provide a clearer presentation of the overall benefits and costs of the preferred set of options, including quantitative estimates where available.

(10) The consultation annex should present better the different stakeholder views, including diverging views.

The Board notes the estimated costs and benefits of the preferred option(s) in this initiative, as summarised in the attached quantification tables.

(D) Conclusion

The DG must revise the report in accordance with the Board's findings before launching the interservice consultation.

If there are any changes in the choice or design of the preferred option in the final version of the report, the DG may need to further adjust the attached quantification tables to reflect this.

Full title	Amendments to the Capital Requirements Regulation and the Capital Requirements Directive
Reference number	PLAN/2019/5320, PLAN/2019/5321
Submitted to RSB on	25 June 2021
Date of RSB meeting	Written procedure

ANNEX: Quantification tables extracted from the draft impact assessment report

The following tables contain information on the costs and benefits of the initiative on which the Board has given its opinion, as presented above.

If the draft report has been revised in line with the Board's recommendations, the content of these tables may be different from those in the final version of the impact assessment report, as published by the Commission.

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	- 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.

	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.	
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	Increased cost of capital for exposures that would be	Costs to adapt current supervisory	Costs for running the new procedures

			the changes made to the prudential framework	subject to higher capital requirements compared to the current rules	practices and processes to the new standards	(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	Direct costs			Changes to systems to accommodate new	Costs of preparing the new information		

risks by banks				disclosure templates.	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.

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Brussels,
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Opinion

Title: Impact assessment / Amendments to the Capital Requirements Regulation and the Capital Requirements Directive

Overall opinion: NEGATIVE

(A) Policy context

To reduce the risk of banking crises and to ensure a resilient banking system that supports the real economy, the EU requires banks to meet capital standards. New global standards have evolved in the multilateral talks at the Basel Committee on Banking Supervision (BCBS) following the financial crisis. The Commission has committed to implement these standards, known as Basel III rules, taking into account European specificities.

The Parliament and the Council have expressed concerns about further increases in overall capital requirements for the banking sector.

This report examines impacts of several proposed changes to capital requirements. Some reflect Basel III, others address EU-specific issues. A main thrust is to better match capital requirements to risk and prevent gaming of the rules.

(B) Summary of findings

The Board notes that the report concerns amendments to many elements of the legislation that collectively have wide-ranging effects.

However, the Board gives a negative opinion, because the report contains the following significant shortcomings:

(1) The report lacks a clear and evidence-based narrative that is transparent about remaining uncertainties and knowledge gaps.

(2) The report does not show the need to act with regard to current EU banking sector issues. The nature and scale of the problems are unclear.

(3) The report does not adequately describe how the proposed measures would contribute to better outcomes for different types of banks, for different economic actors, including SMEs, and for the economy as a whole.

(4) The report does not adequately analyse the policy trade-offs of the proposed measures.

(C) What to improve

(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.

(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.

(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.

(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.

(5) While it is an important objective to contain administrative and compliance costs, it is less clear whether this is different from 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.

(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.

(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.

(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.

(9) The report should expand the analysis of the limits to supervisory powers in controlling banks' discretion in using 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.

(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.

(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 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.

(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.

Some more technical comments have been sent directly to the author DG.

(D) Conclusion

The DG must revise the report in accordance with the Board's findings and resubmit it for a final RSB opinion.

Full title	Amendments to the Capital Requirements Regulation and the Capital Requirements Directive
Reference number	PLAN/2019/5320, PLAN/2019/5321
Submitted to RSB on	12/02/2020

Date of RSB meeting	04/03/2020

Electronically signed on 22/07/2021 17:01 (UTC+02) in accordance with article 11 of Commission Decision C(2020) 4482