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Regulatory News Alert

Implementing Basel III in the European Union

2 December 2019

Preparing for the legislative proposal of 'CRD6/CRR3' in 2020

The European Commission is now preparing the EU's next bank capital legislative package, the **sixth Capital Requirements Directive and third Capital Requirements Regulation (CRD6/CRR3)**. This legislative proposal is expected to be published in mid-2020 and will implement the final elements of the Basel III framework agreed in December 2017 by the Basel Committee on Banking Supervision (BCBS) (often referred to by industry as "Basel IV").

As part of this preparatory work, the European Banking Authority (EBA) provided the Commission with technical advice on the implementation of Basel III in August this year, and is expected to publish a second report with further advice by year-end. The Commission has also issued a public consultation (open for input until 3 January) and held a day-long public hearing in Brussels on 12 November to debate the EU's approach to implementing the Basel framework.

The CRD6/CRR3 package will be wide-ranging, but is expected to include core Basel III components as well as market risk. However the Commission consultation also raises the prospect of further initiatives being included in the package, namely:

1. Streamlining regulatory reporting;
2. Reflecting environmental, social and governance (ESG) risks in the capital framework;
3. Enhancing the fit-and-proper requirements in the CRD to strengthen bank governance.

Expected next steps in the proposal of CRD6/CRR3:

- The EBA is due to report back to the Commission by year-end with its second impact assessment and technical advice on implementing the Basel III framework (with this report focusing on market risk and CVA, and the potential macroeconomic impact).

- The Commission will then draft the CRD6/CRR3 legislation implementing Basel III and carry out its own impact assessment of the proposed rules.
- CRD6/CRR3 is due to be proposed by the Commission in June 2020, although this date could yet be pushed further back by delays in the legislative drafting process.
- The proposal will then have to go through detailed legislative negotiations in both the European Parliament and the European Council before it can become law. This is usually a lengthy process, and one that took over two years for both the recently-completed CRD5/CRR2 package and the earlier CRD4/CRR.
- Depending on the timing of the UK's departure from the EU, CRD6/CRR3 may also be the first major piece of financial services legislation that is negotiated by EU institutions without the participation of UK representatives.

The rest of this note highlights a number of key areas of concern arising from the discussion at the Commission's public hearing in Brussels on 12 November. In our view, these debates will be central in determining the shape of the legislation that the Commission will propose next year, the political negotiations following that, and ultimately how the EU choses to move forward with the adoption of Basel III.

Key questions arising in the public hearing of 12 November

Timing of implementation

The European Commission and other regulators (such as the EBA) have made very clear that they are committed to implementing the revised Basel III rules on time, according to the 1 January 2022 target set by the BCBS, with a five-year implementation period for the standardised output floor (running to 1 January 2027). Despite this, and as we have noted previously, **there are growing doubts over whether there is enough time left for legislative negotiations to conclude before this deadline**. Given the precedent set by the EU's earlier negotiations of CRR2 and the original CRR, **a legislative package of CRR3's complexity and importance will likely take at least two years of negotiations at the political level**. This will have to be followed by an appropriate implementation period before new rules can be brought into force.

While the length of any potential delay is unclear at this stage, and tied to an inherently political process, it raises the possibility that firms will face inconsistent timing in the implementation of Basel III across their different jurisdictions of operation.

Faithful implementation of Basel standards

This is shaping up to be one of the most controversial points in the CRD6/CRR3 debate. EU regulators (led by the EBA and the ECB's Single Supervisory Mechanism (SSM)) have emphasised the importance of the EU not deviating from the rules agreed by the BCBS in December 2017. There is, however, increasing pressure for the EU to modify the Basel III framework in implementation in order to mitigate the expected capital impact of the revised rules (projected by the EBA's August report to be a 24.4% increase in minimum capital requirements for EU banks).

Much of this debate centres on the calibration of the standardised output floor by the BCBS at 72.5%, which was a critical element of the overall Basel III agreement reached in 2017. **Regulators have cautioned that modifying the calibration in the EU's adoption of the framework may put at risk the international consensus around the post-crisis rulebook for bank capital**. EU officials are concerned that such a breakdown in consensus might encourage some jurisdictions not to proceed with the implementation of key parts of the regulatory framework.

Reflecting European specificities in the framework

'European specificities' have been watch-words in previous CRD/CRR negotiations for structural market characteristics that require, or justify, the EU to deviate from the global BCBS standards. This has re-emerged as a major area of debate due to the expectation that the capital increases arising from Basel III will have a disproportionate impact on European banks vs. their global peers and could lead them to face even greater competitive pressures in an environment of already weak profitability and thin margins. Assessing where these structural specificities might exist is made still more pressing by **the 2018 commitment of European finance ministers that the implementation would not lead to an increase in aggregate capital for EU banks**.

One area of significant debate is the treatment of exposures to unrated corporates under the revised SA for credit risk. Industry associations and a number of EU Member States have argued that this penalises European banks, as EU SMEs are much less likely than their US counterparts to have a credit rating. The EBA and SSM have recognised that the Basel III rules are not always well suited to the European economy, but nevertheless insist that an imperfect regulatory solution is a price worth paying to have a consistently implemented global standard. Global standard setters (such as the BCBS and Financial Stability Board) have noted that the Basel III framework already includes a number of amendments to suit the European banking industry and should not be modified further in implementation. The European Commission, however, has made clear that it is open to considering where the rules may need to be modified to suit the EU market and is willing to propose such modifications where their need is backed by strong evidence.

Proportionality

There is an ongoing debate as to whether it is appropriate for the EU to apply the full BCBS bank capital framework to all banks, or whether a more proportional or tiered approach to implementation could be pursued. This is a question that also featured prominently in discussions ahead of the proposal of CRR2 in 2016 and led to some streamlining of reporting requirements for small and medium-sized banks. Opinion on further proportionality measures is mixed, with **officials at the European Commission arguing that since, in their view, smaller banks are not inherently less risky, they cannot justify applying relaxed prudential standards to them**. Instead, most of the discussion now appears to be focused on finding ways to reduce the administrative burden of regulatory implementation for smaller banks.

In addition to this debate, some industry and Member State representatives have pointed out that because 99% of the Basel III capital increases projected in the EBA's impact assessment arose in large banks, in their view, measures targeted at small and medium-sized banks would do little to mitigate the overall impact on the EU banking sector. Instead, they argue that **proportionality needs to be interpreted more broadly to include the proportionate treatment of different risk types and different business models**.

Fragmentation in the EU banking market

There is continued concern about fragmentation of the EU banking market and the implications that this may have on cross-border consolidation and the financial efficiency of groups. We expect that the European Commission will make another attempt in CRD6/CRR3 to allow home supervisors to waive sub-consolidated capital and liquidity requirements for Eurozone subsidiaries of Eurozone parent entities. This, however, was attempted unsuccessfully in CRR2 and ultimately failed due to resistance from predominantly host Member States.

There is also a related debate over the appropriate level of application of new capital requirements, most notably the standardised output floor. The EBA's implementation advice to the Commission in August recommended the floor be applied at both the group and subsidiary level. This, however, has been opposed by many stakeholders because they see it complicating risk management for more diverse banking groups. At the 12 November public hearing, **SSM Chair Andrea Enria indicated that his preference is for the floor to be applied only at the consolidated level**. The Commission has also asked the EBA to produce a follow-up analysis assessing the pros and cons of sub-consolidated application.

More evidence from industry

The European Commission has said that it is keen to hear more from the industry on why it might propose an approach to Basel III implementation that could deviate from the BCBS standards. The Commission previously ran a consultation on Basel III implementation in May 2018, and the launch of the public consultation that is currently open should be interpreted as a **signal from the Commission that it needs stronger arguments and more data from the industry if it is to act**. The Commission is particularly interested in whether there is further evidence that the Basel III framework disproportionately affects European banks, that it could disrupt lending and financing to the 'real economy', and that measures designed to enhance the proportionality of the prudential framework would lead to good economic and risk outcomes.

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