



Finance Watch

# **“Cracks in the pillars – Financial stability loses out in the EU’s Basel III endgame”**

Finance Watch perspectives on the  
Banking Package 2021

**Finance Watch Policy Brief**



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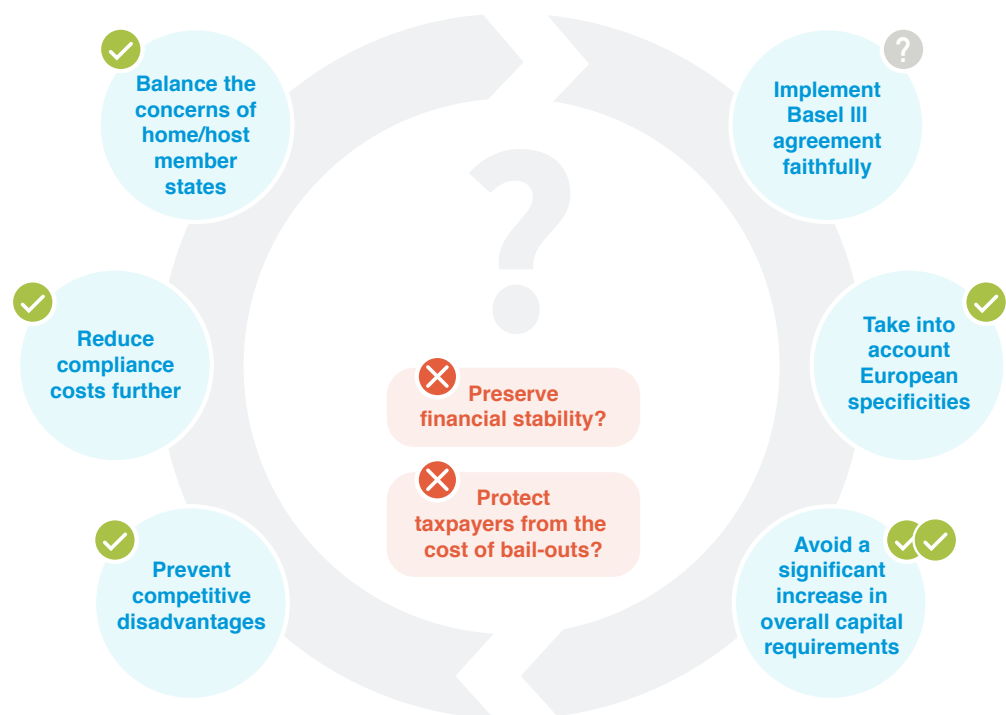


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**A difficult balance:** Leaving out the most important objectives does not make it any easier.



At a time when risks in the financial sector are building up again at an alarming rate, the notion of 'financial stability' seems to have disappeared altogether from the legislative agenda. The draft Banking Package 2021 fails to do justice to the Basel III cycle of post-crisis reforms and continues to leave European banks insufficiently capitalised, and taxpayers exposed.

Source: European Commission, Finance Watch



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# 1. Overview

The global regulatory framework agreed by the Basel Committee on Banking Supervision in December 2017 (Basel III), was created to address the insufficient capitalisation and inadequate risk controls of the banking sector that led to the financial crisis of 2008/09. The Commission’s legislative proposal, also known as the **‘Banking Package 2021’**, aims to complete the post-crisis reforms and to *‘faithfully implement the outstanding elements of the Basel III reform in the EU, while taking into account EU specificities and avoiding significant increases in capital requirements’*.<sup>1</sup>

## 1.1. Contents of the legislative proposal

The Commission’s legislative proposal comprises:

- a regulation amending the Capital Requirements Regulation (CRR II)<sup>2</sup> as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor;<sup>3</sup>
- a regulation amending CRR II and the Capital Requirements Directive (CRD V)<sup>4</sup> as regards the prudential treatment of global systemically important institutions (G-SIIs) with a multiple point of entry (MPE) resolution strategy and a methodology for the indirect subscription of instruments eligible for meeting the minimum requirement for own funds and eligible liabilities (MREL);<sup>5</sup>
- a directive amending CRD V as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU.<sup>6</sup>

## 1.2. Regulatory objectives

The final instalment of the Basel III standards, agreed and published, for the most part, in December 2017<sup>7</sup>, aims at (i) completing the post crisis reform of the prudential framework for banks at the global level; and (ii) correcting flaws that have become apparent since the first Basel III standards came into force in 2014.<sup>8</sup> In particular, the finalisation of Basel III comprises measures to

- reduce the excessive variability of risk-weighted assets (RWA) calculated by banks under the Internal Ratings-Based (IRB) approach by limiting its use for certain categories of credit risk and removing it altogether for operational risk and off-balance sheet exposures;
- improve the granularity and risk-sensitivity of calculating capital requirements under the Standardised Approach (SA) for credit risk, and introduce a new, standardised framework to cover operational risk and risk related to off-balance sheet exposures;
- introduce an ‘output floor’ for banks using the IRB approach to limit the divergence between risk-weighted assets calculated under the different approaches (SA and IRB); and
- introduce a ‘leverage ratio buffer’ to further limit the leverage of global systemically important institutions (GSIIs).

### 1.3. Proposed measures

The Banking Package is intended to complete the implementation of the Basel III framework into EU law. The Commission’s explanatory notes set out four main objectives:

- strengthen the risk-based capital framework, without significant increases in capital requirements overall;
- enhance the focus on environmental, social and governance (ESG) risks in the prudential framework;
- further harmonise supervisory powers and tools; and
- reduce institutions’ administrative costs related to public disclosures and improve access to institutions’ prudential data.

In its implementation, the Commission is proposing a number of deviations from the original Basel III standards. These ‘EU-specific adjustments’ are designed, according to the Commission, to balance a number of political objectives:

- implement the Basel III agreement faithfully;
- take into account European specificities;
- avoid a significant increase in capital requirements;
- prevent competitive disadvantages;
- reduce compliance costs further; and
- balance the concerns of home/ and host member states in line with the logic of the Banking Union.

### 1.4. Comments and recommendations

#### 1.4.1. General observations

Finance Watch welcomes the initiative of the EU co-legislators to proceed with the implementation of the final instalment of the Basel III standards. We note, however, that the primary and overarching objective of the Basel III process – to restore financial stability and protect EU citizens and society at large from excessive risk-taking in the banking sector – is no longer mentioned as a policy objective in the Commission’s list of trade-offs that shaped its legislative proposal, which merely commits, rather tersely, to “*implement the Basel III agreement faithfully*”. Judging by its content, the legislative proposal seeks to do justice, just about, to the letter rather than the spirit of the agreement. The largest EU banks, G-SIIs and major O-SIIs<sup>9</sup>, would be allowed to continue operating with lower levels of capital, on average, than their global peers and with a competitive advantage over smaller and mid-sized banks in the EU domestic market. EU citizens, and society at large, would remain exposed to the systemic risk emanating from a poorly capitalised banking sector and liable to underwriting the losses of underperforming banks. If policymakers agree to cementing the unsatisfactory status quo in this way, they will, by the same token, have abandoned any pretence of completing the Banking Union. This circle does not square.

#### 1.4.2. Priorities and trade-offs

It is worth noting that the Commission's trade-offs, which inform the majority of the proposed deviations from the Basel III standards, are (i) guided expressly by political rather than prudential and financial stability considerations; and (ii) reflect, for the most part, the concerns of the banking sector rather than those of European bank customers and citizens at large. Financial stability no longer appears to be a priority – a reflection of the (questionable) assumption that EU banks are already adequately capitalised (see 1.4.3).

In its legislative proposal, the Commission invokes, time and again, its commitment to avoid any significant increase in capital requirements, particularly for the largest EU banking groups. That commitment was indeed made by the Basel Committee, upon instructions by the G20 governments, but it was made at the global level, not at the level of individual jurisdictions or even institutions. The stated purpose of the final instalment of Basel III was to rebalance capital requirements, not to increase them. European G-/O-SIs, traditionally among the most avid users of internal modelling, have long been beneficiaries of the variability in RWAs facilitated by flaws in the original design of the 'risk-sensitive' IRB approach to determining capital requirements. It is not surprising, therefore, that they should be more affected by the Basel Committee's proposed realignment, too.

A number of 'EU-specific adjustments' were introduced already as part of the so-called 'CoVid-19 CRR Quick Fix' regulation<sup>10</sup>, which was put into place in April 2020 to provide regulatory relief to EU banks during the Covid-19 crisis. They include, in particular, (i) the postponement, by two years, of the requirement for EU banks to adjust their capital requirements for loan loss provisions in line with the adoption of the IFRS 9 standard for classifying non-performing exposures (NPEs); (ii) the postponement, by one year, of the introduction of the leverage ratio buffer; (iii) the accelerated introduction of a higher 'SME supporting factor' and an 'infrastructure supporting factor' on certain loan exposures; and (iv) bringing forward the decision to no longer require banks to deduct internally developed software from regulatory (CET 1) capital. These measures already provide significant levels of capital relief for EU banks.

### 1.4.3. Capitalisation and impact

Finance Watch does not agree with the Commission's general assessment that *"the overall level of capital in the EU banking sector is now considered satisfactory"*.<sup>11</sup> Various studies by EU and international bodies demonstrate that the level of capitalisation of major EU banks continues to lag behind their global peers. As of December 2020, leverage ratios (fully phased-in) continued to be lower in Europe (5.5%) as compared to the Americas (7.0%) and the rest of the world (7.3%).<sup>12</sup> In other words, the capital ratios of major EU banks were 27-33% lower than their global peers'.

In particular, EU GSIs and OSIs continue to make liberal use of internal modelling and, as a result, apply significantly lower risk weights, on average, to their exposures. As a result, EU banks face significantly higher incremental capital requirements from the implementation of the final Basel III standards than their global peers: for a sample of 33 EU banks analysed by the BCBS, the average total capital shortfall was estimated at 17.6%, as compared to 2.5% for the Americas and -5.8% for the rest of the world. Nearly half of this shortfall (42%) was attributable to the output floor.<sup>13</sup>

In its December 2020 impact study<sup>14</sup>, the European Banking Authority (EBA) estimated that capital requirements for EU banks would have to increase, on average, by ca. 18.5% by 2028 to comply with the final Basel III standards (without EU-specific adjustments). In this 'base case' scenario, the total capital shortfall for a sample of 100 of the largest EU banks was estimated at ca. EUR 52.2 bn. A small number of banks (8 GSIs) accounted for virtually all (83%) of the estimated shortfall. In the same study, the EBA also calculated an 'EU-specific' scenario, taking into account a number of 'EU-specific adjustments', some of which had already been applied in CRR I<sup>15</sup> and in the 'CoVid-19 CRR Quick Fix' regulation, as well as the 'alternative approach' of calculating the output floor (see 2.1.5). On this basis, the estimated increase in capital requirements by 2028 declined to 11.9%, equivalent to EUR 26.3 bn for the entire EBA sample. Again, the eight GSIs accounted for a majority (82%) of the shortfall. In all instances the output floor was the single most significant factor, accounting for 36-48% of the total impact.

In its impact study accompanying the legislative proposal<sup>16</sup>, the Commission provides its own estimates of the quantitative impact of additional 'EU-specific adjustments' that were not considered in the EBA's analysis but have been included in the legislative proposal. These adjustments further reduce the incremental capital requirements by another 30-45% from the EBA's 'EU-specific' scenario, primarily by neutralising the impact of the output floor. Compared to the undiluted implementation of the Basel III standards, 'EU-specific adjustments' foreseen in the legislative proposal would decrease the total capital shortfall by ca. 50-75%. As before, the main beneficiaries would be a small number of EU GSIs and major OSIs.

### 1.4.4. Levelling the playing field

A large number of smaller and mid-sized EU banks would remain either largely unaffected or even benefit from the combined effect of (i) the modifications of the Standardised Approach introduced by Basel III, and (ii) the output floor, which caps the 'cost of capital' advantage of banks using the IRB approach. As of today, the EU banking sector is already very polarised: on average, the Top-5 banks in each member state hold more than half of all banking assets in that market.<sup>17</sup> Finance Watch has argued for a long time that a diverse and well-integrated banking sector, comprising banks of different sizes and business models, is demonstrably beneficial for



both financial stability (at the macro-level) and corporate and retail customers (at the micro-level). By seeking to cement the status quo in favour of the very largest institutions the EU is missing a rare opportunity to ‘re level the playing field’, improve the competitiveness for small and mid-sized banks, and enhance the quality of financial services offered to EU citizens and businesses (see also 2.1.3 below).

#### **1.4.5. Addressing risks related to climate change**

A large, and rapidly growing, body of scientific evidence, along with a relentless stream of news events, testifies to the urgency of decisive political action to address climate change. Increasing numbers of financial policymakers, regulators and supervisors acknowledge that the financial system, including banking, requires significant changes to adapt to, let alone facilitate the necessary transition to a ‘net zero’ environment. ECB economists seem to agree that the current framework for capital does not adequately provide for climate risk.<sup>18</sup> Nonetheless, the Commission’s legislative proposal relies on a combination of ‘Pillar 3’ disclosures and ‘climate stress tests’ – which could, over time, serve as the basis for Pillar 2 measures – but stops well short of considering concrete ‘Pillar 1’ measures. In its pilot exercise on quantifying climate risk exposures in May 2021<sup>19</sup>, the EBA identified significant data gaps and divergences in the approaches used by banks to calculate exposures, which suggests that meaningful and reliable ‘climate stress tests’ could still be a long time off. Given the need for urgent action this approach appears slow, and dangerously complacent.

#### **1.4.6. A long and risky transition**

Based on the current proposal, the implementation of Basel III in the EU would be completed when the last transitional arrangements expire, i.e. in 2033. This is more than ten years from now and five years after the deadline agreed by the BCBS member jurisdictions, including the EU. Even then, ‘EU-specific adjustments’ that compensate for one-half to two-thirds of the capital impact of the Basel III package could remain in place, particularly if the proposed legislative review results in perpetuating the disapplication of certain Basel III standards. This extended transition does not only dilute the benefits of the Basel III reforms, leaving the European public exposed for even longer to the risk of another financial crisis, but also diminishes the EU’s global status as a principled and reliable partner who abides by its international commitments.

#### **1.4.7. Recommendations**

In order to faithfully implement the Basel III framework, and achieve its original objectives, the EU co-legislators should take a long, hard look at the Commission’s ‘EU-specific adjustments’ and

- reject the so-called ‘transitional arrangements’ that allow for the preferential treatment of certain exposures (unrated corporates and residential mortgages) and the review clauses in Art. 465 CRR, which pave the way for a permanent, material, and unjustified deviation from the Basel III standards;
- apply the higher risk weights for equity exposures in accordance with the Basel III standards, in line with the original deadline and phasing-in arrangements agreed by the Basel Committee;
- apply the ‘output floor’ to all elements of the capital stack, including Pillar 2 and the Combined Buffer Requirement (CBR), with adjustments strictly limited to the elimination of double-counting for ‘model risk’;

- accelerate the adoption of a specific, and binding, prudential framework to address environmental, social and governance (ESG) risks in general, and climate-related risks in particular; and
- respect the original implementation deadline of 01 January 2023, as it was agreed between the EU and its international partners on the Basel Committee, and the five-year transition period to 01 January 2028.

## 2. Comments on specific issues

The Banking Package 2021 proposes a number of deviations from the Basel III ‘baseline’ which materially reduce the prudential requirements for EU banks. These are justified by the need to reflect EU-specific circumstances, such as the reliance of EU corporates on bank funding. At the same time, by reducing the capital requirements for the banking sector, these measures implicitly transfer risks back to the EU economy and its citizens at large.

### 2.1. Credit risk

#### 2.1.1. Internal Ratings-Based (IRB) and Standardised (SA-CR) Approaches

There is ample evidence that the use of internal models as a regulatory and supervisory instrument is fraught with complexity, riddled with informational asymmetries, and plagued by distorted incentives. Moreover, it appears increasingly doubtful that IRB approaches yield more accurate measures of risk. A remarkable study by the Bank for International Settlement (BIS)<sup>20</sup> observed, for instance, that over a period from 2001 to 2016 *“market-implied RWA estimates were persistently higher than regulatory RWAs”* – in other words, market participants concluded that regulatory RWAs did not accurately reflect the actual risks of banks’ balance sheets and applied their own risk metrics instead. The study also found strong evidence of RWA variability being determined by (i) the share of opaque assets held by banks (e.g. derivatives); (ii) the degree to which a bank is capital constrained, i.e. poorly capitalised; and (iii) jurisdiction-specific factors. Last but not least, the authors of that study pondered that *“RWA variability could be due to banks gaming their internal models”*.<sup>21</sup>

Originally, when the Basel II framework was introduced<sup>22</sup>, lower capital requirements were designed in as an incentive to encourage banks to invest in, update and improve their internal risk management systems.<sup>23</sup> From today’s perspective, it could be said that this objective has been largely met, even to the extent that banks may have overinvested in these systems. Good regulatory practice would suggest that the incentives should be withdrawn when the policy objective they were designed to promote has been met. Accordingly, the credit risk framework under Basel III has been amended to reduce the scope of application of the IRB approaches. Certain portfolios are no longer eligible for the Advanced IRB (AIRB)<sup>24</sup> approach, especially those where significant differences in RWAs were observed for exposures with ostensibly similar risk profiles, such as exposures to other financial institutions and ‘large corporates’ (consolidated revenues greater than EUR 500 mn). Institutions may choose between the Foundation IRB (FIRB)<sup>25</sup> or Standardised (SA-CR)<sup>26</sup> approaches instead. In addition, the Basel III framework introduces, or tightens, the minimum values for banks’ own estimates of IRB parameters (‘input floors’). On the other hand, modifications applied by the Basel Committee are meant to make the SA-CR more ‘risk sensitive’. These include, in particular, the treatment of exposures to other financial institutions and corporates, effectively off-setting some of the impact of removing the option of using AIRB for these portfolios.

#### 2.1.2. The output floor

The most salient feature of the final instalment of the Basel III framework, however, is the ‘output floor’, which sets a lower limit for the capital requirements of banks that use internal modelling.

Banks that apply the IRB approaches, where permitted, have to calculate their capital requirements under both approaches, IRB and SA-CR. The aggregate requirement under IRB cannot be lower than 72.5% of the equivalent amount calculated under SA-CR. The purpose of this provision is to discourage aggressive modelling practices under IRB and narrow the gap between IRB- and SA-CR-based capital requirements.

As mentioned previously, EU G-SIs and O-SIs are among the most dedicated users of the IRB approaches and, therefore, particularly exposed to any hike in capital requirements that results from the application of the 'output floor'. In the legislative proposal, the Commission appears to have gone to great lengths to minimise its impact. The proposed 'EU-specific adjustments' revolve, in particular, around the treatment of unrated corporate exposures, including small and mid-sized enterprises (SMEs), mortgages, certain other categories of 'specialised lending', and equity holdings. The principal arguments for these adjustments are that they (i) reflect European specificities; (ii) prevent competitive disadvantages; and (iii) avoid significant increases in overall capital requirements. Finance Watch agrees to the need for legislation to recognise the specific conditions of the European markets and to respond to the legitimate needs of EU citizens and businesses, including the banks themselves. This legislative proposal, however, seems to put the last of these three above everything else.

The argument that EU banks may find themselves disadvantaged vis à vis international competitors because of the 'output floor' appears difficult to support with facts. EU banks, mainly G-SIs and some larger O-SIs, encounter competition from overseas banks almost exclusively in wholesale banking and the capital markets. Most of the time, these competitors are G-SIs based in North America. Internationally active US banks are subject to the Collins Amendment of the Dodd-Frank Act<sup>27</sup>, already today, which imposes an 'output floor' that is actually stricter than the Basel III version. Nominally, the 'output floor' imposed by the Collins Amendment is set at 100% of the RWAs calculated under the SACR; due to differences in the calculation of RWAs under the SA-CR between the US and Europe the ratio (still) stands at 75% after correction<sup>28</sup>. If anything, the constraints on the use of internal modelling for European banks' US competitors are even stricter than the global compromise agreed by the Basel Committee.

### 2.1.3. Unrated corporate exposures

Generally, under Basel III, SA-CR risk weights are reduced for highly-rated borrowers and increased for lowly-rated and unrated borrowers. Exposures to unrated corporates attract a standardised risk weight of 100%, except for unrated SMEs (85%), and so-called 'retail SMEs' (75%)<sup>29</sup>. In the legislative proposal, the Commission argues that the new risk weights under the SA-CR would be considerably higher than those calculated by IRB-A banks using their own models. The 'output floor' would force these institutions to align average risk weights for these portfolios with a minimum of 72.5% of the corresponding SA-CR RWAs, which could result in a substantial increase in capital requirements.

The Commission points out that corporates are significantly more reliant on bank funding than their counterparts in other regions and argues therefore, that such an increase could disrupt bank lending to unrated corporates. In its draft legislation, the Commission proposes to introduce a transitional arrangement that would allow banks to apply a preferential risk weight of 65% to all unrated corporate exposures for the purposes of calculating the output floor, provided that the PD is less or equal to 0.5% (which corresponds to an 'investment-grade' credit rating). Based on

a report to be prepared by the EBA in due course, the proposal would allow the EU co-legislators to adopt a legislative proposal on this arrangement. It is understood that this review may end up perpetuating this exception. This preferential regime is separate from, and comes alongside the so-called ‘SME supporting factor’, which is already in force and enables EU banks to apply a reduced risk weight<sup>30</sup> for exposures to (rated and unrated) SMEs under both the SACR and IRB approaches. While the ‘SME supporting factor’ benefits all banks, the transitional arrangement is targeted solely at IRB banks.

Finance Watch strongly advises against the so-called transitional arrangement. The Commission’s reasoning is based on the assumption that the competitive environment is static and that banks will pass on any increase in their own funding costs, if any, to their customers. In reality, the financial industry is anything but static and it would not be difficult at all to conceive of a different scenario where closing the gap in capital requirements between banks using the SA-CR and those using IRB would restore a level playing field. The degree of concentration or, more pertinently, polarisation in European banking today is significant.<sup>31</sup> IRB banks account for a majority of SME lending.<sup>32</sup> With smaller and mid-sized banks competing in this segment on level terms, even a modest increase in competition would likely prevent incumbents from passing on the increase in their cost of capital to customers. In the broader context, this could reverse the trend towards concentration and promote a more diverse banking landscape that is more resilient and less exposed to systemic risk, instead of seeking to cement the ‘status quo’.

Moreover, a study by the ECB, published in 2016, appears to conclusively reject the premise that banks using the IRB approach provide a more accurate calibration of risk to supervisors and better pricing to their customers. It observes that. *“all in all, counter to the stated objective of the reform, financial institutions have lower capital charges and at the same time experience higher loan losses under IRB. Furthermore, IRB banks charged on average higher interest rates on IRB loans compared to SA loans. Thus, even though regulatory capital charges of IRB loan portfolios were reduced, banks were aware of higher credit risk in these portfolios (as reflected in the higher rates). The gap between reported PDs<sup>33</sup> and actual default rates has significant effects on the profitability of banks that applied the model-based approach. Back-of-the-envelope calculations (abstracting from risk-based pricing of the cost of capital) suggest that underreporting of PDs allowed banks to increase their return on equity by up to 16.7%.”*<sup>34</sup> It seems, therefore, that the Commission’s concerns about lending to unrated SMEs have more to do with the profitability of major banks than with securing competitively priced funding for European SMEs.

#### 2.1.4. Residential mortgages

The Basel III framework was designed in the wake of a property bubble that began in the United States but whose repercussions were felt worldwide. Several EU member states, such as Spain and Ireland, experienced their own property ‘boom and bust’, the fallout from which devastated their economies for years. The SA-CR within the new Basel III standards comprises new, more granular rules for property-related lending, which, through the ‘output floor’ also constrain outcomes for IRB banks.

In line with established EU practice, the Commission’s legislative proposal maintains the ‘loan splitting’ approach, which applies different risk weights to the secured and unsecured part of a mortgage exposure. Under sec. CRE 20.83 of the Basel III standards, the secured part (up



to 55% of the property value) attracts a risk weight of 20%, the unsecured part is weighted in accordance with the risk of the counterparty, usually the borrower. To reduce the impact of cyclical effects in the economy, in general, and in the property markets, in particular, the Basel III framework freeze the value of the property for the purposes of calibrating capital requirements at the value assessed at the time when the loan was originated. In return, banks are not obliged under the Basel standards to continuously monitor the development of property prices.

The EU already has taken a different approach in that it requires banks to regularly monitor the value of property pledged as collateral and to revalue these assets in line with market developments, i.e. both upwards and downwards. The legislative proposal maintains this practice. In addition, the Commission proposes to introduce a transitional arrangement, which would give member states the option to allow banks to apply preferential RWs of 10% for the secured part (up to 55% of the property value) and 45% for the unsecured part (up to 80% of the property value) to all residential property exposures that are deemed to be ‘low risk’.

Finance Watch disagrees with the proposed transitional arrangement. At the macroprudential level, the development of property prices in many EU member states has been a reason for concern for some time. EU institutions and agencies, especially the ECB<sup>35</sup> and ESRB<sup>36</sup>, have repeatedly warned in recent years about excessive growth in the European residential property markets. Member states have applied macroprudential tools, such as countercyclical and systemic risk buffers, to moderate the supply of mortgage credit and address emerging risks. At the microprudential level, banks in many member states still seem to be content with extending mortgages at very competitive terms in what appear to be increasingly risky market conditions. Credit that may be used more productively seems to flow untrammelled, once again, into an expanding property bubble. The proposed transitional arrangements are far from catering to the needs of the EU markets – on the contrary, they would continue to pour fuel on the flames of an overheating market.

#### **2.1.5. Application of the ‘output floor’**

In its advice to the Commission prior to the publication of the Banking Package<sup>37</sup>, the EBA examined three different options for implementing the output floor: two versions of the ‘single stack’ approach – labelled the ‘main approach’ and the ‘alternative approach’ – and the ‘parallel stack’ approach. The latter was identified by the EBA as being non-compliant with the Basel III standards.<sup>38</sup> The ‘main approach’, endorsed by the EBA, applies the output floor to all elements of the capital stack, i.e. Pillar 1 minimum and Pillar 2 capital requirements and the combined buffer requirement (CBR). In its legislative proposal, however, the Commission appears to have adopted the ‘alternative’ version of the ‘single-stack’ approach, which limits the application of the output floor to the capital requirements that are explicitly mentioned by the relevant Basel III standards, i.e. Pillar 1 minimum capital requirements, the capital conservation buffer and the G-SII/O-SII buffers, if applicable. This approach effectively exempts certain elements of the CBR, particularly the systemic risk buffer (Art. 133(2a) CRD), as well as the Pillar 2 requirement (P2R) (Art. 104a CRD) from the output floor. It may conform – tenuously, if at all – to the letter of the Basel III agreement, but certainly not its spirit, and has been criticised extensively by the EBA in its impact studies.<sup>39</sup>

#### **2.1.6. Treatment of equity holdings**

The treatment of capital requirements for banks’ equity holdings has been a source of controversy since the early days of the Basel III process. Under the final Basel III standards, the SA-CR

becomes the only acceptable approach to calculating the risk charges on equity exposures, replacing both IRB-A and FIRB. Default risk weights are increased from 100% to 250%, with a higher risk weight of 400% for 'speculative unlisted equity exposures' (previously 'high risk equity exposures' weighted at 150%). By way of exception, equity investments under 'national legislated programmes' qualify for a reduced risk weight of 100% subject to certain eligibility criteria and supervisory approval.

The Commission's legislative proposal deviates from the Basel III standards in several important points. Intra-group equity exposures and equity stakes in entities inside the same institutional protection schemes (IPS) continue to be risk-weighted at 100% (Art. 49(4) CRR). The treatment of existing long-term and strategic holdings, both in and outside the financial sector, remains unchanged ('grandfathering') (Art. 495a(3) CRR). Only short-term equity investments (with a holding period of less than 5 years) are assigned the higher risk weight of 400%. This proposal is based on the so-called 'Danish Compromise'<sup>40</sup> but goes one step further by freezing RWAs for existing holdings and the risk weight of 100% for intra-group / intra-IPS exposures.

Finance Watch disagrees with the Commission's approach. It is a generally accepted fact that equity exposures are fundamentally different from, and riskier than credit exposures. The prudent approach to account for this risk would be to deduct them in full from regulatory capital, which would be the base case foreseen originally by the Basel III framework and in Art. 49(1) CRR. If the EU chooses to offer banks the option to allocate capital against RWAs, instead of a full deduction, the co-legislators should, at least, follow the EBA's advice and apply the risk weights provided by the final Basel III framework (i.e. 250% or 400%) to these exposures.<sup>41</sup>

## 2.2. Operational risk

In its legislative proposal, the Commission has applied the discretionary choice, provided by sec. OPE.25.11 of the Basel III standards, to set the Internal Loss Multiplier (ILM) to 1 for all banks in the EU. This implies that the capital requirement for operational risk becomes a static function of the bank's size and business model, irrespective of the bank's history of operational losses and stands in stark contrast to the EBA's extensive analysis, which confirmed that *"a bank's past operational losses are an effective indicator of a bank's current operational losses and consequently its future operational risk exposure"*.<sup>42</sup> The commitment to base capital requirements on 'risk sensitive' metrics, which permeates much of the rhetoric in other sections of the legislative proposal does not seem to enter the equation here.

Exercising the discretion of fixing the ILM at 1 may be permitted under Basel III and, perhaps, justified on competition grounds if no other jurisdiction applies a 'historical loss component' in their calculation of capital requirements for operational risk. It is not at all consistent, however, with real-life trends where banks are increasingly exposed to operational risk factors, such as IT systems failures, cyberattacks, and fraud. The urgency to address these risks has been recognised by the Commission, e.g. in its legislative proposal for a Digital Operational Resilience Act (DORA).<sup>43</sup> The initiative by the Basel Committee to increase capital requirements for banks with a demonstrably poor operational risk record is entirely in keeping with these trends and should be applied as soon as possible, ideally at a global scale.

### 2.3. ESG risks

Climate change represents a major threat to financial stability, including the stability of the banking sector, and evidence suggests that the risk is growing with time.<sup>44</sup> Financing of fossil fuel exploration and production increases the systemic risk of climate change and leaves the banks with portfolios of assets that are likely to be partially or fully stranded, as governments proceed with transition policies towards a more sustainable economy. The ECB, the main supervisory authority within the Banking Union, has recognised that ***“current capital buffers do not capture climate-related financial risks owing to underlying risk weights that do not yet reflect climate-related risks to the full extent”***.<sup>45</sup> Still, the Commission’s proposals lack ambition in defining timely and impactful measures to ensure prudential rules for banks capture climate-related risks.

Instead, the Commission has opted for softer prudential measures to tackle climate-related risks, including the risks of misalignment with the EU’s policy objectives. The measures are focused on banks’ governance, strategy and risk management, as well as the supervisory review process (SREP) and stress testing. So-called climate stress testing, in particular, appears in the legislative proposal as a justification for delaying action at a time when the Network for Greening the Financial System (NGFS), a network of 83 central banks and financial supervisors, has already concluded that ***“methodological limitations may also impair the usefulness of climate exercises to understand the need for targeted prudential policies to tackle climate risks, and to consequently calibrate possible prudential instruments”***.<sup>46</sup>

Overall, the proposed measures leave a high degree of methodological discretion to banks, which will lead to regulatory divergence in their application. Thus, these measures will not tackle the ‘doom loop’ linking the banking system and climate change. Individual financial institutions cannot be expected to come up with consistent approaches to identify, measure and monitor climate-related risks at a time when supervisors themselves recognise the unique features of these risks and challenges of their quantification. Different existing alignment methodologies are incomplete and incomparable, thus increasing the risk of ‘greenwashing’.

From a governance standpoint, the CRD legislative proposal<sup>47</sup> fails to include clear obligations for the banks to set sustainability targets and transition pathways as well as to align a proportion of the management body’s remuneration with those targets. The two mandates to the EBA – (i) to explore, by 2023, whether any prudential capital requirements should be put in place to reflect climate-related risks and (ii) to define minimum standards and reference methodologies for the ESG risk management, including misalignments with the EU policies within 18 months from the date of the amended CRD entering into force (i.e., most probably, not before 2025) – will effectively delay action and lead to much higher risks to the financial system and the economy overall.

### 2.4. Phase-in arrangements

The transition period for implementing the final instalment of Basel III, according to the revised timetable of the BCBS, starts on 01 January 2023, with a five-year phase-in period ending on 01 January 2028. The Commission’s implementation timetable, however, does not start until 01 January 2025 and its five-year phase-in period ends on 01 January 2030. The proposed preferential treatment of ‘high-quality’ unrated corporates and residential mortgages would be extended until the end of 2032, subject to review by the co-legislators.

From the perspective of EU citizens, it is difficult to accept that EU banks should not be able to achieve even the modest targets of this legislative proposal within the internationally agreed-upon time horizon. The extended transition period implies that EU taxpayers would have to wait until the end of the decade until the EU's major banks are, on paper at least, fully capitalised in accordance with this much-diluted interpretation of Basel III.

Moreover, from the perspective of the EU's international partners on the Basel Committee, it leaves a question mark hanging over its commitment to fully complying with the agreed standards, and to financial stability overall. With the EBA due to report by the end of 2028, EU policymakers would be free to turn around in 2028, when other jurisdictions have implemented the standards, and decide instead to make the non-compliant 'transitional arrangements' permanent. This scenario could be detrimental to the EU's credibility on the international scene.

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- 2 Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No. 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings (CIU), large exposures, reporting and disclosure requirements, and Regulation (EU) No. 648/2012, OJ L 314, 05 December 2019, pgs. 1–63.
- 3 European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, COM (2021) 664 (final), 27 October 2021.
- 4 Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L 314, 05 December 2019, pgs. 64–114.
- 5 European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 575/2013 and Directive 2014/59/EU as regards the prudential treatment of global systemically important institution groups with a multiple point of entry resolution strategy and a methodology for the indirect subscription of instruments eligible for meeting the minimum requirement for own funds and eligible liabilities, COM (2021) 665 (final), 27 October 2021.
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- 7 [Basel Committee on Banking Supervision, High-level summary of Basel III reforms](#), 07 December 2017, pg. 1.
- 8 The implementation of Basel III in the EU began with the adoption of the legislative package comprising Regulation (EU) 575/2013 (CRR) and Directive 2013/36/EU (CRD IV) in June 2013, which came into force on 01 January 2014.
- 9 Global Systemically Important Institutions (G-SIIs) and Other Systemically Important Institutions (O-SIIs).
- 10 Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No. 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic (CRR 'quick fix'), OJ L 204, 26 June 2020, pgs. 4–17.
- 11 European Commission (Fn 3 above), pg. 3.
- 12 [Basel Committee on Banking Supervision, Basel III Monitoring Report](#), September 2021, pgs. 5 and 36; see also: GAMBACORTA, Leonardo / SHIN, Hyung Song, [Why bank capital matters for monetary policy](#), BIS Working Paper No. 558, April 2016.
- 13 Committee on Banking Supervision, Basel III Monitoring Report (Fn 12 above), pg. 32.
- 14 European Banking Authority (EBA), Basel III Reforms: Updated Impact Study, EBA/Rep/2020/34, 15 December 2020, pg. 42.
- 15 Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27 June 2013, pgs. 1–337.
- 16 European Commission, Commission Staff Working Document: Impact Assessment Report



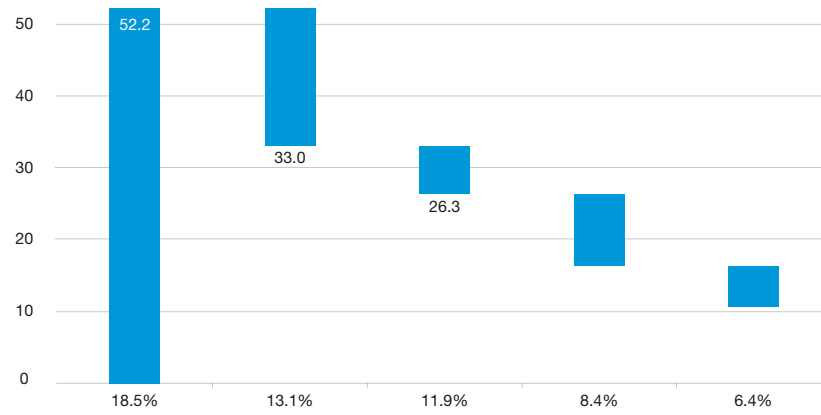
accompanying the documents Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, and Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU, SWD (2021) 320 (final), 27 October 2021.

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- 20 BASTOS E SANTOS, Edson / ESHO, Neil / FARAG, Marc / ZUIN, Christopher, [Variability in risk-weighted assets: what does the market think?](#), BIS Working Paper No. 844, February 2020.
- 21 GAMBACORTA / SHIN, Why bank capital matters (Fn 12), pg. 16.
- 22 The Basel II framework was published by the Basel Committee on Banking Supervision in June 2004 and implemented in the EU with the adoption of Directive 2006/48/EC (Banking Directive) and Directive 93/6/EEC (Capital Adequacy Directive) in June 2006.
- 23 The bank's internal credit assessment, risk monitoring, reporting and management systems and procedures are known in the EU as the Internal Capital Adequacy Assessment Process (ICAAP) (Art. 73 ff. CRD).
- 24 Under the Advanced IRB (A-IRB) approach banks are largely free to use their own estimates for all risk metrics that are used to determine the Expected Loss (EL) (see Fn 34 above) and, on this basis, the required amount of regulatory capital.
- 25 Under the Foundation IRB (F-IRB) approach the national competent authority (NCA) sets common parameters for all institutions in its remit for all risk metrics except the probability of default (PD).
- 26 Under the Standardised Approach to Credit Risk (SA-CR) a single, fixed risk weight is assigned to each exposure category.
- 27 Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376–2223.
- 28 [BNP Paribas, Output floor: On the eve of a \(bad\) agreement?](#), Economic Research Department 'Chart of the Week', 06 December 2017.
- 29 SMEs are corporates with fewer than 250 employees and consolidated revenues below EUR 50 mn; Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, OJ L124, pgs. 26-41.
- 30 For exposures to SMEs up to EUR 2.5 mn, the applicable risk weight is multiplied by the 'SME supporting factor' of 0.7619.
- 31 [European Central Bank \(ECB\), EU structural financial indicators – Table 2: Herfindahl index for credit institutions and share of total assets of five largest credit institutions](#) (year-end 2016-2020).
- 32 European Commission, Commission Staff Working Document: Impact Assessment Report (Fn 17), Annex 5, pg. 90.

- 33 PD (probability of default) is one of the three metrics employed in IRB modelling of credit risk, alongside EAD (exposure at default) and LGD (loss given default); the product of these three components is known as the expected loss (EL).
- 34 BEHN, Markus / HASELMANN, Rainer / VIG Vikrant, The limits of model-based regulation, European Central Bank (ECB) Working Paper No. 1928, July 2016, pg. 3.
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- 37 European Banking Authority (EBA), Policy Advice on the Basel III Reforms: Output Floor, EBA-Op-2019-9c, 02 August 2019; European Banking Authority (EBA), Basel III Reforms: Updated Impact Study, EBA/Rep/2020/34, 15 December 2020.
- 38 European Banking Authority (EBA), Updated Impact Study (Fn 38 above), pgs. 23 and 68.
- 39 European Banking Authority (EBA), Updated Impact Study (Fn 38 above), pgs. 41 and 42; European Banking Authority (EBA), Policy Advice on the Basel III Reforms (Fn 38 above), pgs. 1214.
- 40 The so-called Danish Compromise allows banks that hold equity instruments in insurance (and other financial-sector) companies to apply a risk-weighted capital requirement to these assets instead of deducting them in full from regulatory capital (CET 1).
- 41 European Banking Authority (EBA), Policy Advice on the Basel III Reforms: Credit Risk (Standardised Approach and IRB Approach), EBA-Op-2019-09a, 02 August 2019, pgs. 22 and 25.
- 42 European Banking Authority (EBA), Policy Advice on the Basel III Reforms: Operational Risk, EBA-Op-2019-9b, 02 August 2019, pg. 15.
- 43 European Commission, Proposal for a Regulation of the European Parliament and of the Council on digital operational resilience, COM (2020) 595 (final), 24 September 2020.
- 44 Supervisors confirmed that there are clear benefits for financial institutions for acting early on climate-related financial risks rather than delaying action. See, for example, ALOGOSK-OUFIS, S. / DUNZ, N. et al., ECB economy-wide climate stress test: Methodology and results, ECB Occasional Paper Series, No 281, September 2021.
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- 46 Network for Greening the Financial System (NGFS), Scenarios in Action: A progress report on global supervisory and central bank climate scenario exercises, Technical document, October 2021.
- 47 European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU, COM (2021) 663 (final), 27 October 2021 (Fn 6 above).

# Annex 1

**Chart 1: Estimated impact of subsequent 'EU specific' adjustments on total capital shortfall (EUR bn)**



Source: European Commission, EBA, Finance Watch



## About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see [www.finance-watch.org](http://www.finance-watch.org)

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