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PART 1/4

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, and environmental, social and governance risks, and amending Directive 2014/59/EU

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

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List of abbreviations

Term or acronym	*Meaning or definition*
AIRB	Advanced IRB
BA-CVA	Basic Approached for Credit Valuation Adjustment
BCBS	Basel Committee on Banking Supervision
CCB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
CfA	Call for Advice
CIU	Collective Investment Undertaking
CMU	Capital Markets Union
CRR	Capital Requirements Regulation
CRD	Capital Requirements Directive
CVA	Credit Valuation Adjustment
EAD	Exposure At Default
EBA	European Banking Authority
ECB	European Central Bank
EGD	European Green Deal
ESMA	European Securities Markets Authority
EU	European Union
EUCLID	European Centralised Infrastructure for Supervisory Data
FRTB	Fundamental Review of the Trading Book
GaR	Growth-at-Risk
GFC	Great Financial Crisis
GDP	Gross Domestic Product
GI	Gross Income
ILM	Internal Loss Multiplier
IRB	Internal Ratings Based
LDP	Low Default Portfolio
MRC	Minimum Required Capital
MS	Member State
OF	Output Floor
PD	Probability of Default

P2R	Pillar 2 Requirement
QIS	Quantitative Impact Study
RW	Risk Weight
RWA	Risk-Weighted Asset
SA-CCR	Standardised Approach for Counterparty Credit Risk
SA-CR	Standardised Approach for Credit Risk
SA-CVA	Standardised Approach for Credit Valuation Adjustment
SFT	Security Financing Transaction
SFTR	Securities Financing Transactions Regulation
SME	Small and medium-sized enterprise
SyRB	Systemic Risk Buffer
SSM	Single Supervisory Mechanism
SREP	Supervisory Review and Evaluation Process
TLAC	Total Loss-Absorbing Capacity
TRIM	Targeted Review of Internal Models

1. INTRODUCTION: POLITICAL AND LEGAL CONTEXT

The Great Financial Crisis of 2008-09 (GFC) had its origins in various deficiencies of the financial sector, in particular in the banking sector. According to the 'Report of the de Larosière Group'[1], the origins of the GFC emanated from the combination of several factors, mainly the low cost of borrowing prevailing before the GFC, the financial market search for ever–higher returns and the emergence, and widespread use, of complex financial products created by bundling up new tradable securities from existing underlying risky loans. The deterioration of the credit quality of a large number of these loans triggered a rapid contagion of financial difficulties across the banking sector, highlighting its various deficiencies, including the failure of credit agencies and financial institutions to appropriately assess the risks of these new securities, the excessive interconnectedness of financial institutions worldwide, the inadequacy of banks' prudential framework to impose sufficient loss-absorbing own funds and liquid assets requirements and the insufficiency of supervisory oversight.

The consequences of the GFC on the financial sector resulted in major costs[2] for governments as they had to support the financial sector, and also in a massive contraction[3] of economic activity in the Union and across the world. In response to the GFC, the Union implemented substantial reforms of the prudential framework applicable to banks in order to enhance their resilience and thus help prevent the recurrence of a similar crisis. Those reforms were largely based on international standards adopted since 2010 by the Basel Committee on Banking Supervision (BCBS)[4]. The standards are collectively known as the Basel III standards, the Basel III reforms or the Basel III framework[5]. A summary of the content and timelines of those reforms, as well as their implementation in the Union, is provided at the end of this Section (see *Figure 3*).

The global standards developed by the BCBS have become increasingly important due to the ever more global and interconnected nature of the banking sector. While a globalised banking sector facilitates international trade and investment, it also generates more complex financial risks. Without uniform global standards, banks could choose to establish their activities in the jurisdiction with the most lenient regulatory and supervisory regimes. This might lead to a regulatory race to the bottom to attract bank businesses, increasing at the same time the risk of global financial instability. International coordination on global standards limits this type of risky competition to a large extent and is key for maintaining financial stability in a globalised world. Global

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[1] See "Opinion of the European Economic and Social Committee on the Report of the de Larosière Group (Own-initiative opinion)".

[2] The total amounts of state aid used by Member States to shore up the banking sector during and after the GFC (i.e. over the 2008-2017 period) is estimated to €2 trillion.

[3] While the annual EU GDP growth remained slightly positive in 2008 (+0.8%), it dropped in 2009 (-4.2%) (see https://ec.europa.eu/economy_finance/publications/european_economy/2010/interim_forecast_2010-09_en.htm).

[4] Members of the BCBS comprise central banks and bank supervisors from 28 jurisdictions worldwide. Among the EU Member States, Belgium, France, Germany, Italy, Luxembourg, the Netherlands, and Spain, as well as the European Central Bank are members of the BCBS. The European Commission and the EBA participate in BCBS meetings as observers.

[5] The consolidated Basel III framework is available at https://www.bis.org/bcbs/publ/d462.htm.

standards also simplify the life of internationally active banks – among which are a good number of EU banks – as they guarantee that broadly similar rules are applied in the most important financial hubs worldwide. The EU has therefore been a key proponent of international cooperation in the area of banking regulation

In the Union, the first set of post-crisis reforms that are part of the Basel III framework have been implemented in two steps:

- in June 2013 with the adoption of Regulation (EU) No 575/2013, also known as the Capital Requirements Regulation (CRR)[6], and Directive 2013/36/EU, also known as the fourth Capital Requirements Directive (CRD IV)[7];
- in May 2019 with the adoption of Regulation (EU) 2019/876[8], also known as the second Capital Requirements Regulation (CRR II), and Directive (EU) 2019/878, also known as the fifth Capital Requirements Directive (CRD V)[9].

The reforms implemented so far focused on increasing the quality and quantity of regulatory capital that banks have to hold to cover potential losses. Furthermore, they aimed at reducing banks' excessive leverage, increasing banks' resilience to short-term liquidity shocks, reducing their reliance on short-term funding, reducing banks' concentration risk, and addressing too-big-to-fail problems[10].

As a result, the new rules strengthened the criteria for eligible regulatory capital, increased minimum capital requirements, and introduced new requirements for credit valuation adjustment[11] (CVA) risk and for exposures to central counterparties[12]. Furthermore, several new prudential measures were introduced: a minimum leverage ratio requirement, a short-term liquidity ratio (known as the liquidity coverage ratio), a longer-term stable funding ratio (known as the net stable funding ratio), large exposure limits[13] and macro-prudential capital buffers[14].

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[6] Regulation (EU) No 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 321, 26.6.2013, p. 6).

[7] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

[8] 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.

[9] 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.

[10] See https://www.bis.org/publ/bcbs189.htm.

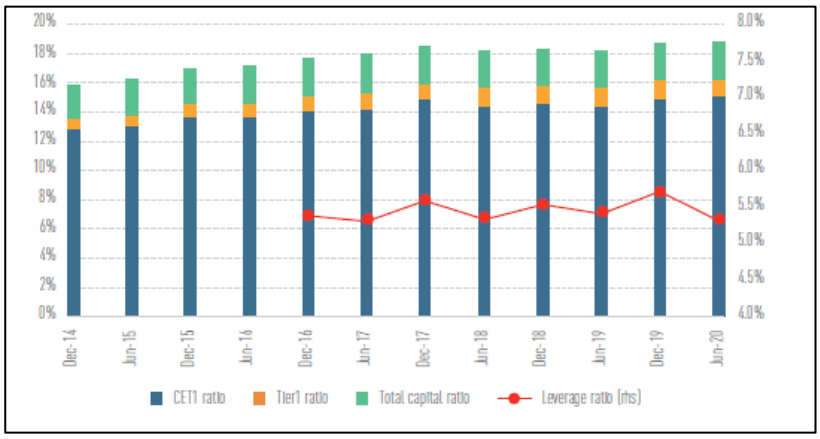
[11] CVA is an accounting adjustment to the price of a derivative to account for counterparty credit risk. For more details, see Section 1.5 in Annex 5.

[12] These were the only significant changes to the part of the standards that deal with risk-based capital requirements that were introduced as part of the first stage of the Basel III reform.

[13] A minimum requirement on large exposure limits was already a feature of Union legislation, but was a novelty for the Basel standards.

Thanks to this first set of reforms implemented in the Union[15], the EU banking sector has become significantly more resilient to financial shocks. One key indication of this increased resilience is the overall increase in regulatory capital EU banks have: between the end of 2014 and mid-2020[16], the average Common Equity Tier 1 (CET1)[17] capital ratio[18] of EU banks improved by 2.5 percentage points (pp) to 15%[19], as shown in *Figure 1*: Weighted average capital and leverage ratios for EU banks over time.[20].

Figure 1: Weighted average capital and leverage ratios for EU banks over time.



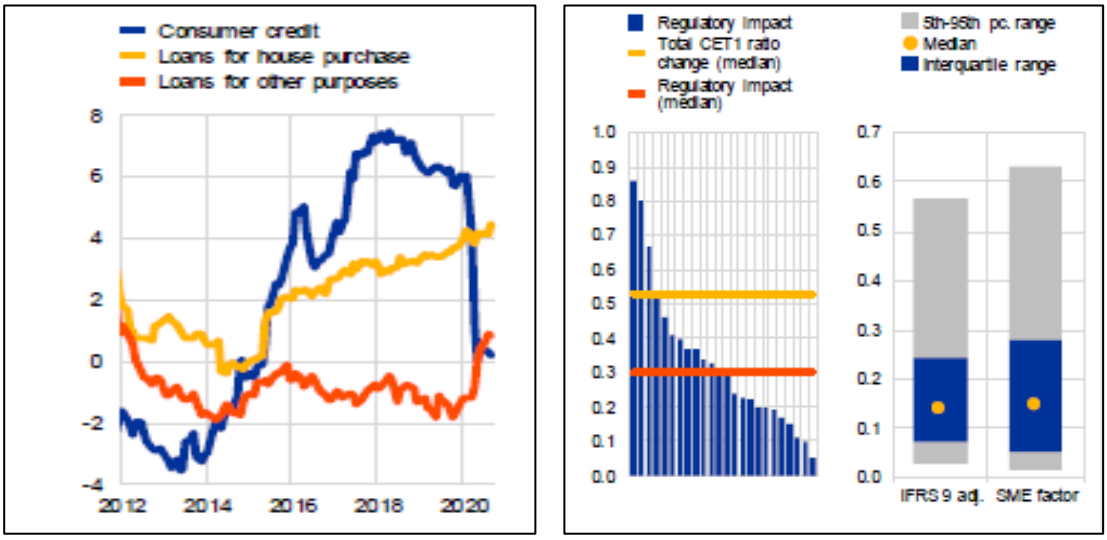
Source: Risk Assessment of the European banking system, EBA, December 2020.
Note: the above ratios are based on the prevailing rules of the prudential framework of the Union at the time, including under the prevailing transitional arrangements.

As a result, the EU banking sector entered the COVID-19 crisis on a significantly more resilient footing when compared to its condition at the onset of the GFC. In addition, temporary relief measures were taken by supervisors and legislators at the outset of the COVID-19 crisis. In its Interpretative Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending - Supporting

[14] More specifically the capital conservation buffer (CCB), the countercyclical capital buffer (CCyB), the systemic risk buffer (SyRB), and capital buffers for global and other systemically important banks (respectively, G-SII and O-SII).
[15] Those first set of reforms have also been implemented in most jurisdictions worldwide as can be observed in the eighteenth progress report on adoption of the Basel regulatory framework published in July 2020 (see https://www.bis.org/bcbs/publ/d506.htm).
[16] Before the publication of this impact assessment, these data will be updated with the latest figures as of Q4 2020 which will be published by the EBA in Q2 2021 it their next Risk Assessment Report.
[17] CET 1 capital is the form of banks' capital recognised by the prudential framework for having the highest capacity to absorb unexpected losses that arise during the normal course of banks' businesses. It is mainly composed of banks' common shares and retained earnings.
[18] The CET 1 ratio is calculated by dividing a bank's CET 1 capital by its total assets weighted by their relative riskiness ("risk-weighted assets" or RWA). The CET 1 ratio is a key indicator of banks' resilience to idiosyncratic risks.
[19] EBA Risk Assessment of the European banking system, December 2020 (see https://www.eba.europa.eu/risk-analysis-and-data/risk-assessment-reports).
[20] Since 2016 the weighted average leverage ratio of EU banks, which will become a binding requirement in June 2021, remained relatively stable and well above the minimum requirement that would be applicable in the EU (3% for all EU banks from June 2021, at least 3.5% for G-SIIs from January 2023). The fact that the leverage ratio did not increase similar to the capital ratios could be explained by the fact that EU banks reduced their exposures to risky assets over the last few years which has no effect on the leverage ratio.

businesses and households amid COVID-19 of 28 April 2020[21], the Commission confirmed the flexibility embedded in the prudential and accounting rules as highlighted by the European Supervisory Authorities and international bodies. In June 2020, co-legislators adopted targeted temporary amendments to specific aspects of the prudential framework – the so-called CRR "quick fix" package[22]. Together with resolute monetary and fiscal policy measures[23], this helped banks to keep on lending to households and companies during the pandemic (as can be observed from *Figure 2* below, which also shows some of the impacts of the relief measures for the Euro area). This, in turn, helped mitigate the economic shock[24] resulting from the pandemic.

Figure 2: Annual growth rate of loans to Euro area households (left hand-side) and some aggregate impacts of the temporary relief measures provided by supervisors and legislators in Q2 2020 on banks' CET1 ratio (right hand-side).



Source: European Central Bank (ECB) Financial stability review, November 2020.

Note: In the two right-hand side charts, the y-axis represents the aggregate impacts of temporary relief measures expressed in percentage points changes between the banks' CET1 ratio between end-Q1 2020 (i.e. before the measures applied) and end-Q2 2020 (i.e. after the measures applied). In the left-hand side chart, the x-axis represents the distribution of the aggregate impacts of temporary relief measures across individual banks supervised by the ECB. In the second chart, the x-axis represents the inter-quantile distribution of the individual banks' impacts of two specific temporary relief measures, specifically the amendments to the CRR related to transitional arrangement for the application of IFRS 9 provisions and the date of application of the SME factor.

However, while the overall level of capital in the EU banking system is now considered satisfactory on average, some of the problems that were identified in the wake of the GFC have not yet been addressed. Analyses performed by the EBA and the ECB (see Section 2.1.1) have shown that the capital requirements calculated by EU banks using

[21] See https://ec.europa.eu/info/publications/200428-banking-package-communication_en.
[22] See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0873&from=EN.
[23] A comprehensive list of such measures has been collected by the ESBR, see "Policy measures in response to the COVID-19 pandemic".
[24] In its COVID-19 vulnerability analysis published in July 2020, the ECB showed that the largest euro area banks would be sufficiently capitalised to withstand a short-lived deep recession and that the number of those banks with insufficient capital resources in case of a more severe recession would be limited (see https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728_annex~d36d893ca2.en.pdf).

internal models demonstrated a significant level of variability that was not justified by differences in the underlying risks, ultimately undermining the reliability and comparability of their capital ratios. In addition, the lack of risk-sensitivity in the capital requirements calculated using standardised approaches results in insufficient or unduly high capital requirements for some financial products or activities (and hence specific business models primarily based on them). In December 2017, the BCBS agreed on a final set of reforms[25] to the international standards to address these problems. In March 2018, the G20 Finance Minister and Central Bank Governors welcomed these reforms[26]. In 2019, the Commission announced its intention to table a legislative proposal to implement these reforms in the EU prudential framework.[27]

In light of the COVID-19 pandemic, the preparatory work has been delayed, reflecting the BCBS's decision of 26 March 2020 to postpone the previously agreed implementation deadlines for the final elements of the Basel III reform by one year[28]. Beyond the temporary measures adopted to facilitate bank lending in the context of COVID-19 referred above, this delay has allowed the Commission services to reassess the impact of the planned reform in light of the potential consequences of the COVID-19 pandemic. The temporarily stressed economic conditions have not altered the Commission services' views on the need to deliver on this structural reform. Completing the reform will address the outstanding issues highlighted above and will thus further strengthen EU banks' financial soundness, putting them in a better position to support economic growth and withstand potential future crises. It will also give banks the necessary regulatory certainty, completing a decade-long reform of the prudential framework for banks. The Commission services consider that the reform can be carried out in a manner that will not disrupt the recovery from the COVID-19 crisis.

This would also be in line with the actions of other members of the BCBS that are committed to implementing the reform timely and faithfully. Indeed, major jurisdictions, (US, UK, JP, HK, CA, AU and SG), have publically committed to adopting rules implementing the reform by 1 January 2023. Some of them, namely JP, CA, HK and SG, have already published draft rules. Those jurisdictions expect the EU to stick to its commitment to implement the reform on time.

Figure 3 below provides an overview of the first and final set of Basel III reforms, as well as the timelines of their adoption in the prudential framework applicable to EU banks.

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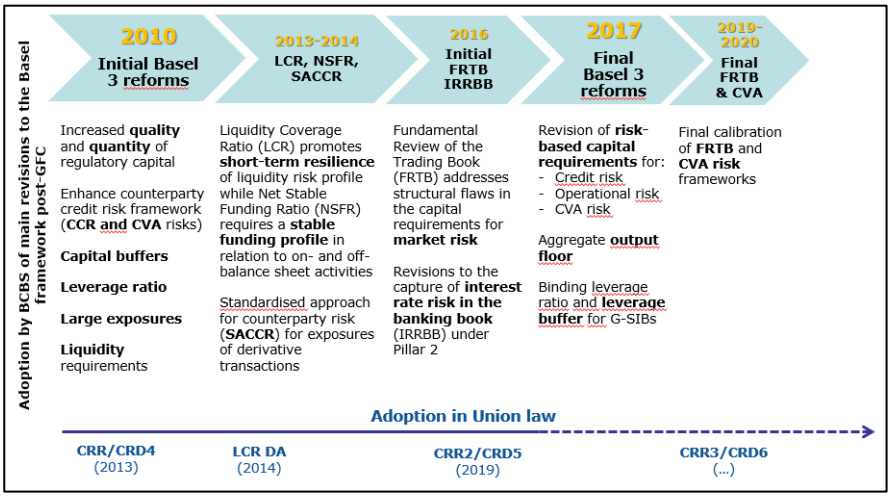
[25] See https://www.bis.org/bcbs/publ/d424.htm

[26] See http://www.g20.utoronto.ca/2018/2018-03-30-g20_finance_communique-en.pdf. The relevant passage of the statement - the latter was agreed by the European Union as a member of the G20 - reads: "*We welcome the finalisation of Basel III, which completes main elements of the post crisis reforms. We remain committed to the full, timely and consistent implementation and finalisation of the reforms and their evaluation to help identify and address any material unintended consequences and ensure that the reforms accomplish their objectives.*" The message has regularly been repeated in subsequent G20 press statements.

[27] See https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_19_6269.

[28] More specifically to 1 January 2023 for the starting date of application and to 1 January 2028 for the full application of the final elements of the reform.

Figure 3: Summary of the main revisions to the Basel framework adopted by the BCBS post-GFC and their implementation timelines in the Union.



Source: European Commission.

Note: The dates coloured in yellow at the top are the dates of adoption of the various Basel III standards by the BCBS. The dates coloured in blue at the bottom are the dates of adoption of standards in Union law.

The completion of the reform of the prudential framework for banks following the GFC is not the only important initiative related to the banking sector.

Another initiative is linked to the Commission's ongoing work on the transition to a sustainable economy. The Commission Communication on the European Green Deal (EGD)[29] clearly set out the Commission's commitment to transform the EU economy into a sustainable economy while also dealing with the inevitable consequences of climate change. It also announced a Sustainable Finance Strategy[30] that will build on previous initiatives and reports, such as the action plan on financing sustainable growth[31] and the reports of the Technical Expert Group on Sustainable Finance[32], but will reinforce the Commission's efforts in this area to bring them in line with the ambitious goals of the EGD. The Taxonomy Regulation[33] will play an important enabling role in this context, by establishing a list of environmentally sustainable economic activities.

Bank-based intermediation will play a crucial role in financing the transition to a more sustainable economy. At the same time, the transition to a more sustainable economy is likely to entail risks for banks that they will need to properly manage to ensure that risks to financial stability are minimised. This is where prudential regulation can play an important role. The abovementioned Strategy acknowledged this and highlighted the need to include a better integration of climate and environmental risks into the EU prudential framework.

[29] See https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1588580774040&uri=CELEX:52019DC0640.
[30] See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12635-Renewed-sustainable-finance-strategy
[31] See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097.
[32] https://ec.europa.eu/info/publications/sustainable-finance-high-level-expert-group_en
[33] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852

Work in that direction has already started. In the CRR II, the co-legislators introduced a requirement for large, listed banks to disclose environmental, social and governance (ESG) risks and mandated the EBA to prepare two reports on how the treatment of ESG risks could be incorporated in the prudential framework. In October 2019, the EBA published its Action Plan on sustainable finance[34], outlining how it intends to achieve the three actions above. In this report, among other things, the EBA encouraged banks to integrate ESG risks, identify simple climate-risk metrics, adopt climate change related scenarios and use scenario analysis.

Work is also ongoing within the international supervisory community. In 2017, central banks and supervisors launched the Network for Greening the Financial System (NGFS)[35]. The aim of the network is to enhance the role of the financial system to manage risks and to mobilise funding for green and low-carbon investments in the broader context of environmentally sustainable development. In May 2020, it has published a handbook for supervisors on how to incorporate climate-related risks into supervision.[36]

The final area of focus is the proper enforcement of prudential rules. Both supervisors and markets play a crucial role in this respect. In order for rules to achieve their intended effect, they need to be properly enforced. For this to happen, supervisors need to have at their disposal the necessary tools and powers (e.g. powers to authorise banks and their activities, require information from them, or sanction them in case they break the rules). The Commission keeps monitoring the functioning of the supervisory framework laid down in the CRD, including through close dialogue with national supervisors, the ECB and the EBA, in order to ascertain whether the powers and tools made available to supervisors are adequate, complete and used appropriately.

Market discipline is another important tool. In order to for investors to properly exercise they role of monitoring the behaviour of banks, they need to access the necessary information. This is why the CRR requires banks to disclose certain information to the markets. As in the case of the supervisory framework, the Commission keeps monitoring disclosure rules, including through dialogue with market participants, to gauge whether the information disclosed by banks is sufficient and easy to obtain.

The above monitoring activity allows the Commission to identify areas where rules need to be adjusted in order to address identified issues.

[34] https://www.eba.europa.eu/sites/default/documents/files/document_library/EBA%20Action%20plan%20on%20sustainable%20finance.pdf.
[35] See https://www.ngfs.net/en.
[36] https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

2. PROBLEM DEFINITION

2.1. What are the problems and problem drivers?

2.1.1. Deficiencies in the current framework for calculating risk-based capital requirements

Banks are exposed to different types of risk as part of their day-to-day business. While the specific types of risks (as well as the intensity of those risks) a bank will be exposed to will depend on the business model of that bank, the four main types of risk that might result in financial losses for banks are credit risk, operational risk, market risk and counterparty risk[37]. In order to ensure that banks have sufficient amounts of regulatory capital to cover unexpected financial losses caused by those risks, banks are subject to binding risk-based capital requirements under the prudential framework (*Figure 4* below shows the aggregate level of risk weighted assets[38] (RWA) for those risks for EU banks over the last few years).

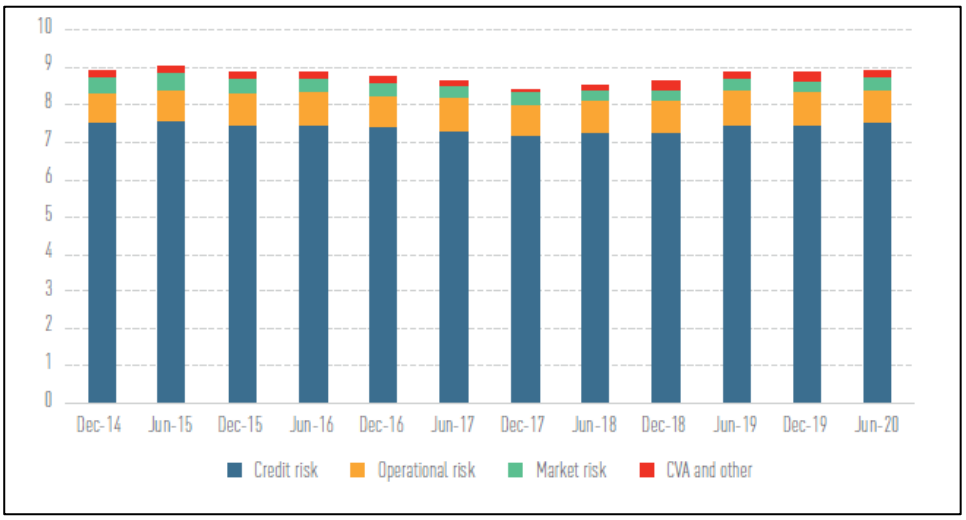
Despite the wide-ranging first set of reforms implemented in the Union after the GFC, increased levels of capital (as shown in *Figure 1*: Weighted average capital and leverage ratios for EU banks over time.) have not yet allowed to fully restore the confidence in the EU banking sector and some problems identified during the GFC remain. One important reason for this is the lack of trust in the risk-based capital requirements calculated by using internal models[39].

[37] Counterparty risk relates to bilateral transactions (e.g. derivatives or securities financing transactions) and include two types of risks: the risk of losses upon the default of the counterparty (default risk) and the risk of market value losses on bilateral transactions due to the decrease in the creditworthiness of the counterparty (CVA risk).

[38] In the prudential framework, banks have first to calculate the corresponding RWAs for those risks (the RWAs are calculated by multiplying the size of a bank's exposure (e.g. a loan) with the appropriate risk weight, which captures the degree of riskiness of the exposure) and then determine the capital requirements as a small portion of those RWAs.

[39] See for instance https://www.wsj.com/articles/basel-committee-to-stop-banks-gaming-risk-models-1446472711; https://blogs.cfainstitute.org/marketintegrity/2015/03/17/bank-risk-weighted-assets-how-to-restore-investor-trust/; or p. 53 of https://voxeu.org/sites/default/files/file/Post_Crisis_Banking_Regulation_VoxEU.pdf.

Figure 4: Amount in EUR trillions of risk weighted assets by type of risk for EU banks over time[40].



Source: Risk Assessment of the European banking system, EBA, December 2020.

Indeed, banks can use two types of approaches to calculate their risk-based capital requirements: the standardised approaches, which banks have to use by default, or the internal model approaches (based on banks' own modelling assumptions), which banks may use upon the permission from their supervisors.

Standardised approaches are benchmark risk measurement techniques which banks have to us by default unless they have been granted permission to use the internal model approaches. Under these approaches, banks have to calculate their risk-based capital requirements according to standard formulas and pre-defined parameters (e.g. regulatory risk weights, loss-given default parameters, market volatilities, etc.) specified in the legislation. This ensures that banks apply those approaches in a uniform manner which makes the calculation of capital requirements under those approaches largely comparable across banks for similar risks. The standardised approaches' parameters are intended to capture a conservative estimate of the average risk of an exposure in a way that is sufficiently simple for a widespread use. The majority of EU banks relies on standardised approaches to calculate their capital requirements.

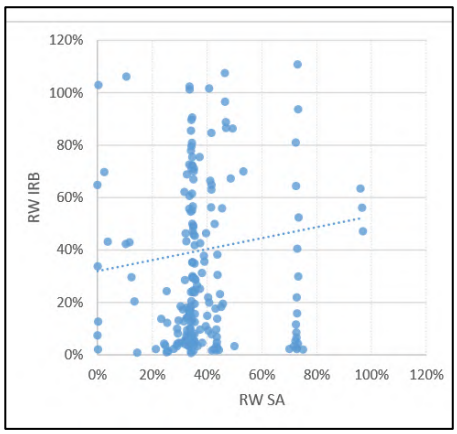
Standardised approaches have shown a number of weaknesses during the GFC which prevent them from acting as solid benchmark. First, some observations of actual losses incurred by banks during the GFC showed that the existing standardised approaches do sometimes underestimate the risks of certain types of exposures leading to insufficient amounts of capital required. The opposite was also found to be true: sometimes standardised approaches overestimated risks, leading to excessive amount of capital required. This can be explained, to an important extent, by the fact that they are designed to be simple. They hence do not always properly reflect the various characteristics of financial products, especially the most complex ones. This may, in turn, have an impact on banks' activities. For example, if the capital requirement for a certain type of loan is

[40] Before the publication of this impact assessment, these data will be updated with the latest figures as of Q4 2020 which will be published by the EBA in Q2 2021 it their next Risk Assessment Report

too low compared to the riskiness of that loan, then the bank may grant too many of those loans while having insufficient capital if those loans start defaulting (and vice versa).

The lack of risk-sensitivity of standardised approaches has been observed for all types of risks, although to different extents. For example, in its 2019 benchmarking exercise of internal models for credit risk[41], the EBA highlighted the high variability of the ratio between the risk weights generated by banks' internal models for credit risk and the corresponding risk weights under the standardised approaches, for different types of credit exposures. As shown in *Figure 5* below, the high discrepancies of those ratios across institutions cannot be explained solely by the high variability in banks' internal model approaches but also by the lack of risk-sensitivity in the standardised approaches.

Figure 5: Comparison between risk weights implied by individual banks' internal models for credit risk or 'Internal Rating Based' (RW IRB) and risk weight of the credit risk standardised approach (RW SA) for mortgage exposures.



Source: EBA.

Notes: Each point represent one EU bank participating to the exercise.

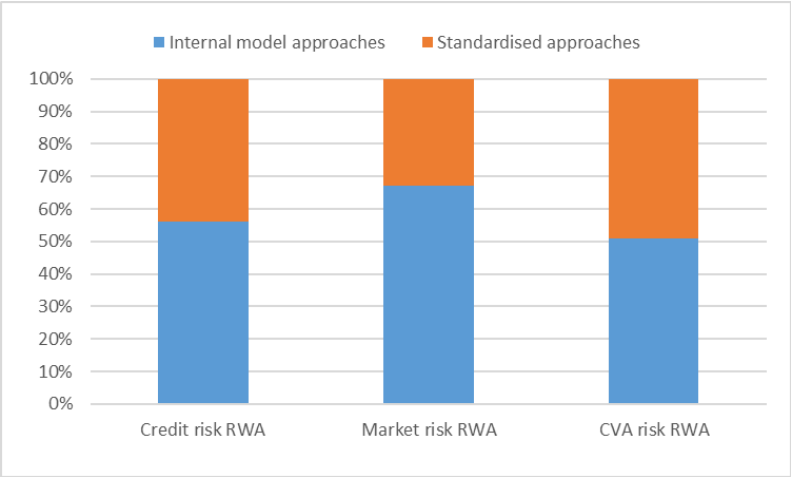
Unlike the standardised approaches, internal model approaches allow banks to estimate most or all the parameters required to compute capital requirements on their own. Since putting in place and maintaining such internal models requires significant resources, the cost of operating internal model approaches are significantly higher than the costs of using standardised approaches. This is why the number of banks that use internal models is much smaller than the number of banks using standardised approaches: according to the EBA's 2019 study of the impact of the final elements of the Basel III reform, , only 79 banks out of 189 participating to the EBA data collection were using internal models[42]. However, those banks tend to be the largest ones in the EU, accounting for a large proportion of the total EU assets. Hence, the capital requirements calculated under the internal model approaches by those banks represent more than half of the overall capital requirements of EU banks as shown in

Figure ***6***.

[41] See https://eba.europa.eu/regulation-and-policy/supervisory-benchmarking-exercises.

[42] In reality, the proportion of EU banks using internal model approaches would be much smaller since the EBA data collection does not include the vast majority of the thousands of small and medium-sized banks established in the EU, most of which do not use internal model approaches.

Figure 6: Breakdown of EU banks' RWAs calculated under the standardised and internal model approaches of the current prudential framework for credit, market and CVA risks.



Source: Basel III reforms: Impact study and key recommendations, August 2019, EBA.

When using internal models, banks can capture risks more accurately by taking into account their own assessment of the characteristics of exposures, such as loans (e.g. the likelihood that the borrower would default and the size of the loss the bank would incur in case there is a default). Since the use of internal models is predicated on close monitoring and assessment of the risks banks are exposed to, banks have a better understanding of how to manage and mitigate those risks.

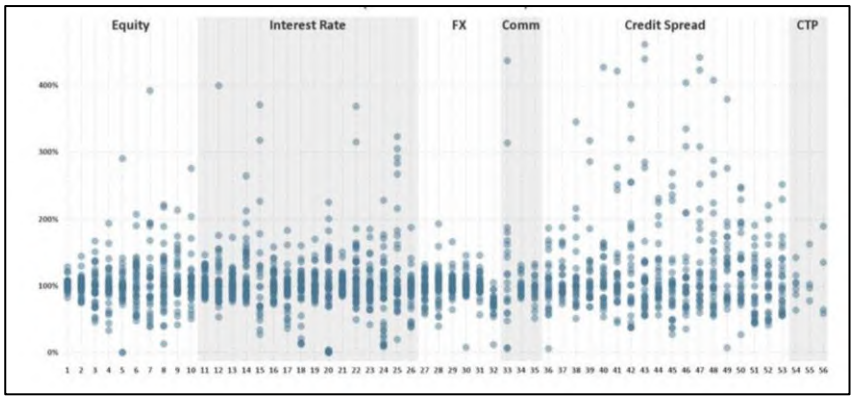
However, the freedom that internal model approaches give to banks has potential downsides. Depending on how these models are built and on the modelling assumptions underpinning them, internal models of different banks can produce different estimates of risks and hence different levels of capital requirements. Given that each bank originates loans to different clients, invests in different assets and trades with different counterparties, a certain degree of variation is to be expected. However, a range of studies conducted at both international[43] and EU[44] levels found a level of variation in capital requirements across banks using internal models that cannot be explained solely by differences in the riskiness of banks' exposures. In fact, those studies have shown that internal models can produce very different capital requirements for very similar or even identical exposures. In some cases, capital requirements for the exact same portfolios of exposures have shown a variation of more than 600%, as illustrated by *Figure 7* below in the area of market risk[45]. This variation makes it difficult to compare capital ratios across banks, puts in question their calculation and undermines confidence in capital ratios and distorts competition across banks.

[43] For the BCBS Regulatory Consistency Assessment Program reports on the variability of risk-weighted assets, see https://www.bis.org/bcbs/publ/d363.htm, https://www.bis.org/publ/bcbs267.htm, and https://www.bis.org/bcbs/publ/d337.htm.

[44] For EBA benchmarking exercises see https://eba.europa.eu/regulation-and-policy/supervisory-benchmarking-exercises.

[45] Risk of losses due to adverse price movements in trading activities.

Figure 7: Variability of capital requirements produced by internal models for market risk for different types of trading activities. Ratio between the individual bank "Value-at-Risk" risk measures for a given portfolio with the median for that portfolio.



Source: EBA report - results from the 2019 market risk benchmarking exercise.

Notes: The category 'FX' refers to trading portfolios with foreign-exchange rate risk, 'Comm' to trading portfolios with commodity risk (e.g. energy or agricultural goods) and 'CTP' to trading portfolios with subject to the specific Correlation Trading Portfolio capital requirement (e.g. collateralised debt obligations).

Moreover, a recent study[46] published by the Bank for International Settlements (BIS) illustrates that, besides a wide degree of variability in capital requirements among banks using internal models, the market perception of the financial risks that banks face is persistently higher than banks' own assessment of risk when calculating capital requirements with internal models. As shown by *Figure 8* **Figure *8***below, this problem of perceived underestimation of risks by internal models is significant for certain banks.

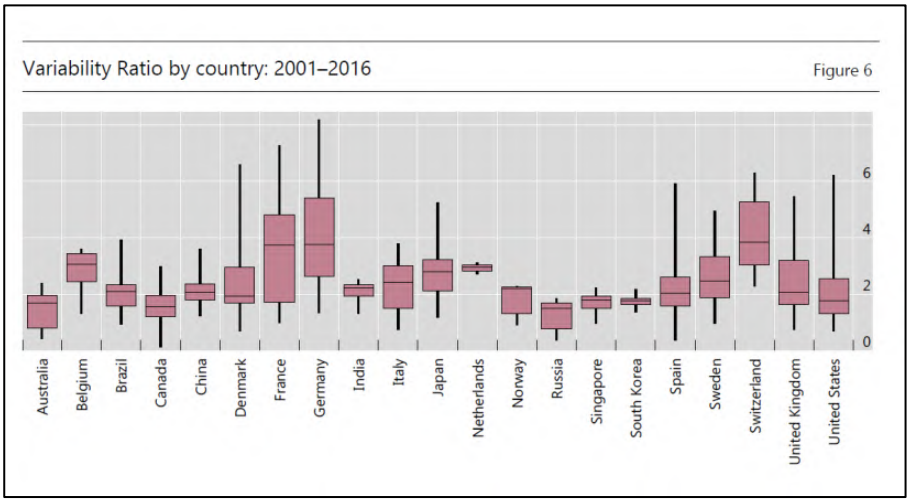
The reliability and robustness of the capital requirements produced by internal models is predicated on the condition that banks should not use internal models to reduce their capital requirements to levels which jeopardise the very objectives of safeguarding financial soundness and covering potential losses. For this purpose, the current prudential framework already provides a number of safeguards, most notably the need for supervisory approval to use an internal model as well as its regular monitoring and review. However, given the growing number and sophistication of models used by banks and the updates made to those models[47], their supervision is becoming more complex and more resource intensive.[48] Furthermore, a reliable internal model requires sufficient data of sufficient quality to be available. This condition is not always met: in some cases the amount of available data is insufficient to allow for reliable and robust modelling of losses. This in turn produces unreliable estimates of the size of the risks a bank is exposed to and hence leads to inaccurate capital requirements.

[46] See https://www.bis.org/publ/work844.htm.

[47] Banks change the design and calibration of (parts of) models to keep pace with changing portfolios, new data and modelling techniques.

[48] In principle, supervisors have the ability to withdraw the permission to use internal models from a bank. However, such measure can have a significant impact on the bank that loses the permission, which is why it is usually used as a very last resort.

Figure 8: Comparison of the Variability Ratio* across countries.



Source: "Variability in risk-weighted assets: what does the market think?", BIS, 2020.

Notes: * The *variability ratio* is defined as the risk perception by the market compared to the risks measured in the regulatory framework across banks in a given country. The higher the ratio, the larger the perceived underestimation of risk.

The identified problems have raised doubts on the adequacy of internal models. Supervisory approval is required for banks to use internal models and supervisors can naturally decide not to allow a bank to use inappropriate internal models. However, the supervisors' approval process of internal models cannot prevent in itself the variability observed across the outcomes of banks' internal models. The supervisory authorities have already undertaken dedicated initiatives to reduce to some extent such variability. In 2016, the EBA produced a roadmap to comprehensively review the current rules for credit risk internal models and in order to issue guidelines, opinions or develop technical standards[49]. Also since 2016, the ECB/SSM has carried out a large-scale targeted review of internal models (TRIM) for the banks under its direct supervision in cooperation with the national supervisory authorities[50]. However, there is a limit to the number of interventions supervisors can make to address issues with individual models used by individual banks, because supervisors have limited resources at their disposal. Once that limit is reached, more structural solutions, like changes to the rules governing models, may need to be contemplated.

2.1.2. No dedicated capture of ESG risks in the prudential framework

Climate change and the profound economic transformations that are needed to contain it pose significant risks to banks, primarily in the form of transition risk (whereby the transition to a sustainable economy can result in big shifts in asset values) and physical risks (whereby more frequent or more severe weather events impact banks and their

[49] For the current status of this exercise, EBA report on progress made on its roadmap to repair IRB models, July 2019 (see https://eba.europa.eu/eba-publishes-report-on-progress-made-on-its-roadmap-to-repair-irb-models).

[50] In April 2021, the ECB published the outcomes of the TRIM exercise which resulted in Euros 275 billion increase in RWAs over the last three years and more than 5,000 findings for banks to remediate (see https://www.bankingsupervision.europa.eu/press/pr/date/2021/html/ssm.pr210419~94c010eb9d.en.html).

customers). Climate (and, more broadly, environmental) risks are often considered together with social risks[51] and governance risks[52] under the heading of ESG risks, as these risks share a number of characteristics and are often intertwined.[53] ESG risks, in turn, are closely linked with the concept of sustainability, as ESG factors represent the main three pillars of sustainability.

ESG risks affect different types of banks' exposures differently: over the longer term, exposures related to the financing of sustainable activities are most likely less risky for banks than exposures financing unsustainable activities. If these risk differentials are not adequately reflected in banks' decision-making, banks may underestimate the overall level of risk that they face, which raises financial stability concerns. For example, Alessi, L., Di Girolamo, F., Petracco-Giudici, M. and Pagano, A. (2021) argue that transition risks might result in an increase of bank losses by 4% in a crisis. Also, banks may also underestimate the risks of unsustainable activities compared to sustainable activities and as a result may overinvest in unsustainable activities while underinvesting in sustainable activities. An adequate reflection of ESG risks in banks' decision-making in turn would help addressing this misallocation of resources and hence make it more likely that banks finance sustainable activities, enabling the Union to reach the EGD's goals.

Against this background, it is essential that banks are able to measure and monitor their exposure to ESG risks, also to enable supervisors and market participants to appropriately assess the ESG risks faced by each bank in order for supervision and market discipline to function effectively.

The current legal framework does not prevent banks from considering ESG risks in their decision-making nor from disclosing information on their exposure to such risks. While availability of relevant data for banks has been an obstacle in this context, steps have been taken to facilitate banks' access to such data, for example by means of requirements under the Corporate Sustainability Reporting Directive (CSRD)[54] and the Taxonomy Regulation. These measures should put banks in a better position to manage ESG risks.

Also, EU co-legislators have deemed that a dedicated approach to capture ESG risks in banks' financial activities could help address the aforementioned challenges and

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[51] According to the EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms, "[s]ocial risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by social factors", with social factors in turn being "related to the rights, well-being and interests of people and communities, which may have an impact on the activities of the institutions' counterparties".

[52] According to the EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms, "[g]overnance risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by governance factors", with governance factors in turn covering "governance practices of the institutions' counterparties, including the inclusion of ESG factors in policies and procedures under the governance of the counterparties".

[53] According to the EBA Action Plan on Sustainable Finance, "[e]nvironmental and social considerations are often intertwined, as especially climate change can exacerbate existing systems of inequality. The governance of public and private institutions, including management structures, employee relations and executive remuneration, plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process.

[54] See https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en.

introduced in CRR II provisions aimed at improving the capture of ESG risks. First, large banks with publicly listed issuances will start disclosing information on ESG risks from 2022 onwards. Second, the EBA has been mandated to assess by June 2021 the potential inclusion of ESG risks in the supervisory review and evaluation process (SREP) performed by supervisors. Third, the EBA has been mandated to assess by 2025 whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified. However, the immediate effectiveness of these provisions is limited, as a large number of banks are outside of the scope of the CRR disclosure rules, and any advice from the EBA on the other two areas under investigation would require subsequent changes to the CRR.

As a result, the present legal requirements alone are insufficient to provide incentives for a systematic and consistent management of ESG risks by banks. This has also been recognised by the EBA in its aforementioned discussion paper, which states that it "sees the need for enhancing the incorporation of ESG risks into institutions' business strategies, business processes and proportionately incorporate ESG risks in their internal governance arrangements". The EBA considers the current legal requirements insufficient for this purpose and therefore "recommends to incorporate ESG risk-related considerations in directives and regulations applicable to the banking sector (e.g. CRD and CRR)".

2.1.3. Inconsistency of powers and tools made available to supervisors across the Union

In order to perform their duties, national and European[55] competent authorities in charge of banking supervision have to use their powers under national laws transposing the CRD. In this regard, the CRD requires Member States (MS) to provide competent authorities with a minimum set of powers to exercise their supervisory functions[56] (thereafter "supervisory powers") and to impose sanctions through administrative measures[57] and administrative penalties[58] (thereafter "sanctioning powers") for banks breaching regulatory requirements (as set out in the CRR rules or national laws transposing the CRD). While the CRD ensures a minimum level of harmonisation across the Union, some MS have identified[59] a number of areas for which they considered it

[55] Since its entry into force in November 2014, the Single Supervisory Mechanism (SSM), established within the ECB, is in charge of the direct supervision of 115 significant banks of the Members of the Eurozone (82% of banking assets in those countries) and of non-Eurozone Member States which have entered, on voluntary basis, into close cooperation with the ECB. The other banks of those Member States (the less significant banks) continue to be supervised by their national supervisors, in close cooperation with the SSM. The action of the SSM is framed by the SSM Regulation and the SSM Framework Regulation, which specifies the functioning and powers of the SSM, within the remit of the broader supervisory framework set at European level by the CRD and transposed in national laws.

[56] For instance, the power to require institutions to have additional own funds in excess to those required pursuant to Pillar 1 requirements; or the power to restrict or limit the business, operations or network of institutions.

[57] For instance, the withdrawal of a banking license.

[58] For instance, fines paid to the supervisory authority.

[59] The difference of approaches from MS in this area may come from, differences in their legal system prior to the application of Union law, the structure of the national banking sector or the supervisory culture of the MS.

necessary to further elaborate the rules and/or to introduce additional powers for supervisory authorities. Consequently, these MS introduced additional provisions in their national laws, making use of the discretion allowed under the CRD. This has led to a situation where supervisors in different MS have different powers.

In the area of sanctioning powers, some MS included additional provisions in order to, inter alia, sanction banks for breaches[60] other than those contained in the minimum list provided in the CRD[61], and determine administrative penalties[62] incurred by banks in case of breaches of CRD/CRR, including the maximum amount[63] of administrative penalties.

In the area of supervisory powers, some MS further specified the assessment of the prudential soundness of banks in case of acquisitions of material holdings in entities other than banks[64], material transfers of assets and liabilities between a bank and a third party, and mergers or de-mergers with other banks.

As regards the supervision of members of a bank's management body and of key function holders[65], the CRD sets a number of principles to assess their suitability ('fit-and-proper assessment'). However, the CRD lacks details on how and when supervisors should conduct fit-and-proper assessments of board members and how to identify the key function holders and assess their suitability. While the publication of joint guidelines[66] by the EBA and the European Securities Markets Authority (ESMA) published in 2017 and the guide to fit and proper assessments published by the SSM[67] in 2018 improved the harmonisation[68] of practices across MS, material divergences in national laws remain. For instance, the supervisors in some MS assess the suitability of board members only a significant period of time after their appointment[69] while in the majority of MS supervisors perform this assessment prior to their appointment. In the case of key function holders, some supervisors do not properly identify them and therefore do not

[60] For instance, breaches of capital requirements, internal models approval and remuneration requirements.
[61] The SSM estimates that for several significant institutions under its direct supervision breaches of CRD/CRR requirements with material impacts cannot be sanctioned due to the lack of powers in the relevant national laws.
[62] Some MS introduced additional powers to impose periodic penalty payments, for instance daily payments until the breach justifying this penalty has ended.
[63] Some MS further specified the definition of 'total annual net turnover' (used in the determination of the maximum amount of administrative penalties) since the CRD lacks details on the inclusion of important elements reflecting the ordinary activities of institutions, for instance interest payables and similar charges, commissions and fees, net profit on financial operations.
[64] Some MS introduced an ex ante notification requirement for banks that allows supervisory authorities to oppose the operation in case of prudential concerns.
[65] According to the applicable EBA/ESMA guidelines key function holders means persons who have significant influence over the direction of an institution, but who are neither members of the management body and are not the CEO. They include the heads of internal control functions and the CFO, where they are not members of the management body.
[66]See https://www.eba.europa.eu/regulation-and-policy/internal-governance/joint-esma-and-eba-guidelines-on-the-assessment-of-the-suitability-of-members-of-the-management-body.
[67] See https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf.
[68] For example, the Guidelines identified more specifically key functions holders as the heads of the internal control functions and the CFO, where they are not members of the management body, and provide provisions identify other key functions holders based on an assessment of their materiality by institution.
[69] Assessment is carried out ex post in eight MS (DK, DE, EE, EL, FR, FI, IT, AT), and partially ex post in four MS (CZ, PL, SI, SE).

carry out an assessment of their suitability to perform their duties, while other do it in a variety of ways[70].

This fragmented regulatory landscape in the definition of certain powers and tools available to supervisors and their application across MS undermines the level playing field in the Single Market and raises doubts about the sound and prudent management of EU banks and their supervision. This problem is particularly acute in the context of the Banking Union, as already highlighted in the Commission's report on the SSM[71]. Differences across 19 different legal systems prevents the SSM from performing its supervisory functions effectively and efficiently[72]. Moreover, as a result of the diverse transposition of the CRD at national level, cross-border banking groups have to deal with a number of different procedures for the same prudential issue, unduly increasing their administrative costs. Banks as well as supervisors, in particular in the SSM, and MS have therefore acknowledged the problem (for more details see Section 6.3. and Annex 2).

2.1.4. Fragmentation and inefficiency in the disclosure of banks' prudential information

Prudential regulation requires banks to publicly disclose financial and other quantitative and qualitative information[73] so that investors, clients, depositors and other interested stakeholders can gauge their level of risk. Banks' disclosure of financial information also contributes to enhanced transparency and market discipline, thereby promoting sound risk management.

In the Union, the CRR II implemented the revised BCBS framework[74] on public disclosure (also known as the 'Pillar 3' framework), and adjusted the content[75] and scope of bank disclosures to make them applicable to all EU banks in a proportionate manner. Under the CRR II, the amount of information that banks need to disclose depends on the size and complexity of their activities (the larger and more complex a bank is, the more information it is required to disclose).

Banks are currently required to disclose all relevant prudential information in one single document or a separate section of their financial report prepared under the applicable accounting standards. Information on banks are therefore scattered on their individual

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[70] For instance, some MS will only identify key function holders as those performing anti-money laundering or audit duties within an institution while others MS will rely on the definition provided in the EBA/ESMA guidelines, or even extend the scope of this definition.

[71] Cf. SWD(2017) 336 final.

[72] On the issue of fit-and-proper assessments see the in-depth analysis requested by the ECON committee: Is the current "fit and proper" regime appropriate for the Banking Union?, March 2020.

[73] The institution's capital and liquidity ratios are examples of the former, while a description of the institution's processes for managing credit risk is an example of the latter.

[74] Pillar 3 requirements have been developed in stages and finalised in December 2018. For more information, please be referred to https://www.bis.org/bcbs/publ/d455.htm.

[75] With limited exceptions, the CRR currently gives institutions a certain degree of freedom in terms of the detail of the information to be disclosed and a significant degree of freedom in terms of the format of the disclosure. The entry into application of the amendments to the disclosure rules (introduced by the CRR II) will bring about a significant harmonisation of disclosures. In particular, this will be done through implementing technical standards to be developed by the EBA, which will contain detailed templates (and related instructions to fill those templates) that institutions will need to use for their disclosures.

websites and other media platforms. However, stakeholders (e.g. investors making investment decisions or analysts making recommendations to their clients) are interested in gathering, analysing and comparing information across several banks.

At present, it is considered difficult and burdensome for these stakeholders to access and aggregate this information. For example, available information on smaller, non-publicly listed banks tends to be harder to find and is usually only available in the language of the Member State in which the bank is established. The current difficulties related to the access to prudential information deprive market participants from the information they need about banks' prudential situations. This ultimately reduces the effectiveness of the prudential framework for banks and potentially raises doubt about the resilience of the banking sector, especially in periods of stress.

In addition to having to disclose certain information, banks must also report certain information[76] to their supervisors as part of a separate process. Two separate processes to share similar financial information imply undue administrative costs for banks[77]; this also makes these processes more vulnerable to a certain type of operational risk (i.e. the risk of misalignment in the same type of information communicated through two different channels).

Since 2018, the EBA, in cooperation with the ECB and national competent authorities, has been working on the creation of the European Centralised Infrastructure for Supervisory Data (EUCLID) to aggregate in a centralised integrated system the reporting information shared by supervisors on the largest EU banks[78]. This system will be particularly useful to feed public reports and analysis with aggregated data and risk indicators on the overall EU banking sector. However, the prudential framework does not yet grant powers to the EBA to disclose individual bank data that is reported to supervisors. Introducing those powers would allow banks to only report information to their supervisors and the EBA which would then proceed to disclose the required parts of that information on behalf of banks. Banks, in particular small and non-complex ones, have repeatedly called to further reduce the administrative burden stemming from reporting[79] and disclosure requirements whereas other market participants (investors, analysts) highlighted the need for a centralised and easy access to banks' prudential information.

2.2. How will the problems evolve?

As far as the **deficiencies of internal models in the current framework for calculating risk-based capital requirements are concerned,** confidence in the risk based capital requirements could be partially restored through the supervisory exercises run by the

[76] There is an overlap between the information that must be disclosed and the information that must be reported, although the amount of information that needs to be reported is normally much larger (and more detailed).
[77] The size of the undue costs cannot be estimated due to lack of data.
[78] EUCLID is expected to be launched in 2021.
[79] See, for example, https://op.europa.eu/en/publication-detail/-/publication/4b62e682-4e0f-11ea-aece-01aa75ed71a1.

EBA and the ECB[80]. Those exercises aim at 'model repair' by means of harmonising certain modelling assumptions across EU banks. However, the completion of those exercises could not fully resolve the issues, given the amount of flexibility the current rules still provide banks to design their individual internal models. In addition, enhanced supervisory review would not address the deficiencies identified in the standardised approaches for calculating risk-based capital requirements. In this context it has to be recalled that capital requirements calculated under the standardised approach represent a significant share of total capital requirements across the Union.

In the absence of changes to address the identified deficiencies related to internal model approaches, the risk-based capital requirements calculated by banks using those models would remain incomparable across banks and in some cases may be too low in relation to the risks of certain exposures. If the deficiencies related to the standardised approaches would remain unaddressed, some financial products or activities (and hence specific business models primarily based on them) would attract either insufficient or unduly high capital requirements. In both cases the potential mispricing of risks by individual banks and consequently the inadequate capitalisation of those risks by those banks would persist.

As a consequence, some mistrust in the EU banking sector would persist with negative consequences for banks' market valuations and funding costs which could in turn undermine their ability to finance the EU economy. The lack of confidence in the EU banking sector could ultimately lead to a higher probability that future periods of stress, whatever their origins, could turn into more severe financial crises.

As regards the **capture of ESG risks in the prudential framework**, the problems that such capture could potentially address (i.e. inadequate management of ESG risks) would become ever more pressing. Both transition risks and physical risks to banks would inevitably increase as the economic restructuring gains speed and as environmental events increase in magnitude and frequency. In the absence of timely legislative action to address these problems (in addition to the limited measures included in CRR II and elsewhere, see Section 2.1.2), banks might continue to misprice ESG risks, which would in turn lead to inadequate financing of the transition to a more sustainable economy risks. It could also lead to undercapitalisation of banks which could lead to financial stability issues.

On the **supervisory and sanctioning powers**, in absence of a legal initiative the discrepancies observed across national laws transposing the CRD would continue to exist, maintaining the current fragmentation and the un-level playing field with regard to the application of supervisory powers and the imposition of sanctions. This would have negative consequences in two respects. On the one hand, some MS would maintain a relative low degree of supervision, allowing some of their banks to perform certain operations that could be risky, thus fuelling mistrust in the soundness of banks. Furthermore, in some MS supervisors would still not be empowered to impose sanctions

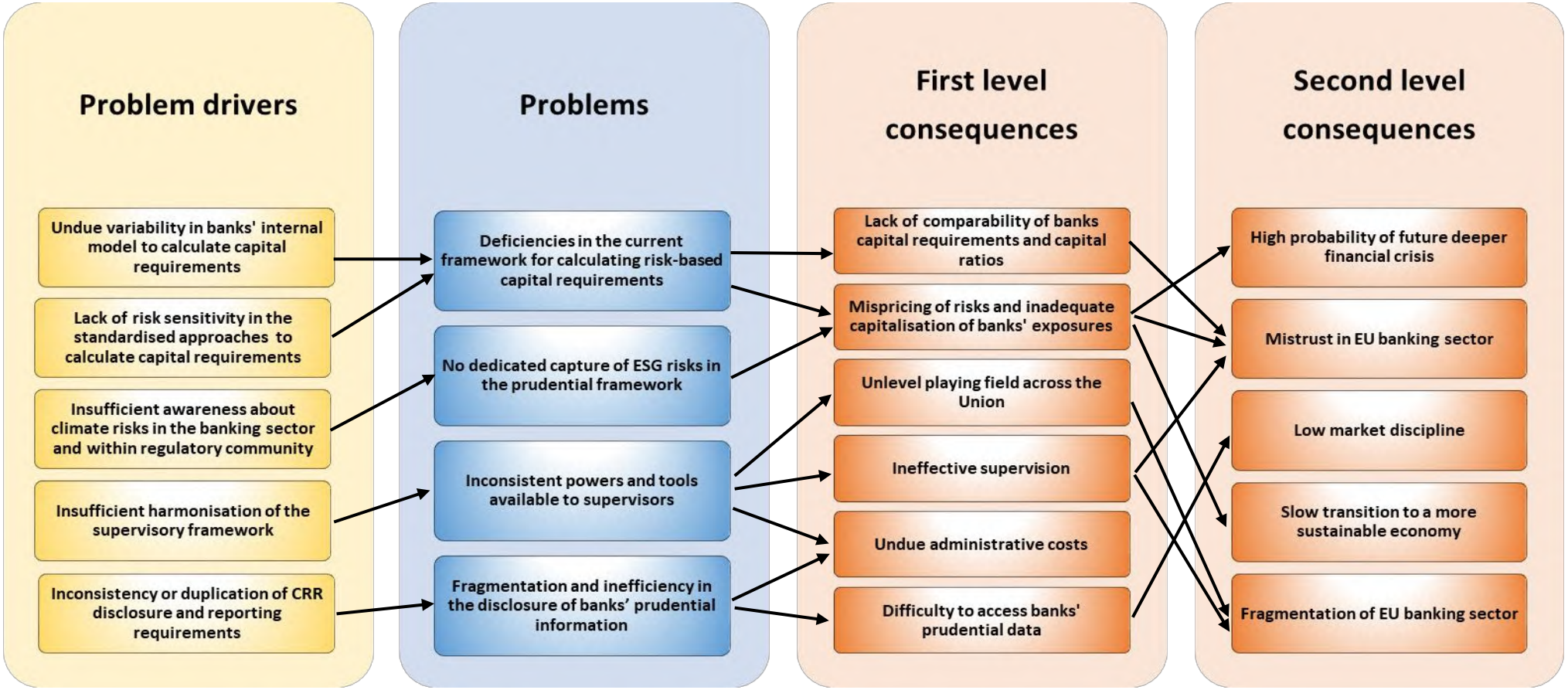
[80] See https://www.eba.europa.eu/regulation-and-policy/supervisory-benchmarking-exercises and https://www.bankingsupervision.europa.eu/banking/tasks/internal_models/trim/html/index.en.html for EBA and ECB, respectively.

for breaches of certain prudential requirements and would thus continue to lack an important supervisory tool. On the other hand, other MS would continue to exercise the legal flexibility available in the CRD in a more conservative manner. Additional supervisory and sanctioning powers in these MS could incentivise some banks to carry out certain activities in other MS without such powers. Finally, without a change, the ECB/SSM would not be able to apply the same supervisory tools and exercise the same powers to all banks under its supervision in a consistent way which would impede the effectiveness of its supervision.

The existing **inconsistencies and identified deficiencies of the application of fit-and-proper requirements** lead to a less effective and efficient supervision regime. In a number of MS, members of the management body would continue to take up their position without having been vetted upfront by supervisors. This involves the risk that unqualified managers could contribute to key decisions for the banks' businesses and its risk management. In the absence of proper definitions of key function holders and rules for their assessment the current un-level playing field across institutions within the Union would continue to exist, creating reputational risk for EU banks and their supervisors, undermining trust in the banking sector.

Finally, in the absence of actions to address the **fragmentation and the inefficiency in the disclosure of banks' prudential information to the public**, analysing and comparing information on individual banks would remain burdensome and costly for the relevant stakeholders and would continue to undermine the effectiveness of market discipline. In addition, banks' processes to report information to supervisors and to disclose information to the public would continue to run in parallel, unduly maintaining unnecessary administrative costs.

Figure 9: Mapping of problems, problem drivers and their consequences if not addressed



3. WHY SHOULD THE EU ACT?

3.1. Legal basis

All actions considered frame the taking up, pursuit and supervision of the business of banks within the Union, with the objective of ensuring the stability of the internal market. One of the fundamental components of the Union's financial system, banking is currently providing the largest part of financing within the internal market. The Union has a clear mandate to act in the area of the internal market and the appropriate legal basis consists of the relevant Treaty Articles[81] underpinning Union competences in such area.

The legal basis falls within the internal market area, which is considered a shared competence, as defined by Article 4 TFEU. Most of the actions considered represent updates and amendments to Union law, and as such, they concern areas where the Union has already exercised its competence and does not intend to cease exercising such competence. A few actions (particularly those amending the CRD) aim to introduce an additional degree of harmonisation in order to achieve consistently the objectives defined by that Directive.

3.2. Subsidiarity: Necessity of EU action

In the context of global cooperation on financial stability, supervisors and regulators meeting within the BCBS, including from several EU Member States, the ECB, the EBA and the Commission, have developed common international standards that members jurisdictions should apply to their internationally active banks. Following the GFC, the BCBS launched a fundamental review of the international standards to strengthen the resilience of the global banking system and improve comparability across banks worldwide. A number of the revised standards have already been incorporated into Union law by means of the CRR and the CRD IV, as subsequently amended by the CRR II and CRD V. However, a number of additional revisions adopted by the BCBS in December 2017 in relation to credit risk, operational risk, CVA risk, market risks and the replacement of the Basel I floor by an aggregate output floor have still to be transposed in Union law. These proposed revisions address remaining shortcomings in the international prudential framework as identified during and after the GFC.

The objectives pursued by those revisions of international standards can be better achieved at Union level rather than by different national initiatives as they represent adjustments to the EU prudential framework. The identified problems (see section 2.1.1) and the underlying causes are similar across Member States and potential differences pertain to the behaviour and business model of individual institutions, not their location within the Union. No action by the Union would render the existing prudential framework outdated in relation to evolving market challenges and would create major misalignments with standards applied by other jurisdictions. This would have reputational, financial stability and market impacts.

[81] The relevant Treaty Articles conferring the Union the right to adopt measures are those concerning the freedom of establishment (in particular Article 53 TFEU), the freedom to provide services (Article 59 TFEU), and the approximation of rules which have as their object the establishment and functioning of the internal market (Article 114 TFEU).

The ability of Member States to adopt national measures to address the identified issues is limited, given that the CRR and the CRD already regulate those aspects, and changes at national level would not be able to derogate from Union law currently in force. If the Union were to cease regulating those aspects, the internal market for banking services would become subject to different sets of rules, leading to fragmentation and undermining the recently built single rulebook in this area. National measures would affect the degree of cross-border service provision, capital flows and market integration across Member States. This would be detrimental to effectively ensuring financial stability in the internal market.

With regard to the current rules on supervision (e.g. fit and proper rules, supervisory powers and sanctions), the current national laws supplementing the prudential framework have displayed some substantial differences. The absence of sufficient common rules does not allow for a level-playing field, potentially fuelling regulatory or supervisory competition. Also, in the context of the Banking Union, where the ECB exercises direct supervisory powers set out in national laws transposing the CRD, the ECB does not have the same range of powers with regard to all banks under its supervision. The objective of efficient and harmonised supervision throughout the Union cannot be achieved by individual MS actions.

3.3. Subsidiarity: Added value of EU action

There are clear benefits from action at Union level. The Union's prudential framework for banks would be aligned with the latest international standards, thus becoming more fit for purpose and ensuring a greater resilience of the Union's banking sector. It is more efficient to change the current Union rules than repealing them and replacing them with national rules. EU action also allows for a more homogenous approach, taking into account all EU specificities in a comprehensive way.

As regards those aspects that would supplement existing rules (e.g. fit and proper rules, supervisory powers, sanctions) additional harmonisation will contribute to a more homogenous approach and reduce the fragmentation of the internal market. At the same time EU action contributes to establishing a level playing field and a higher quality of supervision across the Union.

4. OBJECTIVES: WHAT IS TO BE ACHIEVED?

4.1. General objectives

There are **two general objectives** pursued by this initiative:

1. **Contributing to financial stability.** Only a stable and financially sound banking system, which is well capitalised and where risks are adequately managed, will lead to a reduced probability of banking crises, and reduce the impact of such crises should they occur. This will in turn allow to maintain investors' and depositors' confidence in the banking system, especially in periods of stress.
2. **Contributing to steady financing of the economy in the context of the recovery post-COVID-19 crisis**. The EU economy is heavily reliant on financing provided by the

banking sector. While initiatives are underway to develop a Capital Markets Union (CMU) that might over time reduce this reliance, the banking sector will in particular play a key role in financing the medium-to-long term recovery from the COVID-19 crisis.

4.2. Specific objectives

The two general objectives pursued by this initiative can be broken down into the following **four specific objectives**:

1. **Strengthen the risk-based capital framework, without significant increases in capital requirements**. To ensure a resilient and stable banking system, it is essential to have a solid prudential framework in place which ensures that risks are accurately measured and adequately covered by capital. In particular, trust in the banking system is conditional upon trust in the reliability of the risk-based capital framework. Internally modelled approaches that EU banks use for calculating risk-based capital requirements should result in adequate capital levels and produce comparable outcomes. At the same time the prudential framework should provide robust and sufficiently risk-sensitive standardised approaches for banks using them. However, strengthening the risk-based capital framework should not come at the cost of significantly increasing capital requirements as requested by the EU Parliament and the Council[82].
2. **Enhance the focus on ESG risks in the prudential framework**. Including a sustainability dimension in the prudential framework would ensure a better management of ESG risks and a better allocation of bank funding across projects, thus helping the transition to a more sustainable economy.
3. **Further harmonise supervisory powers and tools**. Supervisory tools such as fit-and-proper assessments, supervisory powers and sanctioning powers play a key role in ensuring the safety and soundness of individual banks and the stability of the EU banking system as a whole. Certain tools should therefore be made available to supervisors in all Member States and applied consistently. This would also help reduce administrative costs resulting from the current fragmentation.
4. **Reduce banks' administrative costs related to public disclosures and improve access to banks' prudential data**. Public information on individual banks that is easily accessible and comparable should enhance the ability of bank clients, investors and other market participants to monitor and exert market discipline on banks' behaviour. Banks in turn would benefit from a more efficient system that integrates supervisory reporting and disclosure, and thereby reduces their administrative burden.

[82] See https://www.europarl.europa.eu/doceo/document/TA-8-2016-0439_EN.pdf for the EP and https://www.consilium.europa.eu/media/22659/st11052en16.pdf for the Council.

5. WHAT ARE THE AVAILABLE POLICY OPTIONS?

5.1. What is the baseline from which options are assessed?

The baseline option from which the considered policy options are assessed assumes no legislative change to the prudential framework applicable at Union level.

Under this option, the structural shortcomings of internal models of the current prudential framework as described in Section 2.1.1 would remain unaddressed, and the Commission would solely rely on the supervisory initiatives taken by the EBA and the ECB under their current remits to improve the situation. In addition, the EBA will continue performing its annual supervisory benchmarking exercises on credit and market risk internal models to highlight the degree of variability of EU banks' internal models. The EBA and ECB initiatives could achieve to some extent a reduction of the variability in capital requirements calculated based on internal models for credit, counterparty and market risks[83]. While acting as important complements, these supervisory initiatives cannot substitute for the necessary reforms of the binding requirements included in the current prudential framework. Without those reforms, the problems described in Section 2.1.1 would continue to exist.

In the same vein, without changes to the standardised approaches, they would remain insufficiently risk-sensitive. Since those standardised approaches are legally binding, they are virtually identical for all banks that apply them. Therefore initiatives employed by supervisory authorities cannot be used to tackle the deficiencies identified in Section 2.1.1.

Moreover, under this scenario, the only binding requirement related to ESG risks that would apply would be the requirement for large banks to disclose information on those risks from end-June 2022 onwards, as highlighted in Section 2.1.2. While competent authorities will continue to be able to exercise their Pillar 2 powers to require banks to address ESG risks, due to the lack of an explicit reference to those risks in the CRD, those powers will not be applied systematically and consistently. Any additional requirements that the EBA may propose in the reports due in 2021 and 2025 (see Section 2.1.2) would require legislative action.

Not changing legislation would also mean that divergences among MS in the area of supervisory powers made available to competent authorities under the CRD, identified in Section 2.1.3, would persist. For example, the prudential framework would still not require MS to give competent authorities powers to sanction certain types of regulatory breaches. Furthermore, there would be no legal requirement for an intervention in the case of specific situations that could raise prudential concerns, such as the acquisition of material holdings in entities other than banks, material transfers of assets and liabilities, and (de-)mergers. MS would still have ample leeway to grant the competent authorities these supervisory powers at their own discretion. The CRD would also still not require competent authorities to assess the suitability of key function holders. At the same time, the prudential framework would continue to lack specifications on how competent authorities should conduct fit-and-proper assessments. As a result, the rules would remain subject to broad margins of interpretation by

[83] Internal models used to calculate capital requirements for operational risk are not covered by TRIM.

MS, leaving clearly identified prudential concerns unaddressed. The initiatives conducted by the EBA and the ECB/SSM (see Section 2.1.3) could help increase the harmonisation of the fit-and-proper assessment across Member States but, only if MS would empower supervisors by amending their national frameworks. In absence of such national empowerments, inadequate supervision of key function holders would persist in some MS, as associated with the risks of employing unsuitable individuals as members of the management body.

Finally, under this scenario of no change to the current prudential framework, banks' investors and other stakeholders interested in banks' prudential information would still find it burdensome to collect such information on individual banks' platforms. In addition, banks would continue to have to follow two separate processes to report and disclose the required information, which would continue to generate an undue administrative burden for them, as described in Section 2.1.4.

5.2. Description of policy options

5.2.1. Improve the current framework for calculating risk-based capital requirements

Option 1 *- Implement the Basel III reforms in full alignment with the BCBS standards and implementation timelines*

This option would implement in Union law the final elements of the Basel III reform (adopted by the BCBS between December 2017 and July 2020) in full alignment with the standards and the timelines agreed by the BCBS. The agreement was the result of a strategic review of the international prudential standards for banks, which was conducted by the BCBS in the wake of the GFC, with a view to improving the balance between simplicity, comparability (mainly of the internal model approaches) and risk-sensitivity (mainly of the standardised approaches) of those standards.

This option would entail implementing the final elements of the Basel III reform agreed in December 2017, namely:

- the revisions to the standardised approach for credit risk (SA-CR) to improve the robustness and risk sensitivity of the existing approach;
- the revisions to the IRB approaches for credit risk to reduce unwarranted variability in banks' calculations of RWAs;
- the minimum haircut floors for non-centrally cleared securities financing transactions[84] (SFTs) to limit the pro-cyclicality of these transactions and the build-up of excessive leverage in the financial system;

[84] SFTs are secured funding or lending transactions that imply a temporary exchange of assets with one leg of the transaction serving as a guarantee (collateral). Repurchase agreements (repos) constitute the most important category of SFTs in terms of outstanding amounts and turnover. They are generally motivated by the need to borrow cash. From the borrower's point of view, the transaction consists of selling securities against cash, while agreeing in advance to buy back the securities at a predetermined price. The sold securities serve as collateral for the buyer (provider of cash) in the repo. Securities lending, the second largest category of SFTs, is primarily driven by market demand for specific securities, e.g. for short selling or settlement purposes. In this type of

- the revisions to the CVA risk framework consisting of the removal of the use of an internally modelled approach and the introduction of a new basic approach (BA-CVA) as well as revisions to the standardised approach for CVA (SA-CVA) to enhance the risk sensitivity, strengthen the robustness and improve the consistency of the framework;
- the new standardised approach for operational risk (SA-OR), replacing all the existing standardised and internal model approaches for this risk to simplify the framework and increase comparability; and
- the aggregate output floor (OF) to 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.

In addition, this option would implement the revised[85] (i.e. January 2019) version of the original (i.e. January 2016) market risk standards, known as the 'fundamental review of the trading book' (FRTB), for the purpose of calculating capital requirements. Most of the revised FRTB standards have already been implemented in EU law as part of the CRR II. Following an agreement between the European Parliament and the Council, they were implemented for reporting purposes only (i.e. banks are not required to use them to determine their capital requirements). Under this option they would be converted into a capital requirement, fully aligned with the final 2019 standards.

transaction, one counterparty lends securities for a fee against collateral in the form of cash or other securities given by another counterparty.

[85] Apart from modifying the calibration of the original FRTB standards, the revised version also aligned the implementation date of the standards with the implementation date of the overall framework (the date was originally set to January 2019).

Table **1** below presents a more detailed list of the key elements of the reforms included in the December 2017 agreement, as well as the revised market risk framework adopted in 2019.

This option would address the main deficiencies, identified in Section 2.1.1, with the current prudential framework for calculating risk-based capital requirements applicable to EU banks[86]. At the same time, this option would entail no adjustments to the final Basel III standards to cater for specificities of the EU economy and would also remove some of the EU-specific rules currently in place to fully align the EU prudential framework with those standards (e.g. it would remove the exemptions from the CVA risk charge and the small and medium-sized enterprise (SME) supporting factor).

[86] Note that the final elements of the Basel III reform were not specifically intended to address the problems identified with the risk-based capital requirements of EU banks; the same problems have been identified with their international peers with similar business models and activities. When developing the reform, the BCBS took a rather global approach in addressing those problems, therefore not necessarily taking into account the specificities of the banking sector of each of the BCBS members.

Table 1: Overview of the main revisions to the Basel framework introduced by the final elements of the Basel III reform.

Risk area	Main revisions
Credit risk – standardised approach	• For rated exposures to banks, some of the RWs have been recalibrated. In addition, the RW treatment for unrated exposures to banks is more granular than the existing flat RW, which depends on the RW applicable to the central government of the Member State in which the bank is established. • For exposures to corporates, a more granular RW treatment has been developed. In addition, a specific treatment for exposures to project finance, object finance and commodities finance was developed. • For real estate exposures (both residential and commercial), more risk-sensitive approaches have been developed to better reflect different funding models and stages in the construction process. • For retail exposures, a more granular treatment was developed, which distinguishes between different types of retail exposures and reflects FX risk. • For subordinated debt and equity exposures, a more granular and generally stringent RW treatment was developed. • For off-balance sheet items, a more risk-sensitive treatment was developed, which is more stringent for unconditionally cancellable commitments.
Credit risk – internal models approach	• The possibility to use of internal models was either limited or altogether removed for portfolios and risk parameters where the BCBS had concluded that the available data was insufficient to ensure reliable modelling (i.e. exposures to financial institutions and large corporates, equity exposures). • New minimum values ('input floors') were introduced for banks' estimates of the probability of default, loss-given default and exposure at default (EAD). • The option for banks to pick and choose between the use of internal models and the standardised approach per asset class was introduced.
Market risk (FRTB)	• More objective rules were introduced to allocate transactions either to the trading book, or to the banking book. • Both the standardised approach and the internal model approach were be completely overhauled to better capture market risk. • New tests were introduced to ensure the robustness of the internal models and leave less flexibility for banks to use their own modelling assumptions.
CVA risk	• Internal models were replaced by standardised approaches, leaving banks with a choice between a more sophisticated and a simpler approach. • For banks with non-centrally cleared derivatives contracts with a combined notional value of less than EUR 100 bn, a simplified approach was made available.
Securities Financing Transactions	• For certain non-centrally cleared SFTs with certain counterparties, minimum haircut floors were introduced; as a result SFTs which do not meet the haircut floors must be treated as unsecured loans.
Operational risk	• The current internal model approach and the three existing standardised approaches were replaced with a single risk-sensitive standardised approach to be used by all banks. • The capital requirement under the new standardised approach depends on the size of the bank (expressed in terms of a refined measure of gross income) and the bank's operational risk-related loss history.
Output floor	• A revised output floor was introduced. The floor sets a lower limit to the capital requirements that are produced by a bank's internal model at 72.5% of the capital requirements that would apply if the bank would calculate its capital requirements using standardised approaches[87].

[87] For more details on the level of application see section "Flexibility in the Basel III standards" below.

Option 2 *- Implement the final Basel III reforms with EU-specific adjustments and in alignment with the BCBS implementation timelines*

Similar to option 1, option 2 would also implement all the final elements of the Basel III reform. Compared to option 1, this option would include a number of targeted adjustments to cater for the specificities of the EU banking sector and the funding structure of the EU economy, and taking into account the context of the recovery, with the objective to avoid disproportionate impacts or unintended consequences of the reforms on essential activities and financial services provided by EU banks. In fact, the Basel standards are designed to capture common financial risks that can be observed across the world. They are calibrated based on averages of data collected across banks and financial markets located in different regions of the world. As a result, the capital requirements under some Basel standards may not capture more specific financial risks appropriately which could lead to disproportionate impacts on the corresponding financial activities. In addition, a few other targeted adjustments under this option would help to ensure an international level playing field for trading activities. Finally, this option would also make use of the flexibility the international standards provide in order to harmonise their application across the Union, in line with the objectives set out for this legislative proposal.

Specificities of the EU banking sector and EU economy

EU businesses (and in particular SMEs, see also Section 3 of Annex 6) rely heavily on bank lending to finance their investment and working capital needs, much more than in other major jurisdictions. However, the international standards do not always sufficiently take into account the specific financing structures and risk management strategies used in the EU. To address this issue, option 2 includes several targeted adjustments:

- Treatment of unrated corporates: corporate lending in the EU is predominantly provided by banks using IRB models. With the implementation of the OF those banks would also need to apply the SA-CR which relies on external ratings to determine the credit quality of the corporate borrower. Most EU corporates, however, do not typically seek external credit ratings, due to the cost of establishing a rating[88] and other factors[89]. Given that capital requirements calculated under the SA-CR are, on average, more conservative for unrated corporates than for corporates that have a rating,[90] the implementation of the OF could cause substantial increases in capital requirements for banks using internal models (because the standardised approach would be used to calculate the OF). To avoid disruptive impacts on bank lending to unrated corporates and provide enough time to

[88] For example, according to one provider of credit ratings the average cost of obtaining a rating for an SME is approximately between EUR 40000 and 50000 for the initial evaluation, and then EUR 30000 to 35000 annually for keeping the rating updated. However, these figures are only indicative, as the cost depends on various factors, such as the complexity of the company, its financial structure, and the size of the debt issue.

[89] For example, according to one ratings provider some of the other reasons why SMEs do not seek to obtain ratings are the availability of financing from banks (ratings are usually sought when debt is sold in the markets), unmet expectations about the quality of the assigned ratings (ratings turn out worse than the company issuing the debt expects), and reluctance to make financial data available.

[90] A bank's exposure to an unrated company is assigned a 100% risk weight under the SA-CR, whereas an exposure to a company with a good credit rating can attract a lower risk weight (20% in case of the highest rating).

establish public and/or private initiatives aimed at increasing the coverage of credit ratings, option 2 would introduce a transitional period. During this period banks using internal models could apply a favourable treatment when calculating their OF for exposures to unrated corporates. This transitional arrangement would be coupled with an empowerment for the Commission to further extend the length of the period, based on a report by the EBA. This would ensure sufficient access to bank funding by unrated corporates during the transition period, as banks could continue to apply lower capital requirements whilst initiatives to foster widespread use of credit ratings would be established. After the transition period banks would refer to credit ratings to calculate capital requirements for most of their exposures to corporates in accordance with the Basel III standards. More details about this specific issue and the dedicated adjustment to address it are provided in subsection 1.1.1 of Annex 5.

- SME supporting factor: Given their fundamental role in creating jobs and economic growth in the EU, EU co-legislators decided that capital requirements for SME exposures should be lower than those for large corporates to ensure appropriate bank financing of SMEs. As a result, an SME supporting factor was introduced in the CRR and its scope extended in CRR II[91]. Option 2 would maintain this SME supporting factor in the prudential framework, which would result in lower capital requirements for SMEs than the specific treatment provided by the Basel III standards.

- Infrastructure supporting factor: bank financing of infrastructure and other specialised projects is also a defining characteristic of the EU economy, as compared with other jurisdictions where such projects are predominantly financed by capital markets. Large EU banks are major providers of funding for specialised projects[92], objects finance[93] and commodities finance[94], in the EU and globally. They have developed a high level of expertise in those areas. A preferential treatment has been introduced in CRR II to foster bank finance and private investment in high quality infrastructure projects ('infrastructure supporting factor'). Option 2 would maintain this treatment, which would result in lower capital requirements for infrastructure projects than the specific treatment provided by the Basel III standards. Furthermore, a new preferential treatment under the standardised approach for "high quality" object finance would be introduced. It would apply where financial risks are specifically managed. Conflicting signals to banks active in this market segment should be avoided.[95] This option would also empower the Commission to adopt delegated acts that would adjust the internal models approach, if such adjustment would

[91] As a result of CRR and CRRII, banks can now apply a 23.81% discount when computing their capital requirements on SME exposures of up to EUR 2.5mn EUR whereby the part of an SME exposure exceeding EUR 2.5mn EUR are subject to a 15 % reduction in capital requirements (so-called SME supporting factor).
[92] Namely, loans funding long-term important infrastructure or industrial projects.
[93] Namely, loans funding the acquisition of physical assets such airplanes, ships, satellites, railcars, fleets, etc.
[94] Namely, financing exchange-traded commodities like crude oil, metals or crops.
[95] This would avoid undermining incentives for proper risk-mitigation of those transactions, for instance through close monitoring and various forms of collateralisation. The EBA would be mandated to develop criteria to determine what constitutes a high-quality project and to determine the calibration of the applicable RW.

be found appropriate based on a comprehensive assessment by the EBA during the implementation period.

- Equity exposures: Many EU banks hold long-standing, strategic[96] equity participations in financial and non-financial corporates. The final Basel III standards increase the RWs for all kinds of equity exposures over a 5-year transition period without providing a specific treatment for strategic equity investments. Applying the more conservative approach embedded in the Basel III standards to the whole stock of existing equity holdings could jeopardise the economic viability of existing strategic relationships. Option 2 would exclude equity holdings in entities within the same banking group or covered by the same institutional protection schemes (IPS)[97] from the application of the more conservative treatment. In addition, it would grandfather existing strategic participations where banks exercise influence, including via holdings in insurance undertakings, whilst applying the new, more conservative treatment to new equity exposures. More details about this specific issue and the dedicated adjustment to address it are provided in subsection 1.1.3 of Annex 5.

- Treatment of Collective Investment Undertakings[98] (CIUs) used for trading purposes: CIUs play a crucial role in facilitating the accumulation of personal savings, whether for investments or for retirement. The seamless provision of CIUs as investment product hinges on banks' ability to continuously offer to their clients the possibility to buy or sell back those instruments. For that purpose, banks must keep inventories of CIUs in their trading books. The revised market risk standards adopted in 2019 rely on a number of conservative assumptions and complex operational requirements[99] that could increase significantly the capital requirements for those instruments, therefore restricting their supply. To avoid this unintended effect on those trading activities, Option 2 would provide a number of adjustments to the treatment of CIUs under the market risk rules. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.3 of Annex 5.

- Treatment of financial products based on the EU emission trading scheme (ETS): banks play an important role in providing liquidity to the EU market for carbon emissions allowances. Banks typically fill their clients' estimated demand for allowances at a future date via derivatives ('forward') transactions. Under the revised market risk rules, the exposures to carbon emission allowances are assimilated to electricity contracts, and

[96] E.g. investments in equities of corporates with which the bank has a long-term business relationship.

[97] An institutional protection scheme (IPS) is defined in the CRR as a contractual or statutory liability arrangement which protects its member institutions and in particular ensures that they have liquidity and solvency needed to avoid bankruptcy where necessary.

[98] Under CRR, a "CIU" means an Undertakings for Collective Investments in Transferable Securities (UCITS) as defined in Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council or an alternative investment fund (AIF) as defined in point (a) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council.

[99] As described in Annex XX, these requirements include the restricted permission to capitalise exposures to CIUs under the internal model approaches only if the bank can look through the CIUs' composition and the conservative calibration of some of the standardised approaches available for those exposures.

therefore get allocated to the same risk weight (60%). In light of the historical price volatility of EU ETS, this risk weight appears excessively high. Furthermore, in its Communication[100] on fostering openness, strength and resilience of the European economic and financial system, the Commission announced its intention to support further ETS trading activity in the EU, notably as part of the 'green' transition[101]. Option 2 would therefore introduce a specific category for ETS allowances, distinct from electricity, for which RWs would be calibrated to reflect the actual price volatility of this commodity in the EU ETS market. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.3 of Annex 5.

- Exemptions from capital requirements for CVA risk: When implementing the initial Basel III reforms in Union law through the CRR, the EU co-legislators exempted certain transactions[102] from the calculation of capital requirements for CVA risk. These exemptions were agreed to prevent a potential excessive increase in the cost of some derivative transactions triggered by the introduction of the capital requirement for CVA risk, particularly when banks could not mitigate the CVA risks of certain clients[103]. While the introduction of the revised capital requirement for CVA risks adopted as part of the final elements of the Basel III reform would improve to some extent the risk-sensitivity of the standardised approaches for CVA risks, the level of capital requirements would still remain very high for the exempted transactions, notably due to the removal of the internal model approach for CVA risk. In this context, Option 2 would maintain the existing CRR exemptions. To help supervisors monitoring the CVA risks arising from the exempted transactions when they are excessive, option 2 would require institutions to report to their supervisors the calculation[104] of capital requirements for CVA risks of the exempted transactions. In addition, option 2 would introduce EBA guidelines to help supervisors to identify excessive CVA risk. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.5 of Annex 5.

- Introduction of the minimum haircut floor framework for non-centrally cleared SFTs: SFT markets play an essential role[105] in the EU financial system by allowing financial institutions to manage their own liquidity position and support their securities market-making activities, as well as central banks to transmit, via financial institutions, their monetary policy plans to the real economy. However, SFTs can also enable market participants to recursively leverage their positions by reinvesting cash collateral and re-using non-cash collateral, respectively. To address some concern with respect to the risk

[100] COM(2021) 32 final.
[101] For specific policy options to deliver on the EGD by addressing ESG risks see next section.
[102] The exemptions cover derivative transactions with certain non-financial companies, governments, pension funds, but also intragroup transactions within the same banking group.
[103] These situations arise where banks could not put exchange collateral on derivative transactions with their clients or where they cannot find guarantee provided by third-parties (e.g. via credit derivatives) to protect them from the non-payment of the clients obligations under the derivative transactions.
[104] That is the calculation of capital required for CVA risks if the transactions were not exempted under CRR.
[105] As an example of the importance of the EU SFTs market, the total value of the EU repo market (the most widely traded form of SFTs in the EU) amounted to around EUR 8.3 trillion at the end of 2019, according to the ESRB.

of build-up of excessive leverage outside the banking sector, the Financial Stability Board (FSB) published[106] in 2013 a recommendation to its member jurisdictions to introduce minimum collateral haircuts for some non-centrally cleared SFTs traded between banks and non-banks, either, at the discretion of each jurisdiction, directly via a market regulation or indirectly via a more punitive capital requirement that was later developed by the BCBS[107]. Presently there is still a lack of certainty about the impact of implementing this FSB recommendation on the EU SFTs market and whether its prudential objective could be attained without creating undesirable consequences. In this context, option 2 would propose to delay its implementation in the EU until the EBA and ESMA provide in the coming years a joint report to the Commission assessing its impact and recommending the most appropriate approach. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.6 of Annex 5.

International level playing field for trading activities.

Banks trading activities in wholesale markets can easily be carried out across borders (for certain activities, even between the EU and non-EU countries). The capital requirements applied to these activities should therefore converge as much as possible across jurisdictions to avoid a potential competitive advantage for those banks for which the domestic rules are more lenient.

In this context, option 2 would turn the existing reporting requirement for market risk based on the BCBS FRTB framework into a capital requirement, as proposed under option 1. However, option 2 would contain a safeguard that would allow addressing disruptions to the playing field for EU banks' trading activities that could materialise if other major jurisdictions would delay the implementation of the FRTB framework or adjust its calibration[108]. Specifically, option 2 would introduce an empowerment for the Commission to delay, if necessary, the application of the capital requirement based on the FRTB framework and/or to adjust its calibration considering international developments. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.3 of Annex 5.

A second adjustment under option 2 would address the conservative calibration of the standardised approach for counterparty credit risk (SA-CCR) currently applied to derivative transactions and already transposed[109] in Union law by means of the CRR II. At the time of adoption, the EU co-legislators requested the EBA to report by June 2023 on the current SA-

[106] FSB: Strengthening Oversight and Regulation of Shadow Banking, 29 August 2013.
[107] The implementation of this FSB recommendation has been aligned with the implementation of the Basel III reforms, including the one-year postponement to 1 January 2023.
[108] Hong Kong and Singapore publically announced the application of the final FRTB standards as a reporting requirement from 1 January 2023 and committed to implement the standards as a capital requirements at a later stage. Other jurisdictions have already publically indicated a delay of the application of the final FRTB standards as capital requirement, as compared to the BCBS recommended implementation date: Q3 2023 for Japan; 1 January 2014 for Canada and Australia. Finally other major jurisdictions (e.g. US, CH) have publically announced their commitment to implement the FRTB framework as capital requirements without more details at this stage.
[109] The Basel standards for SA-CCR were adopted in 2014.

CCR calibration. Subsequently, in the Capital Market Recovery Package[110] they requested the Commission to review the appropriateness of the SA-CCR calibration by June 2021. Considering that at least one major jurisdiction[111] has already lowered the calibration of SA-CCR for certain types of derivatives transactions, option 2 would temporarily lower the existing calibration of SA-CCR for all derivatives transactions when calculating the OF. This would provide sufficient time to further discuss this issue at international level. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.7 of Annex 5.

Flexibility in the Basel III standards

The Basel standards usually leave some flexibility for their local implementation, either by explicitly allowing jurisdictions to choose between different implementation options at their own discretion or by implicitly not providing all the technical details for the operationalisation of the standards. Option 2 proposes to make use of this flexibility and would implement those discretions in a harmonised manner.

First, the introduction of the OF in the prudential framework represents one of the key elements of the final Basel III reform, aimed at reducing the excessive variability of banks' capital requirements calculated with internal models and thereby enhancing the comparability of capital ratios. The Basel III standards arguably leave some room for interpretation as regards the requirements[112] to which the OF should apply and, in case of banking groups, the level[113] at which it should apply. Under option 2, the OF would include all the existing capital requirements in scope of Union law, including the systemic risk buffer (SyRB) requirement and the P2R imposed on EU banks by the relevant authorities (i.e. competent authorities or designated authorities). This is coherent with the current prudential framework and consistent with the objective of the OF. In order to avoid disproportionate capital impacts, while still strengthening financial stability and complying with the Basel III standards, option 2 would also prescribe that any overlap between the risks captured by the OF and the risks captured by any of those two requirements must be avoided[114].

Moreover, the Basel standards, including the OF, apply foremost at the level of a banking group (consolidated level). In the EU prudential framework, capital requirements usually apply both at the level of individual banks/subsidiaries (individual/solo level) and at

[110] See EUR-Lex - 32021R0337 - EN - EUR-Lex (europa.eu)

[111] In their implementation of SA-CCR adopted in November 2019, the US authorities introduced a number of adjustments to the Basel standard which would reduce the capital requirements of some derivate transactions with corporates by about 30%.

[112] More specifically the Basel III standards refer to the Pillar 1 requirements, the capital conservation buffer requirement, the countercyclical capital buffer requirement, as well as the buffer requirements for global systemically-important and, respectively, other systemically-important institutions (G-/O-SIIs) and the total loss-absorbing capacity (TLAC) requirements. However, they do not include a reference to the systemic risk buffer requirement (SyRB) and the Pillar 2 requirement (P2R), as these are not implemented, or not implemented in comparable ways, in all member jurisdictions of the Basel Committee.

[113] Capital requirements can be calculated at the level of individual banks ("individual level") or at the level of a banking group ("consolidated level"). The Basel standards, including the OF, apply foremost on a consolidated level. The requirements in the CRR are principally applied at both individual and consolidated level.

[114] The relevant authority would do this by adjusting the calibration of the requirement that would be found to double-count the risks already covered by the OF.

consolidated level. Some concerns have been raised that certain EU banking groups would incur an excessive increase in capital requirement due to the introduction of the OF if it were applied at solo level, in addition to its application at consolidated level. In this context, option 2 would introduce the OF at consolidated level only. However, to adequately capture the risks of both parent entities and their subsidiaries, whilst remaining consistent with the logic of the Single Market, option 2 would require any additional capital resulting from the application of the OF at consolidated level to be distributed fairly across the various entities of the group according to their risk profile as if the OF was applied at individual level[115].

More details about the impacts of the output floor and the different implementation options are provided in section 1.8 of Annex 5.

In addition, the revised standardised approach for operational risk (SA-OR) introduced a discretion to allow jurisdictions to disregard the inclusion of banks' own historical losses related to operational risk through the Internal Loss Multiplier (ILM) indicator in their calculations of capital requirements for operational risk under this approach[116]. While there is empirical evidence showing that banks experiencing greater operational risk losses historically are more likely to experience operational risk losses in the future, the events that have led to the largest operational losses are less amenable to prediction based on historical loss data than for other types of risks. For this reason, option 2 would exercise the discretion provided by the Basel III standards and set the ILM to 1. More details about this specific issue and the dedicated adjustment to address it are provided in section 1.4 of Annex 5.

Finally, option 2 would also exercise the flexibility provided in the Basel III standards to clarify that holdings of unlisted equities with a holding period of at least 3 years would not be considered as speculative holdings and would therefore not be subject to the most conservative treatment.

Option 3 *- Implement the Basel III reforms with EU-specific adjustments and transitional arrangement adapted to the COVID-19 crisis*

This option would mirror option 2, but with a later date of application of the reform. Instead from 1 January 2023, the reform would apply from 1 January 2025, followed by a 5-year transitional period as proposed by the BCBS. This would lead to the full application of the reform by 1 January 2030.

Option 3 would fulfil EU's commitment to implement the international standards, and provide certainty for banks' capital planning and lending decisions, whilst at the same time leaving them more time to comply with the revised capital requirements. The extended implementation period would allow banks to focus on managing their financial risks

[115] This means that the distribution key for any additional capital required by the OF would depend on the contribution of each entity to the consolidated floor requirement.

[116] The inclusion of banks' own historical losses through the ILM indicator would either increase their capital requirement for operational risk in case the banks suffered large operational risk losses in the past (in this case ILM would be higher than 1) or decrease it if banks did not suffer such losses (in this case ILM would be lower than 1). A supervisory discretion introduced in the Basel III standards allows supervisors to set ILM to 1 for all banks in their jurisdictions, in order to disregard banks' own historical losses as a driver of the level of their capital requirement for operational risk.

stemming from the COVID-19 crisis and financing the recovery and give them enough time to adjust before the reform would reach its full effect. In addition, to reinforce the signal that banks would have ample time throughout the recovery phase to adjust to the new rules and thereby help avoid that other market participants would put pressure on banks (in particular the few most impacted banks) to frontload[117] the new requirements, this option would entail dedicated communication efforts to explain the additional implementation period.

5.2.2. Dedicated capture of ESG risks in the prudential framework

Option 1 *- Introduce measures for a better management of ESG risks by banks*

Under this option, several measures would be introduced to improve the management of ESG risks by banks and to reinforce the specific review by bank supervisors as well as the degree of market discipline, without directly targeting banks' minimum capital requirements. These measures would aim to improve the resilience of banks to ESG risks and increase bank funding of sustainable activities by means of an improved understanding of the risks involved and an anticipation of expected market pressures.

As regards risk management, there is currently no explicit requirement for banks to have in place internal processes to manage ESG risks, nor an explicit requirement for ESG risks to be part of the supervisory review and evaluation process (SREP). Under this option, the current CRD V mandate for the EBA to issue a report to assess the inclusion of ESG risks in the SREP would be reinforced by explicitly requiring supervisors to ensure that banks manage ESG risks adequately. To the same end, the EBA's mandate would be clarified to require an assessment of how such risks should be included in the SREP via guidelines. Finally, the EBA would be mandated to specify further how ESG risks should be identified, measured, managed and monitored. This would include internal stress tests on banks' resilience to climate change risks and long-term negative impacts.

The annual stress tests performed by supervisors are an important tool to gauge the viability of banks under adverse conditions. At present, the CRD requires supervisors to perform annual stress tests on the banks they supervise, while the EBA is mandated to define a common stress test methodology via guidelines. Under this option, this requirement would be extended to include regular climate change stress tests and to mandate the EBA together with the other ESAs to develop a methodology for that purpose.

In the area of disclosure, the disclosure requirements related to the disclosure of ESG risks would be extended to a larger universe of banks (i.e. beyond large, listed banks to whom the existing requirement will apply from 2022) while respecting the proportionality principle.

As the EU economy is transitioning towards a sustainable economic model, while at the same time being exposed to sustainability risks, exposures due to the financing of sustainable

[117] NB: Large banks and their supervisors have started to prepare for the implementation of the final elements of the Basel III reform soon after their adoption by the Basel Committee in 2017. This frontloading behaviour is also confirmed by the EBA's Basel III monitoring exercises, which show a steady decline in capital shortfalls at EU banks with respect to the requirements implied by the Basel III reform (see for instance also https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/dutch-banks-unflustered-by-front-loading-of-capital-rules-54955966). The presentation of the Commission proposal is hence not going to cause any additional or accelerated frontloading but rather slow it down.

activities might be expected to be less risky for banks than exposures financing unsustainable activities. While this option would not include comprehensive adjustments to capital requirements for these exposures, it would contain a specific review clause that would allow such adjustments to be made in the near future, once sufficient evidence would be available[118]. In addition, the deadline for the EBA to deliver its report on the prudential treatment of these exposures would be advanced from 2025 to 2023 in order to ensure greater timeliness of any changes to the prudential rules that may be needed.

Option 2 *- Adapt minimum capital requirements to reflect ESG risks*

Option 2 would adapt the minimum capital requirements under so-called "Pillar 1" of the prudential framework for the financing of certain activities and/or products where specific evidence exists that they are more or less risky than comparable exposures as a result of ESG factors. For the exact delimitation of environmentally sustainable activities deemed to be of lower risk based on such evidence, the Taxonomy Regulation and its delegated acts would be used.[119] Under this option, capital requirements for sustainable exposures would be lowered, while capital requirements for unsustainable activities would be increased, to reflect the differences in ESG risks inherent in the two types of exposures. As under option 1, the deadline for the EBA to deliver its report would be advanced from 2025 to 2023.

5.2.3. Improve the consistency in the application of supervisory powers

Option 1 *- Clarify and complement certain provisions on supervisory and sanctioning powers while leaving ample flexibility to Member States*

Under option 1, several elements of the prudential framework related to supervisory and sanctioning powers would be clarified compared to the status quo in order to ensure a more consistent application of the supervisory toolkit. However, this option would still grant flexibility to MS to detail certain supervisory and sanctioning powers in national laws.

As regards supervisory powers, this option would introduce harmonised obligations for banks to notify competent authorities ahead of specific events with prudential relevance (acquisitions of holdings, transfers of assets and liabilities, mergers and demergers). To avoid placing an unnecessary burden on competent authorities and banks alike, the notification obligation would be subject to a materiality threshold. This option would abstain from specifying relevant related powers or obligations for the competent authorities. This means that MS would be left with the discretion to grant competent authorities *ex ante* supervisory powers to oppose or to approve these events.

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[118] Such evidence would primarily come from the EBA report mandated under Article 501c of the CRR.

[119] At present, the work on the taxonomy related to environmental risks is the most advanced one: a first delegated act on sustainable activities for climate change adaptation and mitigation objectives (see https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en#taxonomy) was formally adopted on 4 June 2021 for scrutiny by the co-legislators. A second delegated act for the remaining objectives will be published in 2022. On 12 July 2021, the Platform on Sustainable Finance has published two draft reports on the potential extensions of the taxonomy framework to cover i) social objectives and ii) activities that are significantly harmful to environmental sustainability, and those that have no significant impact on it (see https://ec.europa.eu/info/publications/210712-sustainable-finance-platform-draft-reports_en).

As regards sanctioning powers, this option would introduce a generic sanctioning provision, giving competent authorities a general power to sanction all possible breaches of the regulatory framework[120]. This option would also include a clarification of the distinction between the enforcement dimension (e.g. compelling entities to comply with the rules) and the punitive dimension (sanctioning a breach or a misconduct) of sanctioning powers. Lastly, this option would mandate the EBA to harmonise the basis for the calculation of pecuniary sanctions applicable to EU credit institutions (e.g. the total annual net turnover) by means of regulatory technical standards.

Concerning the fit-and-proper framework, this option would introduce harmonised rules for banks by requiring them to carry out an assessment of members of the management body and of key function holders before they take up their positions. This would be mandatory for all the banks in the group in which those persons are supposed to hold their functions. In addition, the option would address the assessment procedure in order to make it more reliable. This would include a specification of competent authorities' powers and processes for the assessment of members of the management body[121] but not for key function holders as this category comprises very different roles[122].

Option 2 - *Ensure a greater level of harmonisation of the provisions on supervisory and sanctioning powers by narrowing down the flexibility of Member States*

This option would go a step further compared to option 1. It would frame the current flexibility of Member States in determining which powers and tools to grant supervisors in national laws.

As regards supervisory powers, based on the notification requirement already foreseen in option 1, option 2 would introduce in the CRD explicit powers for competent authorities to *ex ante* oppose or approve events with prudential relevance (e.g. acquisitions of material holdings, material transfers of assets and liabilities, mergers and demergers).

As regards sanctioning powers, compared to option 1, the list of key CRD/CRR breaches subject to administrative sanctions would be completed based on a risk-based approach[123]. The list of sanctionable breaches would be expanded (e.g. breaches of additional reporting requirements and capital requirements[124] would be included). In this regard, this option would ensure that the breaches to these important regulatory requirements would fall under the scope of the sanctioning regimes of all Member States. Like option 1, this option would introduce a clarification between enforcement and punitive dimension of sanctioning powers. But in addition to that it would grant an additional enforcement tool (periodic penalty

[120] This option would also include a general obligation for Member States to ensure that breaches of all relevant CRD and CRR provisions are sanctioned

[121] For instance, competent authorities should assess them prior to their appointment (and not ex post).

[122] Ranging from e.g. chief financial officers to persons in any other control function.

[123] The additional breaches would concern only elements of the regulatory regime applicable to supervised banks which are, according to national and European competent authorities, as the most sensitive from a prudential perspective.

[124] Financial sanctions would be applicable exclusively to the members of the management bodies of institutions and not to the institutions themselves.

payments[125]) to competent authorities in order to reinforce their ability to ensure a strict application of prudential requirements. Furthermore, this option would include a harmonisation of the definition of total annual net turnover by using the indicator currently used in the calculation of capital requirements for operational risk[126] in order to foster a comprehensive and consistent application of administrative penalties across the EU and ensure comparability of sanctions.

Finally, under this option, the obligation for competent authorities to assess members of the management body and key function holders before they would occupy their positions would be limited to positions in the parent entity and material subsidiaries of large banks only (i.e. those powers would not be extended to small banks) following a risk-based approach. This would allow both supervisors and banks to focus their resources on the most important appointments. As with option 1, EU law would specify the procedural requirements for the fit-and-proper assessment, irrespective of whether the assessment is done ex ante or ex post.

5.2.4. Reduce disclosure costs and improve market access to bank prudential information

Option 1 *- EBA provides a single electronic access to EU banks' quantitative disclosures*

Under this option, the EBA would provide investors and other stakeholders with a single electronic web-based access to quantitative information that EU banks are required to disclose. Specifically, the EBA would publish this information on its website. The data would be sourced directly from the supervisory data that banks are required to report to their competent authorities, with the frequency determined by the disclosure rules. Specifically, they would be sourced from the EUCLID platform which is expected to be launched in 2021. This would be similar to what the EBA does as part of its EU-wide Transparency Exercises. It is important to highlight that the EBA would only provide the platform for the centralised disclosure; the ownership of the data and the responsibility for its accuracy would remain with the banks that produce it. Under this option, any qualitative information that banks have to disclose would not have to be published on the centralised platform; the disclosure of that information would be left to banks to manage.

Option 2 - *EBA provides a single electronic access to EU banks' quantitative and qualitative disclosures.*

Under this option, the EBA would provide investors and other stakeholders with a single electronic web-based access to both quantitative and qualitative information that EU banks are required to disclose. As under option 1, the quantitative information would be sourced from the EUCLID platform. Conversely, the qualitative information would be sent to the EBA by banks. The qualitative information could be simply sent in the format that institutions currently use (e.g. in the form of a pdf document; that document would then be

[125] The institution concerned has to pay a daily amount – up to 5% of its average daily turnover – for every day the infringement continues during a maximum period of six months.
[126] as defined in Article 316 of the CRR

published on the centralised platform). Subsequently, the format could be amended[127] in line with developments related to other initiatives, e.g. the European Single Access Point (ESAP). As under option 1, the ownership of the information and the responsibility for its accuracy would remain with the banks that produce it.

6. WHAT ARE THE IMPACTS OF THE POLICY OPTIONS AND HOW WOULD THEY COMPARE?

In this section, the policy options identified to address each problem in Section 5 are assessed against three criteria:

- effectiveness: the extent to which the different policy options would achieve the objectives;
- efficiency: the analysis of the costs versus the benefits of the different policy options; and
- coherence: the coherence of the different policy options with the overarching objectives of EU policies

Based on the analysis provided, a score is assigned to each policy option for each criterion. This helps to understand the selection of the preferred policy option, i.e. the policy option with the highest overall score.

6.1. Improve the current framework for calculating risk-based capital requirements

As explained in Section 5.2.1, **option 1** would address the main outstanding deficiencies of the prudential framework identified after the GFC, by strengthening the calculation of risk-based capital requirements and ensuring more comparability in this calculation across banks. Despite the ongoing COVID-19 crisis, these reforms are still needed since they address structural shortcomings of the prudential framework. Those shortcomings undermine the reliability of banks' risk measurement and calculation of capital requirements. This can, in turn, have negative consequences on financial stability in situations of future financial crises or wider economic downturns. In its response to the CfA published in December 2020, the EBA showed that the reforms would meet their purposes to reduce the variability across banks' internal models (due to the introduction of new constraints in using internal models) and to provide banks with more risk-sensitive standardised approaches.

However, the implementation of the final elements of the Basel III reform without adjustments would affect the overall level of EU banks' minimum capital requirements. The EBA's updated impact analysis, which uses the latest available estimates (based on Q4 2019 data), confirmed that implementing the final Basel III reforms under option 1 (i.e. in full alignment) would significantly increase the overall minimum capital requirements for EU banks when the reforms apply in full in January 2028 (i.e. once the transitional period would end). By this date, EU banks included in the EBA sample[128] would face an average[129]

[127] Please note that this would not require any changes to the CRR.
[128] 99 EU banks representing 75% of all EU bank assets according to the EBA.
[129] The EBA impact analysis also shows the distribution of banks' individual total impact in minimum capital requirements as a result of implementing the final Basel III reforms under option 1. It can be noted that a quarter

increase of 18.5% in total minimum capital requirements[130], with 13 out of the 99 banks in the EBA sample that would have a combined capital shortfall[131] of EUR 52.2bn, all else equal (see *Table 2*). As shown in

of EU banks in the EBA sample will incur a total impact in minimum capital requirements lower than +2.2%, while another quarter of these EU banks will incur a total impact in minimum capital requirements higher than +20.5%.

[130] The EBA's methodology estimates the impact of the Basel III reforms on EU banks' minimum capital requirements, i.e. taking into account the Pillar 1 minimum requirement, the Pillar 2 requirements and the fully loaded combined buffers requirement.

[131] Banks incurring a capital shortfall as the result of implementing the final Basel III reforms would have to procure collectively that capital amount by the date of application of the reforms to meet the revised minimum requirements introduced by the reforms. The calculation of capital shortfalls in the EBA's methodology therefore does not take into potential capital management buffers that banks often hold in addition to the minimum required capital amount. A potential management buffer could in theory be used to compensate the capital shortfall incurred by the implementation of the final Basel III reforms.

Table **4**, this impact would be driven by the introduction of the output floor (contributing to an average increase of 6.7% in total minimum capital requirements), the revisions to the operational risk framework (+3.8%), the revisions to the credit risk framework (+2.6% for the IRB and +2.4% for the SA) and the revisions to the CVA risk framework (+2.1%).

In the updated impact analysis published in December 2020, the EBA also estimated, based on a smaller sample of 45 banks[132] out of the 99banks of the EBA sample, the total shortfall in eligible liabilities (TLAC and MREL requirements) resulting from the introduction of the final Basel III standard under option 1: between EUR 7bn to EUR 8.6bn (for the purposes of comparison, the combined capital shortfall for these 45 banks represents EUR 41bn out of the EUR 52.2bn combined capital shortfall for the 99 banks of the EBA sample). Naturally, institutions could not only use own funds, but also MREL-eligible instruments to cover this shortfall. It has to be noted, however, that the shortfalls calculated are an approximation and these estimates should be considered with great caution[133].

The impacts of option 1 would be less significant in January 2023, when the revised rules would start to be phased in under the transitional arrangements, mainly due to the lower value of the output floor (i.e. 50%). However, they would remain relatively important: there would be an average increase of 11.8% in total minimum capital requirements, with 10 out of the 99 banks in the EBA sample having a combined capital shortfall of EUR 27.6bn.

Table 3 below highlights the profile of the EU banks that would incur a capital shortfall under option 1. The vast majority of the combined capital shortfall in 2028 is due to those EU banks that would continue to use internal models under the Basel III standards and for which the OF would become the binding capital requirement[134]. It is important to note that the capital shortfall of those banks would build up progressively during the transitional period. In addition, the EBA updated impact analysis published in December 2020 indicates that the combined capital shortfall under option 1 would be concentrated within the largest banks in the EU, while small and medium-sized banks would incur negligible capital shortfalls or no shortfalls at all (as highlighted in Section 2 of Annex 6, capital requirements of small banks would even decrease on average as a result of the reform). Due to their simpler business models and usually very limited use of internal model approaches, small and medium-sized banks would be mainly affected by the revisions to the standardised approach for credit risk. Indeed, for these banks, the impacts of the revision would remain relatively contained, as the increases for some types of credit risk exposures would be offset by capital requirements decreases for other types of credit risk exposures.

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[132] The reduced sample included 45 of the 99 banks of the EBA sample used to calculate the estimates of the final Basel III reforms impacts on own fund requirement, accounting for roughly 85% of the total RWAs of these 99 banks (see Annex 5 of the CfA December 2020 report)

[133] For instance, the calculations do not take into account the significant discretion of a resolution authority to adjust MREL decisions upwards or downwards, which is meant to ensure that MREL remains a bank specific requirement. In addition, any changes introduced from BRRD2 besides the subordination requirements have been excluded from the analysis.

[134] A bank will be bound by the OF where its total minimum capital requirements calculated by its internal models would be lower than 72.5% of its total minimum capital requirements calculated under the standardised approaches, for the same exposures.

Although the updated analysis shows that the overall impacts would decrease compared to the previous EBA impact analysis[135], option 1 would still not meet the specific objective of "no significant increase" in the minimum capital requirements of EU banks. As a consequence, EU banks that would have a substantial capital shortfall under this option might find it difficult over the next few years to build up[136] the amount of capital required under the revised rules, especially in the current low profitability environment. Consequently, EU banks might be obliged to significantly reduce their activities in certain segments, or sell existing assets ("deleverage"), which may be detrimental to the real economy. Therefore, option 1 would not meet one of the general objectives of this legislative initiative, i.e. to contribute to the steady financing of the EU economy in the context of the recovery post COVID 19 crisis.

In the two public consultations launched by the Commission services in 2018 and 2019 on the implementation of the final elements of the Basel III reform, most respondents from the banking sector and some banks' clients raised concerns regarding the increase in capital requirements resulting from the implementation of the reform without any adjustments (see Annex 2 for a full summary of the responses). In its responses to the Commission's CfA on the impact of the reform, the EBA supported the overall implementation of the final elements of the Basel III reform under option 1. While Member States share the overall view that those reforms are necessary to address the outstanding deficiencies of the prudential framework (see Annex 2), some of them also expressed concerns about the impacts if the international standards would be implemented without adjustments.

The introduction of EU specific adjustments in the implementation of the final Basel III reforms as proposed under **option 2** would more than halve the estimated impact of option 1, as shown in *Table 2.* In fact, when the reforms would apply in full in 2028, the estimated average increase in total minimum capital requirements under this option would be between 6.4% and 8.4%, with 10 banks out of 99 banks that would have a combined capital shortfall of less than[137] EUR 27bn. The lower impact of option 2 would be even more pronounced at

[135] In its report published in December 2020, the EBA also provided the impacts on the same sample of 99 banks but based on Q2 2018 data which was used in their previous impact analysis. From Q2 2018 to Q4 2019, the total increase in minimum capital requirements decreased by over 5 percentage points (i.e. from +24.1% to +18.5%), while the capital shortfall across these banks has more than halved (from EUR 109.5 bn to EUR 52.2 bn). According to the EBA, this reduction can be mostly explained by the strengthening in the total capital positions of EU banks between the two dates, but also by the reduction in the overall impact of the output floor for few large banks and the revision of the calibration of the CVA risk framework adopted by the BCBS in July 2020.

[136] Banks can usually build up additional amount of regulatory capital by either retaining more earnings or by issuing new common shares or other forms of regulatory capital. While the former strategy is inherently difficult in a low profitability environment, the later strategy can also be challenging because the future expected profitability of a bank is reflected in its share price. The lower the profitability outlook, the lower the share price and the larger the number of new shares that have to be issued to raise a given amount of capital, making it more difficult to reach a given new issuance target.

[137] The impact of option 2 in terms of % change to the total MRC includes the Commission estimates for some of EU specific adjustments proposed in Section 5.2.1 that the EBA has not been able to quantify in its impact study (see

Table **4** for the breakdown of these estimates). However, the Commission services did not have the ability to reflect these estimates in the TC shortfall under this option which would require to have access to individual banks data. Therefore, the TC shortfall amounts shown in this table, which only reflect the EU specific

the beginning of the transitional period (i.e. in 2023): the estimated average increase in total minimum capital requirements would range between 0.7% and 2.7%, with only 7 out of 99 banks that would have a combined capital shortfall of less than EUR 7.5bn.

adjustments quantified by the EBA, should be interpreted as an upper bound of the actual TC shortfall incurred by banks in the EBA sample.

Table **4** below provides more details on the mitigating impacts of the various EU specific adjustments under option 2 as compared to option 1.

Under option 2, the estimated shortfall in eligible liabilities would also reduce: between less than EUR 2bn and less than EUR 2.01bn for the 45banks analysed.

The introduction of EU specific adjustments would not jeopardise the overall objective of the Basel III reform, i.e. to address the outstanding deficiencies of the prudential framework. At the same time, option 2 would implement the reform in a way that would meet the specific objective of "no significant" increase in capital requirements across EU banks, as highlighted by the above analysis.

To put the capital shortfalls under the two options into perspective, the 99 banks included in the EBA sample held a total amount of regulatory capital worth EUR 1414bn at the end of 2019 and had combined profits of EUR 99.8bn in 2019. Knowing that option 2 would halve the capital shortfalls of EU banks as compared to option 1, these banks would be in a better position[138] to build up the amount of capital required under the new rules over the next few years under option 2, without the need to abruptly reduce their exposures, particularly in certain financing activities that are key to the EU economy.

Option 2 is broadly aligned with the views expressed by the bank respondents to the two public consultations: they also proposed some specific adjustments when implementing the final elements of the Basel III reform in the EU. After a careful assessment, the adjustments that were deemed justified and appropriate have been included under option 2 (e.g. specific treatment for certain equity and specialised lending exposures, postponement of the implementation of the haircut floor framework, etc.). Other EU specific adjustments proposed under option 2 would simply maintain previously agreed rules already catering for EU specificities (e.g. SME supporting factor and the CVA exemptions). Mixed views have been expressed by the EBA, the ECB, Member States and national supervisors during expert group meeting organised by the Commission on the specific adjustments proposed under option 2. The views of Member States generally depended on the extent to which the EU specificities identified in Section 5.2.1 are present in their banking sector.

Table 2: Summary of overall key impact estimates of the final Basel III reforms on EU banks, under both the implementation policy options 1 and 2.

	Impact in 2023 at start of application (beginning of transitional period)		**Impact in 2028 under full application (end of transitional period)**	
	Average % change in total MRC[139]	Combined TC shortfall (in EUR bn)	Average % change in total MRC	Combined TC shortfall (in EUR bn)
Option 1: Full alignment with Basel III standards	+11.8%	27.5	+18.5%	52.2

[138] Banks without capital shortfalls would also be in a better position to maintain their current level of capital ratio over the next few years under option by building the required amount of capital to do so.
[139] Minimum Required Capital.

Option 2: Implementation with EU specific adjustments	Between +0.7% and +2.7%	Below 7.5	Between +6.4% and +8.4%	Below 26.3

Sources: Basel III reforms impact study, EBA, December 2020; European Commission estimates.

Table 3: Number and profile of EU banks incurring a capital shortfall with the full application of the final Basel III reforms in 2028, under the implementation policy options 1 and 2.

Profile of banks incurring a capital shortfall		**Number of banks incurring a capital shortfall (out of 99 banks in EBA sample)**				**Combined TC shortfall (in EUR bn)**			
		In 2023		In 2028		In 2023		In 2028	
		Option 1	Option 2	Option 1	Option 2	Option 1	Option 2	Option 1	Option 2
Using only the standardised approaches		4	4	4	4	0.7	Below 0.6	0.7	Below 0.6
Using internal model approaches	Bound by the OF	0	0	6	4	0	0	42.5	Below 22.4
	Not bound by the OF	6	3	3	1	26.8	Below 6.9	9	Below 3.3
Total		10	7	13	10	27.5	Below 7.5	52,2	Below 26.3

Sources: Basel III reforms impact study, EBA, December 2020.

Table 4: Breakdown of the impacts of the individual elements of final Basel III reforms under options 1 and 2 in 2028[140] and of the individual EU specific adjustments considered under option 2.

	% change in MRC under option 1 (across all risks and per risk type)	**Individual impact of EU specific adjustments under option 2**		**% change in MRC under option 2 (across all risks and per risk type)**
		Quantified in EBA impact analysis (in percentage points (pp))	Not quantified in EBA impact analysis and based on Commission estimates (in percentage points (pp))	
Across all risks	**+ 18.5%**			**Between +6.4% and +8.4%**
Credit risk (=IRB + SA)	**+5% (=2.6%+2.4%)**	SME supporting factor: -2pp	Unrated corporates: -1.5pp Treatment of equities: -1pp	**+0.5%**
Market risk	**+0.8%**			**+0.8%**
Operational risk	**+3.8%**	ILM=1: -2.1pp		**+1.7%**
CVA risk	**+2.1%**	CVA exemption & proportionality: -1.6pp		**+0.5%**
Output floor	**+6.7%**	EU implementation of the output floor: at least[141] - 1pp		**+5.7%**
Other risk (Securitisation and Leverage ratio)	**+0.2%**			**+0.2%**
Broad impact estimates of other adjustments			Market risk (treatment of CIUs and calibration of EU ETS), credit risk (infrastructure supporting factor, specialised lending), the output floor (SACCR calibration in OF) and postponement of minimum haircut floors: -1pp to -3pp	**-1% to -3%**

Sources: Basel III reforms impact study, EBA, December 2020; European Commission estimates.

The above impact estimates provided by the EBA are based on Q4 2019 data. They implicitly[142] assume that the economic activity and EU banks' balance sheets would recover

[140] The breakdown of these individual impacts in 2023 is basically the same, expect the impact of the output floor which reduces to 0% since its lower value of 50% does not bind EU banks.

[141] In the "EU single stack" approach proposed in this note, supervisors will be able to further adjust the overall than was estimated by the EBA in its impact assessment.

[142] These impacts estimates are calculated by the EBA under a 'static balance sheet' assumption, meaning that they only capture the impacts of a change in the prudential framework at the date they have been calculated. Therefore, the impact estimated presented in this impact assessment implicitly assumes banks' balance sheet

to pre-crisis levels by the time the final elements of the Basel III reform would start applying, i.e. by January 2023. However, it cannot be ignored that over this horizon, banks' balance sheets might still be affected by the consequences of the COVID-19 crisis.

To this end, the EBA's updated impact analysis also provides the Commission with a qualitative and a quantitative analysis of the combined effect of the reform and the potential consequences of the COVID-19 crisis over the short-term, i.e. at the start of the application of the reforms in 2023.

First, one key conclusion of the qualitative analysis performed by the EBA is that the effects of the COVID-19 crisis would not necessarily lead to higher capital impacts under the final Basel III standards than they would do under the current prudential framework. Indeed, the EBA expects an increase in banks' capital requirements as a result of the expected deterioration in ratings, higher probabilities of default and higher expected losses caused by the COVID-19 crisis. In the short-term, this increase would occur under the current prudential framework irrespective of whether the final Basel III standards would be implemented and would, to a certain extent, mitigate the capital impact due to the reform. For instance, for banks using internal models under the Basel III standards, the impact of introducing the output floor might be mitigated by an increase in the capital requirements generated by internal models, which might happen in the coming years due to the higher credit risk of banks' borrowers.

Second, the quantitative analysis performed by the EBA defines two hypothetic, adverse economic scenarios which would imply a significant deterioration of the financial situation of EU banks' borrowers over the short-term horizon as a potential negative consequence of the COVID-19 crisis (the two scenarios differ in terms of how severe[143] this deterioration and the resulting increase of their non-performing loans would be, all other risks of EU banks being equal). Under each scenario, the EBA recalculated the average change in the minimum capital requirements and the resulting capital shortfall of EU banks only under option 2 and only in the short-term, i.e.at the start of application of the reforms in 2023.

As compared to the impact of option 2 (i.e. average increase in banks' minimum capital requirements between +0.7% and +2.7% and a combined capital shortfall of less than EUR 7.5bn as shown in *Table 2*), the average increase in banks' minimum capital requirements under the less (resp. more) severe if the adverse economic scenarios in the short-term would go up to between +4% and +6% (resp. +5% and +7%) leading to a capital shortfall of EUR 30.4bn (resp. EUR 59.8bn) .

As recognised by the EBA in its report, the impact estimates under these two adverse scenarios are more significant than using the Q4 2019 data but the assumptions and the

[143] The first adverse scenario applies a stress effect on the EU banks' credit risk provisions and their credit risk capital requirements to all their borrowers, based on the hypothetical shock arising from the 2018 stress test; the second adverse scenario cumulative the stress effect of the first scenario with more specific stress effects applied to bank's exposures from economic sectors that are the most affected by the COVID-19 crisis. This methodology, which has previously been used by the EBA thematic note on the impact of COVID-19 in the EU banking sector published in May 2020 (see https://www.eba.europa.eu/risk-analysis-and-data/risk-assessment-reports), is described in Annex 6.

methodology used by the EBA in these scenarios were very conservative and need to be interpreted with caution. In fact, the EBA methodology uses a stress-testing approach which assumes a simultaneous deterioration in the financial situation of all borrowers of EU banks, i.e. even for those borrowers that do not currently experience difficulties. Second, the higher combined capital shortfall under the adverse scenarios would not be only due to higher capital shortfalls incurred by banks under option 2 based on Q4 2019 data, but also due to more banks that would incur a shortfall under that scenario. Some of the banks that would incur a capital shortfall under the adverse scenarios would also incur a shortfall if the current prudential framework was used instead of the final Basel III standards (the EBA analysis does not disentangle the two effects – the COVID-19 effect and effect of the final Basel III reforms).

Taking into account these caveats, the EBA analysis still provides a useful indication of what the upper bound of the impacts of the final elements of the Basel III reform could be if the financial situation of EU banks were to significantly deteriorate over the next few years. The continuing EBA monitoring of the impacts of the reform on EU banks will be particularly useful to inform EU co-legislators during the first stage of negotiations of this legislative initiative about the evolution of the impacts of those reforms with more concrete first signs of the consequences of the COVID-19 crisis on EU banks' balance sheets.

Option 3 would lead to the same overall impacts on total capital requirements as option 2 but would give EU banks two more years to comply with the new capital requirements. Due to the uncertainty with the evolution of the financial situation of EU banks' clients, as shown in the above analysis, this delay would give banks time to absorb potential losses coming from the most fragile borrowers that are (or will be) affected by the COVID-19 pandemic, while still leaving them enough room to support the financing of the EU economy during the recovery phase.

Option 3 would provide much needed certainty to the banks that the impact of the EU implementation of Basel III is manageable. Banks usually refer to the EBA's estimates on how much capital requirements would increase if the reforms were implemented in full alignment with the Basel III standards. Given the lack of clarity about the EU's implementation approach and missing certainty on the timeline, banks expect a significant increase in capital requirements as a result of the implementation and the most impacted or weakest amongst them could see this as another reason[144] to hold back from using their capital to lend. Coming forward with option 3 for the implementation would signal that the impact would be quite limited and provide certainty for banks' capital planning and lending decisions throughout the recovery phase while reaffirming the EU's international commitment to the Basel III implementation. In addition, clear communication on the difference between entry into force and effective application of the new requirements would

[144] Recent market observations (e.g. ECB's lending survey or EBA's risk and vulnerabilities assessment) indicate that lending conditions remained broadly favourable in 2020 but started to tighten. This is mainly driven by banks' assessment of the risk related to the deteriorating creditworthiness of borrowers affected by the pandemic, whereas banks' capital position remains strong and did not contribute to the tightening. In the Euro area, banks do not expect that regulatory or supervisory action will constrain their capital positions or lead to a decrease in their total assets.

help reinforce the signalling effect. Postponing further, by contrast, would nurture speculations about the EU's commitment to implement the final elements of the Basel III reform, damage the EU's reputation as a reliable partner in international fora/negotiations, and be likely interpreted as a sign that the EU banking sector is too weak to accommodate the Basel III reforms (with potential negative consequences for EU banks' market valuations and funding costs).

In their communications with the Commission, a good part of the banking sector and some of their clients have been asking for a postponement of this legislative proposal implementing the final elements of the Basel III reforms. Option 3, while not entailing further postponement of the legislative proposal, but given the extended implementation timeline, would largely meet this demand. Member States and supervisors were more supportive of the idea of extending the implementation timelines as an alternative to structural deviations from the final Basel III standards. Most Member States and key MEPs have recently restated their support for a timely and faithful implementation of the final Basel III reforms – taking account of EU specificities – notwithstanding the COVID-19 crisis. They expect the Commission to table a legislative proposal by mid-2021.

In light of the above analysis, which led to the overall score of each policy option in *Table 5* below, **option 3** is deemed the preferred policy option to improve the current framework for calculating risk-based capital requirements.

Table 5 : Comparison of policy options against effectiveness, efficiency and coherence criteria

	EFFECTIVENESS	*EFFICIENCY (cost-effectiveness)*	*COHERENCE*	*OVERALL SCORE*
Baseline option	0	0	0	0
Option 1	+	-	+	≈
Option 2	++	+	++	+
Option 3	++	++	++	++

Magnitude of impact as compared with the baseline option (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

6.2. Dedicated capture of ESG risks in the prudential framework

Option 1 would provide incentives for banks to improve the management of ESG risks by reinforcing banks' obligations as regards the management of ESG risks as well as the supervisory review thereof. This would help ensure that banks would be able to handle their exposures to ESG risks more effectively and aligning their investment strategies accordingly, in line with the stated objective pursued by this initiative. In addition, the suggested reinforcement of disclosure requirements would allow market participants to scrutinise the degree of exposure of banks to ESG risks as well as how close those banks are to delivering on any sustainability commitments they had already made (or would make in the future).

By introducing a dedicated review clause to adapt capital requirements based on concrete evidence, option 1 would pave the way for better aligning capital requirements with the riskiness of ESG assets.

Through the envisaged change to bring forward the delivery date for the EBA report, option 1 would allow to minimise delays in effectively addressing any additional underlying problems that the report may identify. At the same time, it would ensure that any changes in capital requirements would be based on adequate evidence, which would be coherent with the principles of risk-based capital requirements and thus the objective of financial stability.

Option 1 would result in some costs for banks as they would have to adapt their risk management systems and processes and collect the necessary data. To the extent that the data must be obtained from customers, the latter would also incur additional costs as a result. Supervisors would incur costs as their supervisory processes would become more complex.

In contrast to option 1, **option 2** would adapt capital requirements based on currently available evidence without awaiting the EBA report on the relative riskiness of exposures. It would thus have the advantage of effectively responding to calls for an early intervention in view of the urgency of environmental (and more broadly sustainability) challenges. However, research on how the riskiness of bank exposures differs based on sustainability criteria is in its early stages and empirical evidence in this area is still limited. The available research is focused on a very narrow subset of bank exposures, namely lending for the financing of the construction/purchase of energy-efficient buildings or for the "upgrading" of energy inefficient buildings. That research provides tentative evidence that such lending may be slightly less risky than "traditional" mortgage lending[145]. At the same time, other research concludes that such differences either do not exist or can be explained by other factors than environmental ones that are correlated with "green-ness", such as income differences between borrowers.

An attempt to introduce changes to capital requirements for ESG risks based on this limited and inconsistent evidence would likely result in an inadequate calibration of such capital requirements. This would be incoherent with the principles of risk-based capital requirements and would negatively impact financial stability in particular if capital requirements for certain exposures were to be too low to cover the real risks. Also, a premature change in capital requirements would entail the risk that new evidence may subsequently emerge that contradicts the assumptions on the basis of which the changes had been made in the first place, thereby creating the need to undo these changes. At the same time, the available evidence does not allow a detailed assessment of the impact that option 2 might have.

Many stakeholders recognise that prudential requirements for banks must reflect ESG risks, with the EBA recommending "to incorporate ESG risk-related considerations in directives and regulations applicable to the banking sector"[146]. This holds true in particular with respect to proposals to strengthen risk management requirements, supervisory review and stress testing as well as disclosure requirements, even though with respect to the latter some stakeholders have cautioned that these must not result in disproportionate costs.

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[145] Does energy efficiency predict mortgage performance?, Bank of England, 2020 (see https://www.bankofengland.co.uk/working-paper/2020/does-energy-efficiency-predict-mortgage-performance).

[146] See the EBA Discussion paper on management and supervision of ESG risks for credit institutions and investment firms.

However, views vary as regards changes to capital requirements based on ESG factors. Banks tend to be open to the idea of lower capital requirements for exposures to sustainable activities and/or products but strongly oppose higher capital requirements for exposures to activities and/or products deemed to be unsustainable. Civil society stakeholders tend to view increased capital requirements for unsustainable activities and/or products more favourably, while some consider that the potential benefit of a decrease in capital requirements for sustainable activities and/or products would be outweighed by a potential negative impact on financial stability. Supervisors consider that any change in capital requirements must be based on solid evidence of risk differentials based on ESG factors, which they do not consider to be available at present.

In light of the above analysis, which led to the overall score of each policy option in *Table 6* below, **option 1** is deemed the preferred policy option to introduce a dedicated capture ESG risks in the prudential framework.

Table 6: Comparison of policy options against effectiveness, efficiency and coherence criteria

	EFFECTIVENESS	***EFFICIENCY (cost-effectiveness)***	***COHERENCE***	***OVERALL SCORE***
Baseline option	0	0	0	0
Option 1	+	+	++	+
Option 2	?	?	?	?

Magnitude of impact as compared with the baseline option (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

6.3. Improve the consistency in the application of supervisory powers

<u>*On supervisory powers*</u>

In relation to supervisory powers, **option 1** would draw awareness across the Union to the importance of assessing prudentially relevant events in a timely manner. The suggested mandatory ex-ante notification, e.g. of a merger, would allow supervisors to be informed at an early stage and to react promptly, if deemed necessary from a prudential viewpoint. Yet, MS would remain free to implement corresponding supervisory powers. The likely effect would be a perpetuation of the absence of equal rules and limitations for several authorities, including the ECB, to intervene *ex ante*. Option 1 would imply some costs for banks in the form of administrative burden (due to the notification obligation) and would for individual banks depend on whether *ex ante* notification obligations already exist in the relevant MS. However, the materiality thresholds for notifications included in this option would limit those costs, as only event exceeding the thresholds would need to be notified.

On the supervisory powers and procedures concerning the suitability assessment, option 1 would mean assessing *ex ante* all members of the management body by the competent authorities, without considering the characteristics of banks or of the different entities within the group in which those persons hold their functions. While this would ensure a high degree of harmonisation, it would require significant additional efforts from authorities that currently perform *ex-post* assessments, notably to the numerous small banks in their supervisory remit.

By contrast to option 1, the harmonisation of supervisory powers in EU law as suggested in **option 2** would achieve a level playing field, endowing all competent authorities with sufficient capacity to react to prudentially relevant events. It would impact to a different extent banks and supervisory authorities, depending on whether supervisory powers[147] and *ex ante* notification obligations already exist and how they are designed. The incurred costs would in most cases remain ultimately less important than those for *ex-post* supervisory assessments. As in the case of option 1, the costs would be contained due to the materiality thresholds.

As regards the fit-and-proper assessment, under option 2, the *ex-ante* assessment would be introduced only for members of the management body in the parent entity and in material subsidiaries of large banks. Competent authorities would therefore be able to continue *ex-post* assessments for smaller banks which would entail no additional costs. Option 2 would extend the scope to key function holders and require competent authorities to assess them ex ante for the same type of entities as for the members of the management body. The proposed framework would also provide further specifications concerning the supervisory procedures for the assessment of both, board members and key function holders. Furthermore, it would set out criteria for carrying out the assessment of key function holders[148].

Overall, option 2 would achieve a more balanced reform of supervisory powers than option 1. It would ensure a sufficient level of supervisory convergence and keep the administrative burden to a reasonable level.

On sanctioning powers

Option 1 would clarify the distinction between enforcement measures and sanctioning tools for supervisors. This clarification would leave nonetheless an important discretion to Member States to introduce or not additional enforcement[149] and sanctioning powers in their national laws.

Furthermore, option 1 would achieve a significant increase of the harmonisation of sanctioning powers by introducing a general power for supervisors to sanction all potential breaches of the regulatory framework. However, this option might create legal uncertainty as regards its application. A generic clause might not be effective when breaches of a bank are not identified by national and European supervisors under a common standard. In addition, some Member States impose the obligation to state the breach for which a sanction is applicable[150]. Therefore, introducing a general sanctioning power could potentially raise constitutional issues in some Member States[151].

Finally, under option 1 the basis for the calculation of pecuniary measures imposed on EU banks to sanction breaches would be specified by MS, agreeing on a common definition in a

[147] Most MS have already provided their supervisors with at least some approval powers.
[148] Article 91 of Directive 2013/36/EU already provides criteria for assessing the members of the management body.
[149] The possibility for supervisors to impose periodic penalty payments applicable to credit institutions breaching their regulatory requirements
[150] It is the case especially if the breach would lead to financial penalties
[151] In some Member States, it would not be possible to introduce such general administrative sanctioning power because national laws already foresee criminal sanctions for such CRD/CRR breaches

Level 2 text (e.g. Regulatory Technical Standards) that could leave some additional flexibility.

None of the above elements is expected to lead to undue increases in costs for either banks or their supervisors[152].

Option 2 would provide more legal certainty as regards breaches that would be sanctioned than option 1. MS would implement an identical list of key CRD/CRR requirements, which would eliminate inconsistencies as regards the scope of sanctioning powers of the competent authorities. This option considers the proportionality principle. It increases the level of harmonisation as regards sanctioning powers without leaving supervisors and credit institutions with legal uncertainty which is the case for solely generic sanctioning powers under option 1.

Like under option 1, all the important breaches would be subject to administrative sanctions by supervisors and clarifications would be provided on the articulation between enforcement and punitive measures taken by supervisors. However, option 2 would go beyond option 1 by providing an additional enforcement tool to supervisors in the form of periodic penalty payments).

Finally, option 2 suggests a harmonisation of the calculation of pecuniary sanctions based on the notion of total annual net turnover. The use of total annual net turnover as a criterion would benefit from a clarification on the highest level of the EU legislation (e.g. CRD), compared to option 1 (Regulatory Technical Standards).

Similarly to option 1, the changes contemplated under option 2 would not lead to undue increases in costs for banks or for their supervisors (for the latter, the sanctioning procedures could stay unchanged, it is only the scope of breaches to which those procedures would apply that would be expanded).

* * *

Most stakeholders acknowledge that differences in the powers available to supervisors and their application across MS are contrary to the level playing field principle and effective supervision. While supervisors (in particular the ECB) and civil society stakeholders highlight the prudential risks and the uncertainty resulting from the lack of certain powers, definitions and common procedures, the banking industry is concerned about possible distortions to the competition across MS and notes that the status quo would prevent groups from reaping the synergies expected from cross-border acquisitions.

As regards concrete policy options to address the problems, the views of MS and supervisors are largely correlated with their current practices. In particular, those being home and/or predominantly in charge of smaller banks are concerned about potentially increased administrative burden. Their support is hence conditional on the introduction of materiality thresholds which would exempt a significant number of events and the provision of targeted flexibility (particularly regarding the scope of *ex-ante* fit-and-proper assessments) allowing

[152] Under this new regime banks could be hit by sanctions for certain breaches, which would of course represent a cost for those banks. However, those costs are not considered as undue.

for risk-based adjustments as envisaged under option 2. Some MS and the majority of banks, by contrast, prefer limiting the flexibility left to MS and supervisors to the extent possible.

In light of the above analysis, which led to the overall score of each policy option in *Table 7* below, **option 2** is deemed the preferred policy option to improve the consistency in the application of supervisory powers

Table 7 : Comparison of policy options against effectiveness, efficiency and coherence criteria

	EFFECTIVENESS	*EFFICIENCY (cost-effectiveness)*	*COHERENCE*	*OVERALL SCORE*
Baseline option	0	0	0	0
Option 1	+	+	+	+
Option 2	++	++	++	++

Magnitude of impact as compared with the Baseline option (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

6.4. Reduce disclosure costs and improve market access to bank prudential information

Both options would increase the efficiency and effectiveness of disclosures, particularly for small and non-complex banks. These banks would be relieved from the burden to prepare disclosures of prudential information[153], which will be disclosed centrally based on prudential information provided to supervisors. For other banks, the benefits from option 1 may be limited: given that they would still need to manage their disclosures of qualitative information, they may simply decide to continue disclosing the required qualitative and quantitative information as they currently do. At the same time, option 1 would not entail any additional costs for those banks, nor it would entail any additional costs for banks or supervisors more in general as changes to their existing systems would not be required.

For other stakeholders (e.g. investors, academics) **option 1** would achieve all benefits associated with a single, free access point to prudential data (i.e. quantitative information) on all EU banks. It would allow them to undertake a meaningful analysis across EU banks. The disadvantage (but not associated with additional cost) of this option for these stakeholders would be that in order to access banks' qualitative information, they would still need to gather it from the websites of individual banks like they currently do.

Option 2 would entail the same benefits as option 1. In addition, it would eliminate all its drawbacks: all banks would be able to use the centralised platform for all their disclosures (and hence avoid duplication), while the other stakeholders would have a single point of access to those disclosures.

In light of the above analysis, which led to the overall score of each policy option in *Table 8* below, **option 2** is deemed the preferred policy option to reduce disclosure costs and improve market access to bank prudential information.

[153] Following the amendments to the disclosure rules introduced by the CRR II, small and non-complex banks are required to disclose quantitative information only.

Table 8 : Comparison of policy options against effectiveness, efficiency and coherence criteria

	EFFECTIVENESS	*EFFICIENCY (cost-effectiveness)*	*COHERENCE*	*OVERALL SCORE*
Baseline option	0	0	0	0
Option 1	+	+	+	+
Option 2	++	++	+	++

Magnitude of impact as compared with the Baseline option (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

7. PREFERRED POLICY OPTIONS

7.1. Effectiveness

The implementation of the final elements of the Basel III reform under the preferred policy option will address the shortcomings of risk-based capital requirements under the prudential framework that have been identified during the GFC. This will ensure an accurate measurement of risk and an adequate capitalisation of institutions which will in turn ensure financial stability. A more stable and resilient EU banking sector will, in turn, effectively strengthen the trust of global financial markets and international partners in the EU financial system.

The preferred option will also take due account of the specificities of the EU banking sector through a number of specific adjustments to the Basel III standards as well as a longer implementation timeline of the reforms. In this way the preferred option will most effectively help to mitigate the risk associated with a sharp increase in capital requirements for institutions, especially in view of the COVID-19 –crisis. This will ensure a smooth provision of essential financial services to the EU economy during the recovery phase and in the long term.

The preferred policy option will enhance the focus on ESG risks in the prudential framework with a dedicated approach to capture those risks. Improved management of ESG risks will ensure that institutions will be better prepared to withstand those risks, in particular risks due to climate change. Moreover, the explicit reference to ESG risks in the supervisory framework will increase supervisors' focus of those risks. Finally, the enhanced transparency about institutions' exposures to those risks will give markets the necessary tools for an effective monitoring of the sustainability of institutions' activities. The combination of these measures will create the necessary incentives for institutions to allocate more financing to more sustainable investments.

The preferred policy option regarding supervisory and sanctioning powers will further harmonise and strengthen the toolkit available to supervisors across the Union, improving the robustness, application and enforcement of the prudential framework applicable to institutions. By strengthening supervisors' powers to ensure institutions' compliance with the prudential framework across the Union, and by giving supervisors the necessary powers to intervene in transactions that can have a significant prudential impact on institutions, the preferred option will ensure a more effective supervision of institutions and therefore a safer banking sector.

Next to supervision, scrutiny by market participants and other stakeholders constitutes another important control mechanism in the prudential framework. The effective functioning of this mechanism is conditional upon the transparency of banks' activities, their financial position and the risks they face. The preferred policy option would ensure that information (i.e. qualitative and quantitative) that institutions have to disclose would be easily accessible in one place and would be easily comparable, thus enhancing the ability of clients, investors and other market participants to monitor and exert market discipline on institutions.

7.2. Efficiency

The preferred policy option will achieve the desired objectives with enhanced efficiency. By adapting the final Basel III framework to several specificities of the EU banking sector, the preferred option would avoid disproportionate capital requirements for certain financial products or activities provided by banks and are essential to the EU economy. Without adapting the Basel III standards to EU specificities, the resulting increase in capital requirements would likely be significant, resulting in higher costs for institutions' clients, including SMEs. This could ultimately undermine the clients' economic activities or capacity to hedge their financial risks. The proposed two-year postponement of the date of application of the final elements of the Basel III reform in the preferred policy option will enable banks to support the recovery post COVID-19 crisis over the short- to medium-term whilst providing EU banks with regulatory certainty early on, thereby allowing for proper planning and a smooth implementation of the revised prudential framework.

The preferred policy option to address ESG risks will provide the necessary incentives for banks and, indirectly, their clients to take due account of the sustainability of their economic activities and will therefore ensure a more efficient allocation of economic resources. This will, in turn, support the effort to transform the EU economy into a resource-efficient, sustainable and competitive economy.

As regards supervisory and sanctioning powers, the preferred option addresses the current fragmentation of supervisory powers by ensuring that scarce supervisory resources are used in the most efficient way. This is done by allowing supervisors to focus only on events that can materially affect the prudential standing of banks. While the preferred policy option involves an increase in costs for at least some supervisors (especially for those that currently do not have the powers that would be introduced under the preferred option) and the banks they supervise, the increase in costs is limited (due to the in-built proportionality of the rules that focuses only on material events). The costs would be outweighed by the benefits of more harmonisation which will contribute to levelling the playing field in the single market and render supervision in the Banking Union more efficient.

Finally, under the preferred policy option for the disclosure of prudential information, banks will benefit from a more efficient system that integrates supervisory reporting and disclosure, and thereby reduces their administrative burden. At the same time, access to bank data for stakeholders will become more efficient as all the relevant information will be available in one place.

7.3. Coherence

In addition to the effectiveness and efficiency of the preferred policy options chosen to address the problems identified, the preferred options shall be coherent with each other as well as the whole package with other policy initiatives at EU level.

The prudential framework for banks in the Union consists of three main pillars, each of which plays a distinct, key role in ensuring the stability of individual institutions and the banking sector as a whole. The preferred policy options propose changes to each of these pillars, which will increase the coherence of the overall framework.

The first pillar consists of minimum capital requirements, in the form of quantitative and qualitative rules. In 2013, in the wake of the GFC, these rules were moved from a Directive to a Regulation to form a "Single Rule Book", and a large number of national options and discretions was removed. This change improved the uniformity of application of minimum capital requirements in all MS, closed regulatory loopholes and thus contributed to a more effective functioning of the single market for banking services. The current proposal further improves the consistent application of these rules by limiting banks' freedom in calculating their capital requirements; this will make capital requirements and reported capital ratios more comparable across the Union.

The second pillar consists of the supervisory review of banks' activities and risks. This review is crucial to ensure a consistent application of the prudential framework, in particular in the Banking Union. However, where powers and tools made available to supervisors in conducting this review differ across the Union, prudential rules are often applied inconsistently. The preferred options will address shortcomings in respect of strengthening supervisory powers and the sanctioning of breaches.

The third pillar consists of market scrutiny. For banks to be subject to comparable levels of scrutiny, stakeholders must have access to comparable information. The preferred policy options will improve such access and will also increase the comparability of the disclosed information.

Furthermore, the preferred policy options are coherent with other policy initiatives at EU level, in particular:

- The Banking Union aims to increase financial integration and stability in the Economic and Monetary Union. Common supervision is a central element of the Banking Union. However, where the ECB exercises direct supervisory powers set out in national law transposing the CRD, the ECB does not have the same range of powers with regard to all banks under its supervision because of differences in the transposition. This impinges on attaining the objective of efficient and harmonised supervision within the Banking Union. The present initiative aims at addressing some of these obstacles.

- The CMU aims to improve the access to financing for companies and projects across the Union. This overall aim is coherent with the general objectives of the present initiative, whereas the specific measures are complementary: banking regulation mostly relates to bank financing, while CMU mostly concerns non-bank financing. This initiative takes

into account the fact that EU banks also play a role in facilitating companies' access to financial markets, and ensures, by considering EU specificities, that the proposed measures do not unduly constrain this important role of banks.

- The EGD Communication announced that environmental risks would be better integrated into the EU prudential framework, and that the suitability of the existing capital requirements for green assets would be assessed. The present initiative puts this announcement into practice. It will help ensure that the banking sector can play an appropriate role in achieving the ambitious aims of the EGD.

- The ESAP aims at providing investors with easy access to regulated financial information of companies listed on the EU's regulated markets. Although the scope of this initiative is different from the scope of the ESAP, the aim of the two is fully compatible. Depending on the final design of the ESAP, the EBA centralised disclosure platform could either feed information into the ESAP or the ESAP could provide a gateway to the information stored on the EBA platform.

7.4. REFIT (simplification and improved efficiency)

This initiative is aimed at completing the EU implementation of the international prudential standards for banks agreed by the BCBS between 2017 and 2020. It would complete the EU implementation of the Basel III reform that was launched by the Basel Committee in the wake of the GFC. That reform was in itself a comprehensive review of the prudential framework that was in place before and during the GFC, namely the Basel II framework (in the EU that framework was implemented through Directive 2006/48/EC, i.e. the original CRD). The Commission used the results of that review, together with input provided by the EBA and other stakeholders, to inform its implementation work. A fitness check or refit exercise of the EU implementation of the Basel III reform has not been carried out yet because all the elements of the reform need to be put in place before one can be carried out.

Implementing the final elements of the Basel III reform with the EU specific adjustments envisaged under the preferred option would simplify the risk-based capital framework, notably by removing more complex internal models approaches to calculate capital requirements in for operational and CVA risks and by limiting the scope of internal models for credit risk. This would positively impact the recurring administrative and operational costs of EU banks (see Section 1 of Annex 6) and facilitate their supervision.

In relation to disclosure, this legislative initiative would introduce measures to reduce redundancies in respect of information reported to supervisors and disclosures to markets by centralising disclosures via a European data infrastructure based on supervisory reporting data. This would contribute to a reduction in the administrative burden of banks, in particular small ones.

8. HOW WILL ACTUAL IMPACTS BE MONITORED AND EVALUATED

The changes contained in this legislative initiative would start applying in 2025 and become fully applicable in 2030. After that date, an evaluation of the reform will be carried out in principle three years after the latter date.

The below *Table 9* presents some indicators that would help the Commission to monitor and evaluate the effectiveness and the appropriateness of the proposed preferred policy options to achieve the specific objectives mentioned in Section 4, based on the data/information available. The Commission will mostly use data/information from the European Supervisory Authorities (the EBA, the ESMA and the ESRB), the national supervisory authorities and the ECB/SSM, the BCBS, and other market data indicators to monitor and evaluate the impacts of the proposed preferred policy options.

Table 9: Summary of indicators to monitor and evaluate the impacts of the preferred policy options

Objectives	Indicators	Target	Source of information/data
Strengthen risk-based capital framework, in the context of the recovery from the COVID-19 crisis	EU banks' revised minimum capital requirements and capital ratios under the preferred option for implementing the final Basel III reforms	No significant increase in the revised capital requirements over time Gradual increase in the revised capital ratios to comply with the revised requirements over time Banks more resilient to shocks in the future EU stress test exercise	EBA Basel III monitoring exercises EBA stress testing
	Variability metrics in risk weighted assets calculated by internal model approach for market and credit risks	Share of explained variability to increase from current level.	EBA benchmarking exercise reports on market and credit risk internal models
	Volume of exposures subject to standardised approaches, in particular those for which this legislative initiative introduces EU specific adjustments	No significant decrease in the share of key EU banks' activities compared to the total volume of banks' activities.	EBA/ECB/SSM reports
	EU banks' market valuations	No significant decrease in banks market valuations from current level	Market data providers
Incorporate sustainability risks in the prudential framework	Share of banks capturing ESG factors for risk management purposes	Increase in the share of banks capturing ESG factors for risk management purposes	EBA/ECB/SSM supervisory reports and public disclosure information
	Share of banks providing disclosure on ESG risks to stakeholders	Increase in the share of banks providing disclosure on ESG risks to stakeholders	EBA/ECB/SSM supervisory reports and public disclosure information EBA report about integration of ESG risks
Further harmonise supervisory	Number of material acquisitions of holdings by a bank to which the competent authority opposed	Limited number of opposition from competent authorities as institutions gives sufficient importance ex ante, when	EBA/ECB/SSM supervisory reports and public disclosure

powers and tools		assessing the opportunity of a material acquisition of holding, to the prudential concerns the operation could raise.	information
	Number of material transfers of assets and liabilities to which the competent authority opposed	Limited number of opposition from competent authorities as institutions gives sufficient importance ex ante, when assessing the opportunity of a material transfer of assets or liabilities, to the prudential concerns the operation could raise.	EBA/ECB/SSM supervisory reports and public disclosure information
	Percentage of decisions related to mergers or demergers to which the competent authority opposed	Limited number of opposition from competent authorities as institutions gives sufficient importance ex ante, when assessing the opportunity of a merger/demerger, to the prudential concerns the operation could raise.	EBA/ECB/SSM supervisory reports and public disclosure information
	Number of breaches effectively sanctioned and corresponding sanctions	Increase in the number of breaches sanctioned by competent authorities that do not yet possess the new sanctioning powers	EBA's central database of administrative penalties and EBA's lists of published sanctions ECB's list of published sanctions
	Number of fit-and-proper assessments	Increase in share of ex-ante fit-and-proper assessments performed by competent authorities Reduction in assessments taking longer than six months	EBA/ECB/SSM reports on fit-and-proper assessments
Reducing disclosure costs and improving market access to bank prudential information	Annual volume of visitors and downloads from the newly centralised disclosure platform	Gradual increase in visits to and downloads from the platform within the first 5 years of its introduction	EBA centralised disclosure platform reports