



EUROPEAN COMMISSION

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Call for advice to the EBA on the implementation of the final Basel III reforms in light of the impact of the COVID-19 pandemic

Context

As part of their preparatory work for the implementation of the final Basel III reforms, on 4 May 2018 the Commission services sought technical advice from the European Banking Authority (EBA) on the potential impact of these reforms on the EU banking sector and the wider EU economy. Furthermore, the EBA was invited to opine on whether, looking at the EU banking sector as a whole, any significant shifts to or from certain types of activities, exposures, business lines or business models would be expected following the introduction of any of the reforms.

The EBA submitted its advice in two parts, on 5 August 2019¹ and on 4 December 2019², respectively. The advice included a detailed quantitative impact assessment and a set of policy recommendations. The impact assessment was based on QIS data as of end of Q2 2018, which had been collected as part of the extended version of the regular Basel III monitoring exercise.

Over the past few months, the COVID-19 pandemic and the associated containment measures have caused a severe economic shock. A number of exceptional measures have been put in place at Union, Member-State and international levels to enable banks to play a key role in managing that shock, as highlighted in the Commission Interpretative Communication of 28 April 2020³. These measures help the banking sector effectively channel funds to businesses and households and prepare for a swift economic recovery. However, institutions in the Union will inevitably be affected by the financial difficulties experienced by their most vulnerable clients and the increased volatility in financial markets. In this context, structural changes in institutions' balance sheets and hence in their risk profiles can be expected.

¹ The first part covered the areas of credit risk, operational risk, securities financing transactions and output floor.

² The second part covered the areas of market risk and credit valuation adjustment risk standards, as well as a macroeconomic impact assessment (which was carried out in cooperation with the ECB).

³ Communication from the Commission to the European Parliament and the Council - Commission Interpretative Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending - Supporting businesses and households amid COVID-19, COM(2020)169 of 28.04.2020.

As part of the COVID-19 crisis response at international level, the Basel Committee on Banking Supervision (BCBS) agreed to delay the deadline for the implementation of the final Basel III standards by one year to 1 January 2023 in order to free up the operational capacity of banks and supervisors during the COVID-19 crisis.⁴ In line with that extension, the Commission revised its planning for the implementation of the final Basel III reforms in the Union.

As part of the preparatory process, and in light of the recent market information and international developments, the Commission services are inviting the EBA to update its previous advice on the various elements of the final Basel III reforms package, taking into account also the impact of the COVID-19 crisis on the EU banking sector and the wider economy. The Commission will consider the results of this updated advice to account for the impact of the COVID-19 crisis on institutions' financial situation when preparing the impact assessment that will accompany the legislative proposal on the final elements of the Basel III framework.

Scope of the EBA's work

1. General considerations

Given this context, the Commission services would like to invite the EBA to provide all information considered relevant to inform the Commission's decision on the implementation of the final Basel III reforms.

In particular, the EBA is invited to update the individual impact on institutions from introducing each of the key elements of the Basel III reforms in EU legislation (as set out in more detail in the specific sections below) as well as the cumulative impact of all those elements.

The impact should be assessed in comparison with the situation under existing EU legislation applicable at the assessment date as specified below, defining the general "baseline" for the comparison, unless specified differently in the following sections. In comparison to this baseline, the EBA is invited to provide estimates for the individual and cumulative impacts of the abovementioned reforms under two different scenarios for the implementation of the final Basel III reforms in EU legislation, as assessed by the EBA in the first two advices:

- a first reform scenario under which the final Basel III reforms are implemented in EU legislation in full alignment with the Basel standards and within the indicative BCBS timelines for implementation (i.e. 1 January 2023 with a phase-in arrangement for the implementation of the output floor until 1 January 2028);
- a second reform scenario, under which the final Basel III reforms are implemented in EU legislation within the same indicative timelines as the first reform scenario but including a number of adjustments to take into account EU specificities, namely:

⁴ See press release "Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19", 27 March 2020, available at: <https://www.bis.org/press/p200327.htm>.

- maintaining the supporting factors for exposures to SMEs and infrastructure finance;
- maintaining the exemptions from the own funds requirements for CVA risks;
- reusing the eligibility criteria of the Original Exposure Method for the eligibility criteria of the simplified method for the own funds requirements for CVA risks;
- exercising the discretion to set the historical loss component equal to 1 on the own funds requirements for operational risk, either:
 - permanently for buckets 2 and 3 banks only; or
 - as a phase-out arrangement, aligned with the phase-in period for the output floor, in which the discretion would be applied at the beginning of the phase-in period for buckets 2 and 3 banks only but would be then linearly phased-out until the end of the phase-in period.

When assessing the impact of the two reform scenarios, the EBA should, on a best efforts' basis, reflect the effects of the recent COVID-19 related amendments to the CRR⁵ to the extent they would still affect the regulatory capital amounts and risk weighted assets of institutions at the indicative date of application of the final Basel III reforms. This would include, but not be limited to, the transitional arrangement for IFRS 9 provisions, the treatment of NPL minimum required provisions for the loans guaranteed by Member States and the treatment of central bank reserves in the leverage ratio. Where data limitations exist that would not allow the EBA to reflect the effects of those COVID-19 related amendments on the regulatory capital amounts and risk weighted assets, the EBA is invited to provide instead a qualitative assessment of these effects.

The EBA should strive to use all available data and information to ensure a comprehensive response to this call for advice, while considering the feasibility and burden of new data requests. In particular, the EBA is expected to only use data from exercises already scheduled in the EBA work programme without requiring any new data collection.

In light of the above considerations and taking into account the updates to the EBA work programme following the COVID-19 pandemic, the EBA is invited to provide its impact analysis based on the submissions that institutions in the Union made in the context of the regular Basel III monitoring exercise using end of Q4 2019 data⁶. Whenever Q4 2019 data and impacts are not available, the EBA is invited to base its analysis on the data and impacts already provided to the Commission as part of the first two advices. The EBA should clearly indicate all those instances.

The EBA's analysis should cover both the impact in terms of changes to the own funds requirements and, on a best efforts basis, to the eligible liabilities requirements of

⁵ https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2020.204.01.0004.01.ENG& toc=OJ:L:2020:204:TOC

⁶ 31 December 2019 would therefore be the reference date of the updated impacts

institutions. More specifically, these impacts should be expressed in terms of absolute changes to the amounts of risk-weighted assets (RWAs), capital ratios (CET1, Tier 1 and total capital), relative changes to Tier 1 minimum required capital (MRC) and inter-quartile distribution of those changes for the sample and any resulting shortfalls in own funds/eligible liabilities, if applicable. In this context, the EBA is invited to consider all risk-based own funds and buffer requirements (i.e. Pillar 1, Pillar 2 and combined buffer) as applicable under the CRR and CRD as well as the MREL/TLAC⁷ requirements.

In addition to the aggregated possible shortfall in own funds/eligible liabilities, the EBA is also invited to provide the following information with regard to possible shortfalls:

- the number of institutions that would incur a shortfall according to the impact analysis and the inter-quartile distribution of the shortfalls of those institutions expressed as a percentage of their capital amounts at the assessment date;
- a breakdown of institutions that would incur a shortfall in three categories: (i) institutions solely using the standardised approaches available in the final Basel III framework; (ii) institutions using internal models available in the final Basel III framework and not bound by the output floor (iii) institutions using internal models available in the final Basel III framework and bound by the output floor (for each category, the EBA should provide the total number of institutions in shortfall and their total shortfall amounts).

The EBA is invited to provide the abovementioned cumulative impact of the implementation of the final Basel III reforms at the beginning and at the end of the phase-in period for the implementation of the output floor, separately.

To illustrate the representativeness of the sample, the EBA is invited to provide, on a best efforts' basis and at the assessment date, a comparison between:

- the number of institutions per Member States included in the EBA sample used for this Call for advice and the total number of institutions in those Member States;
- the aggregated capital amounts held by institutions included in the EBA sample used for this Call for advice and the aggregated capital amounts of all institutions in the EU;

To present the abovementioned impact, the EBA is invited to use the same breakdowns already used in the first two advices with respect to the size, location and business model of the institutions, where relevant.

The EBA is invited to explain, on a best efforts' basis, the main drivers behind at least the most significant individual and cumulative impacts of the reforms. The EBA may complement the quantitative analysis requested as part of this Call for Advice with qualitative analysis, where possible.

⁷ Respectively, the Minimum Requirement for own funds and Eligible Liabilities and the Total Loss-Absorbing Capacity.

2. Specific considerations

2.1. Specific policy issues

2.1.1. Final CVA risk framework

On 08 July 2020, the BCBS published⁸ a number of final adjustments to the CVA risk framework as part of the final Basel III reforms. Using available data, the EBA is invited, on a best efforts' basis, to reflect these final standards in the assessment of the individual impact of this element of the reform, as well as in the assessment of the cumulative impact of the final Basel III reforms. Both assessments shall be carried out under the two reform scenarios requested in the general considerations section.

The analysis should also provide a qualitative assessment of the implementation in EU legislation of the final adjustments to the CVA risk framework, particularly for those adjustments, which could not be reflected in the impacts due to data limitation.

2.1.2. Output Floor

The Commission seeks a comprehensive overview of the impact of the different options considered for implementing the output floor. The EBA is therefore invited to provide the individual impact for the implementation of each of the three options identified in its separate 2019 advice on the implementation of the output floor⁹. The cumulative impact of the final Basel III reforms should also be determined for each of those options under both the first and the second reform scenarios described in the general considerations section.

Furthermore, the EBA is invited to explain, on a best efforts' basis, the main drivers behind the impact for each option.

2.2. Impact of the COVID-19 pandemic on the final Basel III reforms

The requested update to EBA's previous analysis, described in the general considerations section would provide a more accurate overview of the impacts of implementing the final Basel III reforms based on the situation just before the outbreak of the COVID-19 pandemic. These impact estimates could be interpreted as a "V-shaped" recovery scenario for the EU economy and the banking sector: it would be assumed that, by the application date of the final Basel III reforms in the EU, the market conditions and institutions' balance sheets would return to pre-COVID-19 crisis levels.

⁸ <https://www.bis.org/bcbs/publ/d507.htm>

⁹ <https://eba.europa.eu/sites/default/documents/files/documents/10180/2886865/d00198e3-82ab-4bc8-bb4b-8d95e7e777c1/Policy%20Advice%20on%20Basel%20III%20Reforms%20-%20Output%20Floor.pdf>

However, the recovery of the EU banking sector from the consequences of COVID-19 crisis may take more time than expected. Over the coming years, prolonged adverse economic conditions may lead to significant structural changes in institutions' balance sheets and hence in their risk profiles¹⁰. The relevant data observed¹¹ for the first half of 2020 already indicates developments in this direction.

Uncertainty about the exact form and the pace of recovery seems to be inevitable at this stage. To ensure that the Commission has the most comprehensive set of information for assessing sound policy choices, the EBA is invited to complement its analysis with an assessment of the cumulative and, where relevant, the individual impact of the final Basel III reforms (i.e. impact on each key element of the reforms separately), assuming a situation where the effects of the COVID-19 crisis on the EU banking sector would be prolonged beyond the envisaged date of application of EU legislation implementing these revisions.

The EBA should present this second set of impacts in line with the specifications described in the general and specific considerations sections of this Call for advice, where the impacts are sufficiently representative.

To estimate the impacts from the prolonged effects of the COVID-19 crisis at the indicative date of application of the final Basel III reforms (i.e. 1 January 2023), the EBA should take as a starting point the impacts available in the Q4 2019 regular Basel III monitoring exercise and apply a number of hypothetical assumptions about the evolution of institutions' risk profiles and the application of capital relief measures put in place by Member States and competent authorities. In order to perform this analysis, the EBA would need to build on all available data sources that already show first signs of the effects of the COVID-19 crisis, including the individual data received as part of the supervisory reporting under the current prudential framework as of Q2 2020 (COREP and FINREP).

The EBA is invited to take into account, on a best efforts' basis, the following hypothetical assumptions to estimate those impacts:

- a potential increase in credit risk RWA due to a deterioration in the asset quality of institutions' loan portfolios;
- a potential increase in credit risk provisions, due to higher expected credit losses (ECL) on institutions' loan portfolios. To estimate this impact, the EBA should consider, where possible, the application of stressed transition rates between the three stages of IFRS9 (i.e. stressed flows for the existing credit risk exposures from a less risky stages into riskier stages);

¹⁰ In its thematic note published in May 2020, the EBA expect that banks would likely face growing NPL volumes, particularly on small and medium-sized enterprises (SMEs) or consumer financing, and rising cost of risk amid the prospective macroeconomic deterioration. The decline in asset quality of EU banks might be accompanied by rising risk-weighted assets (RWA). See Thematic note: Preliminary analysis of impacts of COVID-19 on EU banks, EBA, May 2020, available at <https://eba.europa.eu/covid-19-placing-unprecedented-challenges-eu-banks>.

¹¹ In addition to the EBA thematic note, see also Financial Stability Review, ECB, May 2020, available at <https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202005~1b75555f66.en.pdf>.

- any changes in the amounts of regulatory own funds that would have occurred between Q4 2019 and Q2 2020;
- the measures put in place by Member States and competent authorities to relieve institutions from specific capital buffer requirements (e.g. reduction in countercyclical, systemic and O-SII buffers) if these measures were to be maintained.

Where assessing the impact of the two reform scenarios, the EBA should, on a best efforts' basis, reflect the effects of the recent COVID-19 related amendments to the CRR¹² to the extent they would still have an effect on the regulatory capital amounts and risk weighted assets of institutions at the indicative date of application of the final Basel III reforms. This would include, but not be limited to, the transitional arrangement for IFRS 9 provisions, the treatment of NPL minimum required provisions for the loans guaranteed by Member States and the treatment of central banks reserves in the leverage ratio. Where data limitations would not allow the EBA to reflect the effects of those COVID-19 related amendments on the regulatory capital amounts and risk weighted assets, the EBA is invited to provide instead a qualitative assessment of such effects.

3. Final considerations

The Commission is aware that time and resource considerations may constrain the EBA from delivering certain aspects of the analysis requested in this Call for advice. Should this be the case, the EBA is invited to highlight any limitations and omissions in its final report.

The EBA is asked to share the relevant bank data related to the impacts of the final Basel III reforms with the European Central Bank (ECB) in order to allow the ECB to update in a consistent manner the macroeconomic impact assessment originally published as part of the EBA's second advice on the implementation of the final Basel III reforms in the Union.

The Commission recalls that the analysis provided by the EBA will not prejudice the Commission's final decision on a legislative proposal. Moreover, in line with the established practice of discussions with the Expert Group on Banking, Payments and Insurance, the Commission will continue, where appropriate, to consult the experts appointed to participate to the preliminary discussion in the preparation of its proposal.

The EBA is invited to deliver the report to the Commission services by 30 November 2020.

¹² https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2020.204.01.0004.01.ENG&toc=OJ:L:2020:204:TOC