

EBA/CP/2023/38
(EBA consultation on
Pillar 3 disclosure ITS - CRR3)

Version: 21 February, 2024

Deadline: 23 February, 2024

**BANKING
STAKEHOLDER
GROUP**

EBA consultation on Pillar 3 disclosure ITS – CRR3

General considerations

The BSG welcomes the opportunity to give input on the consultation of the suggested amendments to the Pillar 3 disclosure framework related to CRR3 (the Draft Implementing Technical Standards amending Commission Implementing Regulation (EU) 2021/637 on public disclosures by institutions of the information referred to in Titles II and III of Part Eight of Regulation (EU) No 575/2013).

The BSG supports the EBA's view that the Pillar 3 disclosure framework plays an important role in promoting market discipline in the financial sector by increasing the consistency and comparability of the publicly disclosed information across EU institutions, but also between EU institutions and non-EU internationally active banks through its alignment with Basel standards.

The BSG also supports the view of the EBA that uniform disclosure formats shall convey sufficiently comprehensive and comparable information for users of the information in banks' Pillar 3 reports, in order for these users to assess the risk profiles of institutions and their degree of compliance with the requirements laid down in the EU capital adequacy framework. The BSG concurs with the view that adequate disclosure is critical for investors to assess the risk profile of banks and thus to price their securities appropriately.

In December 2017 the Basel Committee agreed on changes to the Basel standards, "Basel III: Finalising post-crisis reforms". A key objective of the revisions of the Basel Committee was to reduce excessive variability of risk-weighted assets (RWAs). At the peak of the global financial crisis, a wide range of stakeholders – including market participants, analysts and academics – lost faith in banks' reported risk-weighted capital ratios. The Committee's own empirical analyses highlighted a worrying degree of variability in the calculation of RWAs by banks. To reduce excessive variability of risk-weighted assets and to enhance the comparability of risk-weighted capital ratios, banks using internal models will

therefore be subject to an “output floor” requirement that is applied to risk-weighted assets¹. The output floor will ensure that banks’ capital requirements do not fall below a certain percentage of capital requirements derived under standardised approaches.

In response to the global financial crisis, the EU embarked on a wide-ranging reform of the prudential framework for institutions aimed at increasing the resilience of the European banking sector. One of the main elements of the reform consisted of implementing international standards agreed by the Basel Committee on Banking Supervision (BCBS), specifically the so-called ‘Basel III reform’. This contributed to the EU banking sector entering the COVID-19 crisis on a resilient footing. The overall level of capital in institutions in the EU has improved significantly. To signal its commitment to international partners of the EU in the G20, the EU (Council and Parliament in December 2023) agreed to implement the outstanding elements of the Basel III reform faithfully. In this decision, the co-legislators also point out that *“At the same time, the implementation should avoid a significant increase in overall capital requirements for the EU banking system on the whole and take into account specificities of the EU economy. [...] Where possible, adjustments to the international standards should be applied on a transitional basis. The implementation should help avoid competitive disadvantages for EU institutions, [.....]”*.

In order to cater for the European specificities, the EU co-legislators put in place a number of transitional arrangements related to the phase in of the output floor. One is related to mortgages with low risk, one to exposures to corporates which do not have an external rating, one related to market risk and one related to securitization.

The response of the BSG mainly focuses on the implications of the proposals of the EBA to amend the Pillar 3 disclosure components related to the output floor, to be found in point 22 of the consultation paper. It is the view of the BSG that the EBA should seek to align Pillar 3 reporting requirements as closely as possible to the intention of the EU co-legislators to take into account the specificities of the EU economy without causing any permanent deviations from the Basel III standards. Therefore, the EBA with its proposed amendments to the ITS should respect the balance set by co-legislators between their ultimate objective of achieving full convergence with the Basel III text and avoiding a significant increase in capital which would, create a cliff effect that could in the view of some members of the BSG, have negative implications for financial stability and for the cost of credit to the EU economy. Other members of the BSG would like to reiterate, in this context, the concerns expressed by the Chairpersons of the EBA and SSM and the Vice-President of the ECB in their joint statement of November 2022², many of which are, in their view, still pertinent.

¹ To note, in parallel, the EBA engaged in an ambitious IRB Repair program, and the ECB in a “TRIM” exercise, with the purpose of improving the reliability of internal models. The remaining degree of unwarranted variability of RWA is monitored by the EBA in its regular benchmarking exercises.

² De Guindos, L. / Campa, J.M. / Enria, A., Strong rules, strong banks: let’s stick to our commitments, ECB Blog, 04 November 2022 (<https://www.ecb.europa.eu/press/blog/date/2022/html/ecb.blog221104~34240c3770.en.html>)

Comments on specific amendment proposals to the implementing regulation

22.

The BSG is mindful of the EU co-legislators' intention to account for European specificities, which are reflected in the inclusion of transitional provisions in CRR 3. At the same time, the EU's commitment to the faithful implementation of the Basel III agreement may suggest that market participants should be given a degree of visibility on the pathway of convergence of EU-based institutions towards the global standard. Some members are of the view that this should be achieved by disclosing the impact of transitional arrangements, as proposed by the EBA.

Some members of the BSG do not support the proposal to include impacts of the output floor on the risk-based capital ratios without applying the transitional provisions of Article 465 of the CRR 3 (so called 'fully loaded output floor capital ratio') in template EU KM1). The reason is that the proposal to disclose the fully loaded output floor capital ratio before the transitional arrangements have expired is contrary to the CRR3 provisions in article 465 and thus could be misleading to the market. A snapshot in 2025 may not give a true picture of expected numbers in 2033, because the balance sheet structures will change during the phase-in period (2025 to 2032). For example, corporates of high quality have incentives to obtain an external rating before 2033. Other members of the BSG note that the transition period stretches over a considerable period of time and argue that market participants should be provided with what they consider could be material information during that period.

Some members are of the view that the risk-based capital ratios without applying the transitional provisions are hypothetical and are not material information for investors and analysts. These members are of the view that this information should only be collected by supervisors, and as part of the Quantitative Impact Studies, to make it clear that this information is hypothetical, and to be used to inform further analysis. They argue that the transitional arrangements are not only long-dated, but also associated with various reports to be produced by the EBA, allowing to redefine the calibrations, with the view not only of fully converging with the Basel framework, but also taking into account evolutions in the EU financial system, for example, the extent to which a larger proportion of EU corporates will be externally rated. They note that co-legislators also instruct the EBA to take into account, when assessing the pathway to exit transitional arrangements, the implementation of Basel III in other key jurisdictions³. Those mandated reports could inform a new legislative proposal to be issued by the European Commission. BSG members observe that disclosures should accurately reflect the legislation in force at the present time, which includes transitional provisions. Some BSG members do not believe that information about capital ratios when transitional arrangements would have expired, by 2032, should be omitted in anticipation of future changes in legislation that have not even been formally proposed.

The objective of the Pillar 3 disclosure framework is to enhance the comparability and consistency of institutions' Pillar 3 disclosures and thereby enabling *"market participants to access key information relating to a bank's regulatory capital and risk exposures in order to increase transparency and confidence about a bank's exposure to risk and the overall adequacy of its regulatory capital"*⁴.

Some members of the BSG are of the view that the EBA proposal would not benefit the comparability of institutions or enhance the clarity of risk profiles or add any information value to the public. In their view, the proposal may even decrease transparency and comparability and may, in a worst-case

³ See in Appendix the exact wording of those mandates, as per the CRR3 text published in Dec 2023

⁴ https://www.bis.org/basel_framework/chapter/DIS/10.htm?inforce=20230101&published=20211111

scenario, increase confusion about the capital position of European banks. They argue that the exercise of estimating the benefit of transitional arrangements at a very granular level is likely to be performed by a small minority of expert analysts and believe that the impact of disclosing a “fully loaded” capital ratio would be confusing, as it would, for some institutions, highlight a capital shortfall that may never materialize because the bank’s balance-sheet structure and risk profile will be largely different in 2032 than in 2025. Assessing the solvability impact of a potential capital shortfall at such a long horizon would require to make assumption about earnings over the same period, and about pay-out ratios. Such assumptions would be highly hypothetical, and bank management generally do not provide any earnings guidance beyond the horizon of strategic plans, usually over a 3-years period. Forward looking guidance toward 2032 would expose bank management to severe market disappointments.

Other members of the BSG are of the view that most investors, both in the EU and in third countries, are already well aware of the transitional provisions in EU legislation and may, in the absence of factual information, apply their own estimates to assess their impact to enable meaningful comparisons between the capital ratios of EU banks and their non-EU peers. As a general principle, those members believe that more rather than less disclosure would seem appropriate in cases where the rules deviate from international standards, even if such deviations are only temporary.

The BSG, aware of the need for a faithful implementation of globally agreed prudential standards in all Basel member jurisdictions, understands the need for supervisory authorities to understand how the gradual phase-in of the output floor may affect banks under its supervisory remit during the phase-in period. The BSG therefore supports and recommends that the supervisory authorities collect the information in the supervisory reporting. Supervisors should, for supervisory purposes, collect data to include impacts of the output floor on the risk-based capital ratios applying the transitional provisions of Article 465 of the CRR 3. The so-called ‘fully loaded output floor capital ratio’, without applying the transitional arrangements, should be reported and analysed as part of the Quantitative Impact Studies in order to inform the work to be done by regulators and supervisors ahead of producing the reports they are mandated for. This would fulfil supervisory needs and add an extra dimension to the information needed to adapt supervisory policies during the gradual phase-out of the transitional arrangements.

The approach towards public disclosure, on the other hand, should be assessed with caution: whereas investors will rightly expect high levels of transparency around Basel III convergence there could also be a risk that published pro-forma ratios, which are likely to fluctuate over the course of the transition period, and could be misinterpreted by investors, analysts and other market participants.

Given the high complexity of the framework, some members of the BSG are concerned that, apart from a handful of expert analysts, market and general media comments may focus on the “fully loaded” ratios, as they will appear as the lowest and therefore, misleadingly, the most binding ones. Other members of the BSG are of the view that investors’ priority will likely focus on which ratio is comparable across the global peer group rather than whether they are higher or lower.

Overall, the BSG recommends to:

- Clearly distinguish the purposes of Pillar 3 (public disclosure of information relevant for investor decision making, based on their analysis of banks’ balance-sheets on a comparable basis) from Supervisory reporting, which should monitor the capital management of the bank, in the known framework (ie phase-in of the output floor), and the QIS/monitoring report process, which should be used to test the impact of potential future regulatory changes, such as the exit from transitional arrangements.

- Maintain the disclosure of more granular risk-based information which will allow investors to assess the risk profile of institutions, in particular comparing the outcomes of internal models and standardized approaches by portfolios.

APPENDIX

Relevant CRR3 extracts on transitional arrangements

Source : December 2023 english version posted on the Commission website: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575>

See also Article 465 for full description of transitional arrangements.

§1 "the overall level of capital in institutions in the Union is now satisfactory on average"

§2 "Where possible, adjustments to the international standards should be applied on a transitional basis."

Transitional arrangements for Unrated corporates (transition until 31/12/32)

§12 - "Any extension of the transitional period should be substantiated and limited to four years at the most."

§13 - "The transitional period should be used to significantly expand the availability of ratings for Union corporates."

Transitional arrangements for Residential mortgages : transition until 2032 on high-quality mortgages and until 2029 for splitting approach

§17 - "To ensure that the impacts of the output floor on low-risk residential mortgage lending by institutions using the IRB Approach are spread over a sufficiently long period, and thus avoid disruptions to that type of lending that could be caused by sudden increases in own funds requirements, it is necessary to provide for a specific transitional arrangement."..."The use of the transitional arrangement should be monitored by EBA. Any extension of the transitional period should be substantiated and limited to four years at the most."

Art 465-5 : EBA report due by end 28, with legislative proposal by end 31

SA-CCR : transition until 31/12/29 (nothing on exit)

Specialized lending exposures : transition until end 29 / some measures until end 32

§21 – "To avoid unintended consequences of the lack of risk-sensitivity of the Basel treatment for unrated object finance exposures, object finance exposures that comply with a set of criteria capable to lower their risk profile to 'high quality' standards compatible with prudent and conservative management of financial risks, should benefit from a reduced risk weight on a transitional basis. That transitional arrangement should be assessed by a report prepared by EBA.

§30 - It is thus appropriate to provide for a transitional period during which the LGD input floor applicable to specialised lending exposures is reduced. Any extension of the transitional period should be substantiated and limited to four years at the most.

Unconditionnally cancellable commitments : transition until 2032

§23 - It is thus appropriate to provide for a transitional period during which institutions will continue to apply a lower credit conversion factor to their UCC, and, afterwards, to assess whether a potential gradual increase of the applicable credit conversion factors is warranted to allow institutions to adjust their operational practices and products without hampering credit availability to institutions' obligors.

Securitisation : transition until end 32

§36 During a transitional period, institutions using the IRB Approach should be able to apply a favourable treatment to their securitisation positions when calculating their output floor. EBA should report to the Commission on the need to eventually review the prudential treatment of securitisation transactions, with a view to increase the risk-sensitivity of the prudential treatment.

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§44 - The Commission should therefore monitor the implementation of those standards in other BCBS member jurisdictions and, where necessary, should take steps to address potential distortions of those rules by means of a delegated act. The measures introduced in this manner should remain temporary. Where it is appropriate for those measures to apply on a permanent basis, the Commission should submit a legislative proposal.

See Art 461a on details