ROUNDTABLE CRRD-CRD6: WHAT IS AT STAKE IN THE TRILOGUE?

The Association Europe Finances Régulations (AEFR), chaired by Pervenche Berès, organized on March 27th a Roundtable moderated by Veronique Ormezzano, aiming at providing a state of play of the discussions around the implementation of finalisation of Basel III in the EU, with interventions by the European Commission (Martin Merlin, Director, Banking, Insurance and Financial Crime – DG FISMA), the European Parliament (Jonas Fernandez Alvarez, rapporteur), the Swedish Presidency of the Council (Eric Lenntorp, Deputy Director General, Head of Banking Division) and the French Treasury (Gabriel Cumenge, deputy director Banking and Financing of General Interest Activities Division), followed by a panel discussion with private sector representatives : the French Banking Federation (Etienne Barel, deputy Director general), Copenhagen Economics (Jonas Bjarke Jensen, Managing economist), Caixa Bank (Christian Castro, Head of public affairs) and Skandinaviska Enskilda Banken (SEB, Johanna Orth, head of Group regulatory affairs).

This executive summary provides key take-aways of this roundtable (a replay is available on AEFR website).

1. Context and timing

Martin Merlin started by mentioning the recent turmoil around SVB and Credit Suisse, stating that banks fundamentals in the European Union (EU) are good, and that the EU had made a reasonable initial choice to apply Basel Committee on Banking Supervision (BCBS) rules to all banks, unlike the United States (US). Lessons need to be learned from the recent events at BCBS level. A comment from the audience insisted that the issue is not the regulation itself, but the way it was implemented in the US (no implementation of the Interest Rate Risk in the Banking Book (IRRBB), wide exemptions of medium size banks (full implementation of international standards only to banks with total assets above 700bn$). Gabriel Cumenge notes that the quality and intensity of supervision is key, and that the Single supervisory mechanism (SSM) is ahead of other jurisdictions in these matters.

Regarding Capital Requirements Regulation 3 – Capital Requirements Directive 6 (CRR3-CRD6), Martin Merlin reminded of the importance of finding a delicate balance between a faithful implementation of the BCBS standard, the need to consider EU specificities, and the importance of avoiding any undue capital increase. In his view, both the Parliament and the Council positions keep this overall balance, even if there has been a lot of amendments.

The trilogue discussions are just starting, and technical discussions are held with a constructive spirit. The Commission plays an active role, providing technical support in those discussions, and helping reaching convergence.

The objective remains to finalize the trilogue under Swedish Presidency, and it is "challenging but doable". Importantly, the EU remains committed to implement by January 1, 2025, as per the Commission initial legislative proposal. Overall, there is a consensus that there is no reason to pause, as the banking sector needs visibility on the future rules, and more given the recent events. Jonas

Fernandez concluded "the EU should implement irrespective of other jurisdictions. Otherwise, we will have a race to the bottom".

2. Key aspects of the package and state of play

2.1 Temporary arrangements

The Commission has introduced temporary measures to avoid a cliff edge in the implementation of the output floor. Erik Lenntorp notes that the output floor reduces the risk sensitivity, but at the same time reduces the model risks, which is important for market confidence. In this context, temporary arrangements are needed in particular as regards unrated corporates (noting that most EU corporates do not see the need for ratings so far). The Parliament supports those transitional arrangements but with a clear end-date considering that the current text provides too much leeway to the Commission to extend these arrangements.

2.2 Keep the European specificities

Martin Merlin specifically cited the SME and infrastructure supporting factors. Erik Lenntorp explained that one of the key features of the EU financial system was that it is "bank-centric", which is critical to the financing of the economy. The regulatory framework is also applied to a wide range of banks, from the small domestic ones to the large Global Systemically Important Banks (G-SIBs) with cross border activities. The EU also relies on a single rule book, but several currencies, and not all countries are part of the Banking Union. All those aspects must be considered when transposing BCBS standards.

The Parliament, however, aims for the EU to be materially compliant. Some deviations are common across Council and Parliament. Some are specific and will require ironing out. There should be an overall review of the magnitude of the deviations at the end of the process, to ensure that implementation remains in the range of "material compliance".

2.3 Avoid undue capital increase

As estimated by the Commission, the average increase in capital requirements for EU banks should be less than 10%. However, the distribution matters. According to Martin Merlin, the increase of capital is intended, where it is needed, but not across the board.

Gabriel Cumenge notes that there will be a substantial increase in capital requirements overtime. However, what really matters is not this increase per se, it is to ensure that there would be no harm on the EU economy. Policy makers must be attentive to the risks that the cumulative impact of regulations does not "overkill".

2.4 Attention to international developments

The Commission recently attended the EU/US regulatory Forum. The US Notice of Proposed Regulation (NPR), which has been delayed for some time, should be published in the summer. The US authorities are still targeting the January 1, 2025, as implementation date, although Gabriel Cumenge's view is that the ongoing delay of the NPR won't allow the US to maintain this date of implementation.

In any case if some jurisdiction delays the implementation or diverge from BCBS standards, the package includes a Delegated Act that gives power to the Commission to adjust the timing and substance of CRR3 on the market risk side, which is the most critical from an international level playing field point of view. This approach has been endorsed by both Council and Parliament, and Gabriel Cumenge confirmed it was an essential tool to be preserved in the package, in particular as the EU regulatory system is more rigid (even if, since COVID there has been more appetite to adapt swiftly legislative rules to changing market conditions).

2.5 Proportionality

There is consensus that the EU made the right choice in applying the BCBS standards to all banks, and that the banking sector pushes for more proportionality, should be taken with prudence.

3. Main discussion points

3.1 Level of application of the output floor and liquidity waivers

Teo make a step toward a more integrated Banking Union (BU), the Commission had proposed to apply the output floor at consolidated level (as per the BCBS standard), with a reallocation mechanism toward the host countries. The Parliament is pushing fora step toward the BU, as it would make room for more efficient allocation of capital across the EU. Therefore, it has maintained this consolidated approach, while modifying the reallocation mechanism. The European Parliament asks for a report by the Commission by 2027 on progress of the BU, and, if the BU has not made sufficient progress, national competent authorities (NCA) could request the allocation of more capital, opening up the possibility of negotiation between NCAs and EBA would have to mediate in case of disagreement. Jonas Fernandez states that the Parliament is united on this position across political groups.

In the same vein, the Parliament has proposed amendments to facilitate the obtention of liquidity waivers.

Eric Lenntorp, however, notes that the CRR logic has always be to apply regulation at solo level. This is the core of the home-host debate. This debate was last summarized in the June 22 BU document, which took stock of the lack of consensus. Therefore, until there is a broader agreement on the BU, the "home-host balance" cannot be changed.

Gabriel Cumenge highlighted that France was supportive of the Parliament stance on making a further step toward the BU, however, he agreed with Erik Lenntorp that, given the Eurogroup had not managed to unlock the debate, the only workable solution was the Council position.

3.2 Integration of ESG factors

The CRR3-CRD6 package is an opportunity to "strengthen the resilience of EU banks to ESG risks", in particular as regards supervision and disclosure of ESG risks. However, as regards Pillar 1 adjustments, the Commission considers that this is premature, given that a European Banking Authority (EBA) report on the subject is expected "later this year". Erik Lenntorp noted that regulation should be based on risks, and not policy goals, and considers that the package already allows to better take into account ESG risks. Gabriel Cumenge also welcomes the signal sent to banks in that matter.

Jonas Fernandez notes that "on ESG, the Parliament always wants to do more". There is no debate about Pillar 2 and 3 which need to be reinforced, in line with what the European Central Bank is already implementing. There is a debate on Pillar 1, and indeed it is important that rules remain risk based. The key question is how climate risks can be "internalized" despite the lack of backward-looking data. He hopes that the upcoming EBA report will provide some avenues to address this issue. At a minimum there is already a provision that ESG risks must be taken into account in the valuation of real estate collateral, this is a step in the right direction.

3.3 Ensure minimum harmonization of the regulation and supervision of third country branches

The importance of ensuring proper oversight of third country branches is only confirmed by the recent turmoil. The Commission continues to believe that a prudent approach is warranted, and, while the Council has deleted most of the Commission's proposal, Erik Lenntorp notes the importance of this aspect in the competitiveness of EU banks. The Parliament is aligned to the Commission proposal.

3.4 Prudential treatment of crypto assets

While the legislative proposal did not include any provision, the Parliament, which adopted its negotiation position after the BCBS finalized its standard, is proposing to include it. The subject will require discussion in trilogue, as the Council never discussed it so far. The Parliament considers as important that prudential rules be in line with the recent MiCA regulation.

3.5 Prudential treatment of securitisation

Tamar Joulia International Association of Credit Portfolio Managers (IACPM) commented on the importance of allowing banks to develop risk sharing transactions, one of the main possible channels being securitisation.

Martin Merlin mentioned that he expected this subject to be reopened in the Basel Committee, and that contagion risks should be carefully assessed. Gabriel Cumenge noted that securitisation was still suffering from a stigma but would be useful to allow risk-sharing. Volumes are clearly low, and not enabled by regulation. This subject should be addressed now as, otherwise, given the upcoming European elections, and a likely slow move by Basel, nothing would be done until 2025/2026, which is too late, as the EU economy requires the investments now to finance its transition.

3.6 Macro-prudential

Despite some work having been done at BCBS and EU level on aspects such as usability of buffers and positive neutral Countercyclical capital buffer (CCyB), this aspect is not mature and will not be included in CRR3-CRD6.

4. Strategic aspects

Erik Lenntorp insisted on the importance of this package, as one of the priorities of the Swedish Presidency. The Presidency's overall focus is on competitiveness, with the view of supporting the green transition while ensuring financial stability. Recent events have shown that, with "information travelling fast", contagion risks had to be addressed. On the other hand, anything that would constrain bank lending capacity should be carefully assessed, especially in an environment where rates hikes and quantitative tapering already pushes toward restrictive credit policies.

Jonas Bjarke Jensen of Copenhagen Economics showed some results of a survey done on 80 European banks, on how Basel III will create fundamental changes to capital cost allocation in the European banking sector. The study, based on EBA monitoring data, shows that, while the average impact is 12%, it is 4% for banks using the standardized approach, 5% for Internal ratings-based (IRB) banks not bound by the output floor, and 17% for IRB banks bound by the output floor. The extent to which banks are bound by the output floor varies widely across countries, with 95% of Danish, Belgium, Netherlands banking assets bound by the output floor, and 0% in Spain, Portugal, Greece, and Central and Eastern Europe (CEE) countries. Overall, 25% of the EU market will see an increase by more than 20%. The most impacted asset class is the corporate lending portfolio, with an increase of 40%. Copenhagen Economics note that, given the impact is very business model dependant, 2 lenders operating in the same market can show very different impacts, according to their business mix, use of models, and geographical presence. This worryingly breaks the consistency between underlying risk, capital requirements and pricing. This angle will deserve further analysis, to better understand how banks will react and adapt their business model.

Etienne Barel (FBF) mentioned the main concerns for the French banking industry:

- the importance of applying the output floor at consolidated level,
- the importance of ensuring that the financial sector can be part of the EU strategic autonomy ambitions,
- the needs to improve the regulatory treatment of securitisation, to make it a viable tool to transfer risks and absorb the increase in capital requirements,
- and the need to be more flexible in the fit and proper framework.

Christian Castro noted that implementation was key, and that the Basel Regulatory Consistency Assessment Programme (RCAP) process should take into account not only the rules, but the scope of banks to which those rules apply. He also welcomed that co-legislators do not intend to implement the "positive neutral" CCyB, considering there are other options that need consideration, in particular making the Capital Conservation Buffer (CCB) releasable.

Johanna Orth insisted on the importance of unrated corporates, and the risk that banks bound by the floor would have to reduce medium term lending to the economy. As shown by Copenhagen Economics, many banks are also on the verge of being bound, and the "distance to the output floor" will inevitably become an important metric in the capital allocation process.

Concluding remarks

The EU is committed to implement Basel and has no intention to pause. Implementation date of January 1, 2025, is challenging but doable. The trilogue should be well advanced, if not finalized, before the summer break.

This will represent a significant increase in capital requirements over time, with a wide distribution across business models and geographies.

Consequently, banks will have to adapt their business models and, as the EU economy continues to be bank-centric, will need to develop securitization as a risk transfer tool, to maintain their origination capacity, notably with corporate clients and mortgages, while sharing risks with other market participants. "The EU cannot do Basel without securitization," said several contributors.
As we approach the end of the current legislative cycle, there is a strong appetite to "put CRR3-CRD6 behind us" and focus on other issues such as competitiveness and strategic autonomy of the EU economy.