CONSULTATION DOCUMENT

EXPLORATORY CONSULTATION ON THE FINALISATION OF BASEL III

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudge the final decision that the Commission may take.

The responses to this consultation paper will provide important guidance to the Commission when preparing, if considered appropriate, a formal Commission proposal.
You are invited to reply by 12 April 2018 at the latest to the online questionnaire available on the following webpage:

Please note that in order to ensure a fair and transparent consultation process only responses received through the online questionnaire will be taken into account and included in the report summarising the responses.

This consultation follows the normal rules of the European Commission for public consultations. Responses will be published unless respondents indicate otherwise in the online questionnaire.

Responses authorised for publication will be published on the following webpage: https://ec.europa.eu/info/consultations/finance-2018-basel-3-finalisation_en#contributions
Introduction

On 7 December 2017, the Group of Governors and Heads of Supervision (GHOS) endorsed a package of amendments to the "Basel framework", the internationally agreed prudential standards for banks developed by the Basel Committee on Banking Supervision (BCBS), with the intention to finalise the post-crisis reforms known as the "Basel III" reforms. This agreement is the result of a strategic review of those international reforms, which was conducted by the BCBS with a view to improving the balance between simplicity, comparability and risk-sensitivity.

The package includes the following key elements:

1. revisions to the standardised approach for credit risk (SA-CR) to improve the robustness and risk sensitivity of the existing approach;

2. revisions to both internal ratings-based (IRB) approaches for credit risk to reduce unwarranted variability in banks' calculations of risk-weighted assets (RWAs);

3. minimum haircut floors for non-centrally cleared securities financing transactions (SFTs) to limit pro-cyclicality of these transactions and the build-up of excessive leverage in the financial system;

4. an overhaul of the credit valuation adjustment (CVA) 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 (SA-CVA), to enhance the risk sensitivity, strengthen the robustness and improve the consistency of the framework;

5. a new standardised approach for operational risk (SA-OR), replacing all the existing standardised and advanced measurement approaches for this risk to simplify the framework and increase comparability; and

6. replacement of the "Basel II" floor with an aggregate more risk-sensitive output floor to place a limit on the regulatory capital benefits that a bank using internal models can derive relative to the revised Basel III standardised approaches.


2 One element of the package of reforms, the final revisions to the measurement of the leverage ratio and the introduction of a leverage ratio buffer for global systemically important banks (G-SIBs), is currently being considered by the European Parliament and the Council to be introduced in the ongoing negotiations of the package of amendments to the CRR/CRDIV published in November 2016 since some of those amendments already relate to the leverage ratio.

3 The Basel II framework ("International Convergence of Capital Measurement and Capital Standards", available at: https://www.bis.org/publ/bcbs128.pdf) introduced an output floor based on the Basel I capital requirements (as set out in "International convergence of capital measurement and capital standards" [available at: https://www.bis.org/publ/bcbs04a.pdf] and the "Amendment to the capital
The implementation of these reforms in the EU would require amendments to current banking regulations, predominantly the Capital Requirements Regulation (CRR) (Regulation (EU) No 575/2013 of the European Parliament and the Council).

As part of the implementation process, the Commission Services are launching this exploratory consultation to seek specific input from stakeholders on the various elements of the package of reforms to finalise the Basel III framework. This consultation aims at gathering evidence on the potential impacts of those reforms on the EU banking sector and the wider economy as well as on implementation challenges which would particularly arise for institutions established in the EU.

General questions:

a) What are your views on the impact of the revisions on financial stability?

b) What are your views on the impact of the revisions on the financing of the economy?

4 accord to incorporate market risks” [available at: https://www.bis.org/publ/bchs24.pdf]). That floor was calibrated at 80% of the relevant Basel I capital requirements.

4 Any legislative proposal to implement the outstanding Basel III reforms would be independent from the package of amendments to the CRR proposed by the Commission in November 2016 that are currently being negotiated by the European Parliament and the Council.
1. **Standardised approach for credit risk (SA-CR)**

The revisions to the SA-CR intend to increase risk sensitivity and granularity while keeping the approach sufficiently simple for its widespread use. Associated with this re-balancing is the objective to reduce mechanistic reliance on credit ratings.

The key revisions can be summarised as follows:

1.1. Due diligence requirements have been strengthened to ensure that banks have an adequate understanding, at origination and thereafter on a regular basis (at least annually), of the risk profile and characteristics of their counterparties. In cases where ratings are used, due diligence is required to assess the risk of the exposure for risk management purposes and whether the risk weight (RW) applied is appropriate and prudent.

1.2. For unrated exposures to banks and corporates and for rated exposures in jurisdictions where the use of credit ratings is permitted, more granular approaches have been developed.

1.3. For rated exposures to banks, some of the RWs have been recalibrated. In addition, the risk-weighted treatment for unrated exposures is more granular than the existing flat risk weight. A standalone treatment for covered bonds has also been introduced.

1.4. For exposures to corporates, a more granular look-up table has been developed. A specific RW applies to exposures to small and medium-sized enterprises. In addition, a specific treatment for exposures to project finance, object finance and commodities finance has been introduced.

1.5. For residential real estate exposures, more risk-sensitive approaches have been developed, whereby risk weights vary based on the loan-to-value ratio of the mortgage (instead of the existing single RW) and in ways that are intended to better reflect differences in market structures.

1.6. For commercial real estate exposures, more risk-sensitive approaches have been developed.

1.7. For retail exposures, a more granular treatment has been introduced, which distinguishes between different types of retail exposures.

1.8. For subordinated debt and equity exposures, a more granular risk weight treatment has been developed.

1.9. For off-balance sheet items, the credit conversion factors (CCFs) have been made more risk-sensitive, including the introduction of positive CCFs for unconditionally cancellable commitments.
1.10. In the credit risk mitigation framework, the comprehensive approach for collateralised transactions has been simplified and at the same time been made more risk-sensitive and comparable across banks. In particular, the applicable supervisory haircuts have been recalibrated and the use of internal estimates (own-estimates of haircuts, value-at-risk model for certain securities financing transactions (SFTs)) has been removed. In addition, the formula for repo-style transactions covered by master netting agreements has been revised to better reflect diversification benefits.

1.11. Furthermore, the BCBS specified the treatment of certain non-centrally cleared SFTs with certain counterparties. The revised framework sets out minimum haircut floors and determines that in-scope SFTs which do not meet the haircut floors must be treated as unsecured loans.

Specific questions:

c) What are your views on the revisions? Please provide details.

d) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

e) Where do you expect particular implementation challenges and why? Please specify.

2. Internal ratings-based (IRB) approaches for credit risk

To address perceived shortcomings of the existing framework, the revisions to the IRB approaches aim at increasing the robustness in modelling certain asset classes while reducing excessive complexity and unwarranted variability of RWAs.

In particular, the BCBS has made the following revisions to the IRB approaches:
2.1. The option to use the advanced IRB (A-IRB) approach has been removed for certain asset classes. These include exposures to large and mid-sized corporates, and exposures to banks and other financial institutions. As a result, banks with supervisory approval will use the foundation IRB (F-IRB) approach. In addition, all IRB approaches are being removed for exposures to equities.

2.2. “Input” floors for bank-estimated IRB parameters that are used as inputs to the calculation of RWAs (i.e. for metrics such as probability of default [PD] and loss given default [LGD]) have been adopted to ensure a minimum level of conservativism in model parameters for asset classes where the IRB approaches remain available. These include PD floors for both the F-IRB and A-IRB approaches, and LGD and exposure at default (EAD) floors for the A-IRB approach. In some cases, these floors consist of recalibrated values of existing Basel II floors. In other cases, the floors represent new constraints for banks’ IRB models.

2.3. Greater specification of parameter estimation practices has been provided with the aim of reducing RWA variability. Adjustments were made to the supervisory specified parameters in the F-IRB approach, including: (i) for exposures secured by non-financial collateral, increasing the haircuts that apply to the collateral and reducing the LGD parameters; and (ii) for unsecured exposures, reducing the LGD parameter from 45% to 40% for exposures to non-financial corporates.

Given the changes to the IRB framework and the introduction of an aggregate output floor (see section 5.), the BCBS removed the 1.06 scaling factor that is currently applied to RWAs determined by the IRB approaches to credit risk.

Specific questions:

a) What are your views on the revisions? Please provide details.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.
c) Where do you expect particular implementation challenges and why? Please specify.

3. CVA risk framework

The first Basel III reforms published in 2011 introduced a new capital requirement for potential mark-to-market losses of derivative instruments as a result of the deterioration in the creditworthiness of a counterparty.\(^5\) This risk – known as CVA risk – was a major source of losses for banks during the global financial crisis, exceeding losses arising from outright defaults in some instances. To address a number of issues identified in the current CVA framework, the BCBS agreed to revise it with the objectives to enhance its risk sensitivity, strengthen its robustness and improve its consistency.

3.1. The revised framework removes the use of an internally modelled approach, and consists of a choice for banks between a more complex approach – the standardised approach – or a simple approach – the basic approach. The standardised CVA approach builds on the Basel market risk framework by using fair value sensitivities to market risk factors of a principle-based definition of CVA. The basic approach builds on the current standardised method for CVA risks. The two approaches are calibrated consistently with the approaches used in the revised market risk framework.

3.2. In addition, a bank with an aggregate notional amount of non-centrally cleared derivatives less than or equal to €100 billion may calculate their CVA capital requirement as a simple multiplier of its counterparty credit risk charge.

3.3. The revised CVA framework enhanced the risk sensitivity of the CVA framework by taking into account the exposure component of CVA risk along with its associated hedges while the current CVA framework captures only the credit spread risk of CVA.

Specific questions:

a) What are your views on the revisions? Please provide details.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive

\(^5\) See "Basel III: A global regulatory framework for more resilient banks and banking systems", available at: [https://www.bis.org/publ/bcbs189.pdf](https://www.bis.org/publ/bcbs189.pdf).
or negative difference is significant in your view, and specify the relevant revision(s).

c) Where do you expect particular implementation challenges and why? Please specify.

d) What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?

4. Operational risk framework

The operational risk framework has undergone a fundamental revision, for two main reasons highlighted by the BCBS: first, operational risk losses incurred by some banks exceeded by a significant margin their capital requirements (regardless of the approach used); second, the nature of such losses (often misconduct and inadequate systems and controls) highlighted the difficulty with using internal models to estimate capital requirements for operational risk.

With the aim to simplify the framework and increase comparability between banks, the current advanced measurement approaches based on banks’ internal models and the three existing standardised approaches are replaced with a single risk-sensitive standardised approach (SA-OR) to be used by all banks.

In particular, the new SA-OR combines a refined measure of gross income with a bank’s own internal loss history over 10 years; conceptually, it assumes that operational risk increases at an increasing rate with a bank’s income (4.1.), and that banks which have experienced greater operational risk losses historically are more likely to experience operational risk losses in the future (4.2.).

4.1. A measure of gross income is reflected in the so-called "business indicator component" (BIC), which consists of a sum of relevant income components (the interest, leases and dividends component; the services component and the financial component) multiplied by a marginal coefficient (depending on the size of the BIC).

4.2. For banks with a BIC greater than €1 billion, the capital requirement may increase or decrease depending on whether operational risk losses were in the past on average higher or lower than the BIC due to the application of an internal loss multiplier.

Specific questions:

a) What are your views on the revisions? Please provide details.
b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

c) Where do you expect particular implementation challenges and why? Please specify.

5. Output floor

Similar to the original "Basel II" floor, the revised floor is intended to provide a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approaches. This is meant to help maintain a level playing field between banks using internal models and those on the standardised approaches. It is also expected to support the credibility of banks’ risk-weighted calculations, and to improve comparability via the related disclosures.

The key features can be summarised as follows:

5.1. Under the revised output floor, banks’ RWAs must be calculated as the higher of: (i) total RWAs calculated using the approaches that the bank has supervisory approval to use in accordance with the Basel capital framework (including both standardised and internal model-based approaches); and (ii) 72.5% of the RWAs calculated using only the standardised approaches.

5.2. Banks will also be required to disclose their RWAs based on the revised standardised approaches.

Questions:

a) What are your views on the revisions? Please provide details.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

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6 The Basel II framework ("International Convergence of Capital Measurement and Capital Standards", available at: [https://www.bis.org/publ/bcbs128.pdf](https://www.bis.org/publ/bcbs128.pdf)) introduced an output floor based on Basel I capital requirements. That floor was calibrated at 80% of the relevant Basel I capital requirements.
More specifically:

i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver.

ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

c) Where do you expect particular implementation challenges and why? Please specify.