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European banks:
EU Council agrees its position on Basel III banking package

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The EU Council has now agreed its common position on the implementation of the final Basel III reforms. With this, it largely follows the legislative proposal presented by the EU Commission a year ago. The timetable for implementing the legislative package remains ambitious. In our opinion, however, the institutions should be well prepared for the innovations.

According to a press release of November 8, 2022, the EU Council of Ministers has reached a unified position on the final Basel III reforms after having devoted a lot of time and effort to address the many political and technical issues of this package. The overall objective is to **boost the resilience of banks** operating in the Union and to strengthen their supervision and risk management by finalizing the implementation of the globally agreed Basel III framework at EU level.

The focus of the amendments still outstanding following the comprehensive regulatory reforms in the wake of the financial market crisis is on **the institutions' capital requirements**. A central element is the introduction of an output floor: Accordingly, the risk-weighted assets (RWA) in the calculation of regulatory capital ratios on the basis of internal models are not to be less than 72.5% of the value that would result from the application of the standardized approach.

The position of the EU Council published yesterday comes a good 12 months after the **EU Commission** published its legislative proposals on October 27, 2021 for the final implementation of the Basel III changes in Europe (so-called banking package 2021, see in detail our publication "**EU banking package 2021 - Banks affected differently by Basel III implementation**" of November 2, 2021). The ambitious goal is for the package to enter into force on January 1, 2023, so that the regulations will apply across Europe from January 1, 2025.

The fact that the EU Commission's proposal last year took account of the special features of the EU banking sector was a source of relief. As a result, the level of **additional capital requirements** that banks would have to meet as a result of the reforms had fallen noticeably: The Commission estimated that the increase in capital requirements for European banks would be less than 9 % at the end of the transition period by December 31, 2029, based on its proposals. This was significantly less than the 18.5 % in the scenario in which the special features of the EU banking sector were not taken into account.

The position now presented by the **EU Council adopts key parts of the Commission's legislative proposal**, in particular with regard to bank financing of companies without external ratings, residential real estate loans, trade finance and the financing of public-sector customers. Thus, burdens of the Basel III framework for the financing of consumers and companies by banks are at least partially mitigated and European specificities are taken into account. Furthermore, the Council also does not provide for any statutory capital requirements for ESG risks.

However, the Council did not follow the EU Commission's proposals in all respects, for example with regard to the easing of capital requirements for strategic holdings and proportionality for smaller institutions.

Our assessment: Banking sector should be well prepared for additional capital requirements

Overall, we welcome the fact that a further step towards completing the Basel III reforms will again create **more legal planning certainty for institutions**. In addition, we believe that it is right to take into account European specifics, in particular the high importance of credit financing via banks - especially as the reforms of recent years have resulted in an extremely high level of regulation and banks have also built up extensive capital buffers to cover unforeseen losses.

The additional requirements for the regulatory capital to be held by European banks as a result of Basel III finalization could now again be somewhat higher than expected, as the Council did not follow the Commissions' proposal in all points. However, we believe that this should be kept within limits, as the components that have a particularly strong impact (corporate finance, mortgage loans) are also taken into account in the EU Council's proposal now on the table.

It should be noted that the new banking package does not catch institutions unprepared; it was preceded by a years-long process of comprehensive regulatory reforms. Prior to the Basel compromise in December 2017, there had been several years of discussion, in some cases with proposals of even stricter requirements. Accordingly, **banks in Europe have been adapting to the stricter requirements for a long time**.

However, it should be noted that there are **quite large differences at the level of individual institutions**; depending on business activities and regions, the equity requirements increase to different degrees. Banks in Germany, for example, make comparatively extensive use of internal models to calculate their risk assets. Dutch banks with extensive mortgage loan portfolios have also been gearing their strategy comparatively consistently for years to the foreseeably stricter requirements.

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