BASEL III IMPLEMENTATION

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The EU implementation of Basel III and its impact

The finalisation of Basel III creates a clear and solid regulatory framework and ensures a global level-playing field. It is a key achievement at the international level. Its full and consistent implementation is key for its success, which will have clear macro-economic benefits and will further underpin the trust in the banking sector.

The EU sat at the negotiating table in Basel and defended the specificities of its banking market. Consequently, the final agreement incorporates many suggestions by EU authorities that make the Basel III framework fit for purpose to be adopted in the EU. The EC's proposal to implement Basel III in the EU, incorporates further specifications that better fit to the risk profiles of certain EU banks' business models. However, some possible deviations remain. Therefore, the EBA would advise the co-legislators to reconsider them as much as possible in their final negotiations, as, they might go further than what is justified in terms of the risk faced by EU banks. Making sure that the framework remains risk based would ensure the framework's robustness in these times of uncertainties.

The EBA has calculated, using data as of December 2021 and based on conservative assumptions, that capital requirements may increase by 11.5% if the EC's proposal would be implemented. The output floor (+6.4%) remains the key driver, explaining more than half of the total impact, followed by market risk (+1.8%) and operational risk (+1.7%). The credit risk reforms (+1.6%) and the revised CVA framework (+0.4%) contribute less to the total impact. The reform has a materially higher impact on globally systemic important institutions (G-SIIs) than on other types of banks.

On average G-SIIs see their capital requirements increase by 18%, while non systemically important group 1[1] banks and group 2 banks see their capital requirements increase from the baseline levels by 12.7% and 5.7% respectively. These estimates do not take into account possible adjustments on existing capital requirements beyond pillar 1 nor changes in banks current portfolio of activities that may occur going forward. This potential increase in capital requirements will not necessarily imply a corresponding increase in the amount of capital held by banks. The aggregate capital shortfall was found to be EUR 10.1 billion, out of which EUR 9.6 billion (i.e., more than 95%) is in Group 1 banks and of which EUR 7.8 billion (i.e., more than 75%) corresponds to G-SIIs.

All in all, only 7 out of 160 banks included in the impact study did show a capital shortfall following the implementation of the reforms under the EC's proposal. Finally, we have seen a clear reduction in EU banks' estimated aggregate capital shortfalls over the past 5 years as asset quality has improved and banks have enhanced their capital positions in anticipation of the future reform. This suggests that the increase in capital requirements is not significant for the majority of the EU banks and for the banking sector as a whole.

The outcome of the reform is therefore in line with what was intended. It remains risk based while ensuring that the use of internal models for capital purposes does not result in underestimation of potential unexpected losses. It is large systemic banks that are the most ardent users of IRB models who will experience the largest increase in capital requirements. Increased requirements to offset those risks should not come as a surprise. In fact, the rules were designed in such a way as to impose higher capital requirements to these types of banks. At the same time, an important element of the new rules is also the increased risk sensitivity of the standardised approach which will further reduce the gap between internal model banks and those using the standardised approach.

To mitigate the impact of implementation of Basel III in the EU, several transitional arrangements have been put forward, such as a 5-year phase-in period for the output floor and targeted provisions that help to spread the impact of the implementation over up to 8 years. This will provide banks more time to fully comply with the reforms, minimising the potential for any cliff effect.

Therefore, banks are ready today to implement the reforms loyally and in time, which will ensure that banks remain robust to confront the risks they face and that , when crises hit (as for instance during COVID) are capable to provide adequate lending to the economy to support growth. This is a key objective and requires the reforms to be implemented quickly.

[1] Group 1 banks are banks that have Tier 1 capital in excess of EUR 3 billion and are internationally active. All other banks are labelled as Group 2 banks.

JONÁS FERNÁNDEZ
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Towards a final agreement on CRR/CRD

In the coming weeks, the Council of the EU and the European Parliament will finalise the agreement on the CRR/CRD banking package, with technical support from the European Commission. More than 15 months of intense work, analysis and negotiations have passed since the initial proposal was published and we are now reaching the final discussions to strengthen the regulatory and supervisory framework of the European banking sector.

The events that happened in March should serve as a reminder of the risks within the banking activity. These risks must be managed and channelled, finding a difficult balance between the aims of industry, regulators and legislative powers.

Given this, as rapporteur, I must first call on the Council, the Commission and my colleagues in Parliament to reflect further on the implementation of the Basel recommendations and their co-existence with the so-called "European specificities". Of course, within our banking sector and financial system as a whole, there are some European particularities that must be considered, although not all of them lead to a potential relaxation of prudential rules. It's rare to hear industry voices mention any of the specificities that imply greater risks, despite the fact they obviously exist.

On the other hand, local interests are often presented as such and at certain moments the principle of proportionality is used as a way to escape the regulatory straitjacket. Moreover, some seem to demand that possible capital increases resulting from the implementation of an output floor – designed to minimise the risks of using internal models – must be netted of other capital buffers that exist within the regulation to achieve other objectives. All in all, having been reminded of the banking crisis by the events of little more than a month ago, co-legislators should exercise extreme caution.

Secondly, there is a key difference in the positions of the Council and Parliament regarding the level at which the output floor is applied. While the Council applies this measure at all individual and consolidated levels, leaving some room for manoeuvre within each Member State, Parliament recognises the reality of the single market. Despite the outstanding matters that must be addressed to complete the banking union, Parliament opts to implement the output floor at a consolidated level only.

The application of the output floor at consolidated level only comes, nonetheless, with two safeguards. On the one hand, if any competent authority considers that the capital calculated at the subsidiary is too low, it can request a redistribution with the competent authority of the parent organisation. On the other hand, if we don't make progress in the coming years towards completing the banking union, then the Commission would have the power to propose the output floor be applied at all levels.

Parliament considers this to be the most suitable option to relaunch the banking union and introduce additional incentives in this direction. Finding an agreement on this point will not be easy, but I hope that the Council will manage to listen to Parliament's arguments and find alternative ways forward in the interest of the Member States. Furthermore, there are major differences regarding transitional provisions for the introduction of the output floor, which Parliament wants to limit in time.

An agreement before the summer will allow banks and regulators to implement both legal texts in time.

Finally, the two texts differ on other significant issues. Parliament supports the Commission's attempt to improve the selection processes for board members and key positions in banking institutions, as well as increasing adequate supervisory control on third country branches. The Council, however, does not. I therefore trust Member States will further reflect on this issue. We also hope to see similar levels of receptiveness when it comes to implementing the latest Basel recommendations on prudential management to crypto-asset exposures in the EU.

In short, Parliament has begun negotiations with the Council in good faith and with the aim of reaching an agreement before the summer, which will allow banks and regulators to implement both legal texts in time. And that is where we remain.

ALBAN AUCOIN
Head of Public Affairs - Crédit Agricole

Unravelling the economic impact of Basel and its implications for the EU

The latest BCBS Basel III Monitoring Report issued in February 2023 highlights that the 2017 recommendation on the finalisation of Basel III would result in a 19% increase in minimum Tier 1 capital risk-based requirements for Group 1 European banks. In contrast, the impact on the Americas was nearly neutral with a mere increase of 0.3%, and the rest of the world would even witness a 4.8% decrease.

The banking package discussed now is not going to dramatically change this impact. According to the EBA Basel III Monitoring Report published in September 2022, the impact of the Basel norms on European banks would be a 15% increase in Tier 1 capital requirements, with Group 1 banks seeing an even higher increase of 16%. For G-SIBs, the impact is even more significant with a 24.7% increase in capital requirements. Even with the adjustments included in the banking package, the fully loaded impact would be a 10.7% increase for all banks, a 12% increase for Group 1 banks and a 20% increase for GSIBs. These figures are underestimated, since some adjustments, for instance on SA-CRR, have already been rejected at the current stage of the legislative process.

It is evident from these figures that the EU is not going to comply with the Basel accord overarching principle of 'no significant increase in capital requirements'. Meanwhile, banks in other jurisdictions will get a competitive advantage. The study 'The EU Banking Regulatory Framework and its Impact on Banks and the Economy' published by Oliver Wyman in January 2023, shows that on average and taking into account differences in business models and market structures, EU banks face higher capital requirements than their US peers (10.6% of CET1 in the EU versus 9.9% in the US). The Basel III framework is bound to widen this gap further. In addition, only 13 US banks apply the Basel standards, leaving many others with much weaker requirements, as illustrated by the collapse of the Silicon Valley bank.

Since the US was the impetus for the Basel framework, many of its features have been designed to address the specific conditions of the US economy. However, the situation is very different for the EU where distinct features call for a different approach. For instance, the EU has a much smaller capital market and an economy based on a majority of unrated corporates. Additionally, the output floor significantly reduces the risk sensitivity on mortgage loans in internal models. This penalises European banks, which have lower risk thanks to the double recourse to debtors and real estate assets, while US banks have recourse only to assets. The solvency ratios may be identical but conceal very different realities.

International convergence of prudential regulations is desirable to avoid the distortion of competition, but also for that, it is necessary to take into account the specificities of each market. The banking package incorporates some adjustments to cope with these specificities. Unfortunately, the most significant adjustments are temporary and European adaptations only give 5pp relief on the increase in capital requirements. This is a limited adaptation to the EU risk profile and, even with this relief the impact remains very significant for European banks.

While the temporary measures proposed by the Commission have helped to avoid a one-size fits all approach and to adapt the international standard to the EU economy, the impact of the banking package on the financing of the European economy will still be massive. Apart from unfair competition, banks have the means to adapt to this situation by reducing their financing and/or increasing their margins and fees to cope with the extra cost of capital. The problem will mostly be for European borrowers. According to Oliver Wyman's study considering the higher capital requirements in the EU vs the US 'A review of current capital requirements and supervisory processes could, in a hypothetical scenario, provide capacity for €4-4.5 trillion additional bank lending'.

The impact of the banking package on the financing of the European economy will still be massive.

The Copenhagen Economics study 'EU implementation of the final implementation of the final Basel II standard' estimated that the finalisation of Basel III could reduce banks' financing capacity by approximately €3 trillion. This increasingly unlevelled playing field when it comes to prudential standards is very detrimental to the EU, when at least € 500bn is required every year to finance new investments in sustainability and digitalisation.

Copenhagen Economics has calculated that the cost of borrowing in Europe will significantly increase by €25-30bn overall. Corporate customers are expected to be the most impacted, with a 0.25pp estimated increase in borrowing costs in average in the EU.

MARTIN NEISEN

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A closer look at the individual impacts of CRR III on European banks

While the goal of the finalisation of Basel III is to improve the resilience of banks, the specific changes focus mainly on calculating Risk Weighted Assets (RWAs) and increasing the risk sensitivity of capital requirements. Impact studies of BCBS and EBA showed that the weighted average in total Tier 1 minimum required capital increased by 13.7 per cent. Considering the adjustments made in the EU Banking package, the EU Commission estimates the impact of Basel IV/CRR 3 to be significantly lower, especially during the transition phase: the average increase in total minimum required capital will be between 0.7 per cent and 2.7 per cent in 2025, considering all transitional provisions. In 2030, when the major part of the transitional provisions will be phased out, the increase will be between 6.4 per cent and 8.4 per cent.

The results of detailed impact analyses by PwC, based on a high granularity and even single exposure level, showed that the impact varies significantly depending on banks' business model and to the extent internal models are used. Generally, the higher the risk appetite of banks, the higher the increase of RWA. And the impact of the new output floor (OF) increases with the use of internal models. For example, banks with a low-risk credit portfolio that use mostly the IRB approach will face a significant increase due to the OF.

A closer look shows how the effects of the new CRR III regulations are material in individual cases. Regarding the new standardised approach for credit risk (SA-CR), for example, the changes in the exposure class "institutions" may reduce RWAs for individual-rated institutions. However, a significant increase in risk weights is expected for unrated banks with high creditworthiness in countries with excellent external ratings. Applying the sub-exposure class specialised lending definition can be challenging and surprising and may lead to higher RW impact for corporate exposures. Regarding the exposure class "real estate financing," we observed that the credit splitting approach could lead to higher risk weights in the first years after the origination of the loans, as the loan-to-exposure ratios (LTE) are relatively high.

Moreover, the more a loan is paid back over the loan lifetime, the whole loan approach would be more beneficial for banks. We identified banks with a conservative business model based on very low LTEs that face an increase in RWA compared to the current rules, while banks tend to grant high LTE loans. Another interesting observation is that LTEs in more rural areas were lower than in urban areas. Therefore, banks with a portfolio concentration in metropolitan areas often have relief in terms of RWA than banks in more rural areas.

The biggest lever for real estate exposure is the real estate value. Without detailed guidelines by EBA, the variation of RWs will stay huge. A surprisingly high impact was observed for subordinated debt and equity exposures. Currently, these exposures are not easy to identify according to the new definition. Once identified, the impact became clear and higher than expected.

The impact on RWA in the Internal Ratings Based Approach (IRB) depends on the bank's business model and if the foundation or advanced IRB approach is used. For example, well-collateralised positions will likely experience an RWA boost from the new LGD floor rules for banks using the advanced IRB approach. In contrast, the over-collateralisation of loans under the foundation IRB approach will lead to significant relief compared to today.

The impact of the OF is very individual and depends on various factors, such as business model and the degree of coverage with internal models. Banks whose business model is relatively low-risk and at the same time have a high degree of coverage with internal models are potentially more affected than banks with higher-risk business models.

CRR III impact varies significantly depending on business models and the use of internal models.

The differences between RWAs according to standardised approaches and RWAs according to internal models tend to be smaller for higher-risk business models. Complex interdependencies between the newly introduced OF, new SA-CR, new rules for IRB and a new standard for internal models for market risk will make optimal capital management more difficult in future. One of the biggest challenges will be an adequate reallocation of the OF to the exposure level.

New regulatory requirements have always had an impact on banks' business models. However, with the CRR III regulations, a new level has been reached. The influence on the institutions' business models is very individual and can have both positive and negative effects – and will pose strategic, operational, and regulatory challenges for the banks concerned.

PHILIP EVANS
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Implementing Basel 3.1 in the UK

On 30 November last year, the UK's Prudential Regulation Authority (PRA) published our proposals for the final part of the post-crisis reforms designed to improve the resilience of the international banking system. We call these standards 'Basel 3.1' and they will be by far the largest package of international banking standards that the PRA has implemented since the UK left the EU.

The high-level aims of the Basel Committee on Banking Supervision's (BCBS) Basel 3.1 package are twofold:

The first is to improve the robustness of RWAs by increasing risk-sensitivity and reducing excessive variability. To achieve this, Basel 3.1 makes the standardised approaches better reflect the risk of institutions' exposures and makes internal models unavailable in areas where modelling is too difficult to perform robustly.

The second is to contain the capital benefits of using internal models because of concerns about model risk and uncertainty. To achieve this, Basel 3.1 introduces an 'output floor' – a 'backstop' that stops modelled RWAs from falling too far below those of the standardised approaches.

So, what has the PRA proposed?

In keeping with the UK's status as a global financial centre, we have proposed an approach that maintains high standards that are aligned with the international standards that we helped to shape. We do not see a fundamental trade-off between maintaining high standards to underpin confidence and maintaining the UK's global competitiveness and relative standing. Quite the reverse. As long as we are careful to avoid excessive conservatism, these goals should be re-enforcing over the medium term – recent events in the banking sector remind us just how important maintaining confidence is.

There are many tricky issues in constructing a balanced package. For instance, we haven't chosen to adopt one standardised approach for small firms without models, and a different one for larger firms with models for the purposes of output floor. We believe that having a different approach for larger firms would perform poorly against our secondary competition objective of seeking a level playing field between small and large firms.

Alignment with international standards also raises a delicate issue because some parts of the UK's existing rulebook are below existing Basel standards. Two of the most significant examples are the Small and Medium Enterprise (SME) and infrastructure support factors. They lower the risk weights for lending to their respective sectors and are intended to support lending, though the evidence is quite mixed on whether they have been effective in that regard.

Helpfully, the Basel 3.1 rules introduce new lower risk weights that at least partially cover the ground of the support factors. We propose to align with the risk weights that the BCBS members agreed to, and the vast majority have aligned with.

Although alignment with international standards is at the core of our proposals, we can, and do, propose to make some limited evidence-based adjustments to tailor the package to the UK market where we believe the prudential outcome would not be materially different.

One example is our proposed approach to unrated corporates in the standardised approach. In Basel, for countries that allow the use of external credit ratings, like the UK, risk weights would vary by external rating where one exists, and a flat 100% risk weight would apply where the corporate is unrated. However, the 100% risk weight for unrated corporates is particularly risk insensitive. We have therefore proposed a hybrid approach for this that introduces more risk-sensitivity with a lower risk weight for investment grade corporates and a higher risk weight for non-investment grade.

So, what happens from here?

The window for feedback on our consultation closed on 31 March, and we are in the process of reviewing responses with a view to finalising the package. We are acutely aware that the package is large and covers many significant and complex issues. We worked hard to gather evidence to support our proposals before the consultation, and during the consultation period that effort has continued with our institutions actively working with us to gather all the evidence available to support us in settling on the final package.

ANNA DUNN

EMEA Chief Financial Officer - J.P. Morgan

Importance of Basel III implementation for financial stability and resiliency

As I write this article, the aftermath of the Credit Suisse merger with UBS is just beginning and the initial repercussions from the collapse of Silicon Valley Bank are gaining in strength and clarity. Capital adequacy is not the topic of the hour. Nonetheless it is more important than ever to complete the implementation of the Basel III post-crisis reforms, as the international banking system being well capitalised relative to its risk is the foundation for any further reflections in areas such as liquidity and interest rate risk. Yet again the markets have shown that investor sentiment on banking is global, and consistency in standards is a strength.

It is helpful to remind ourselves of why we began this journey: bank capital is meant to appropriately address the risks held by banks, and Basel III is a meaningful step forward in providing consistent capital calculations that are risk sensitive. Exemptions for favoured sectors, whilst appearing a neat lever in the short term, ultimately through the economic cycle will mean that banks are not adequately capitalized for the risk they assume.

"Specialised lending" or "Project Finance" risk weights for infrastructure have been lowered in Basel III, so keeping current EU CRR supporting factors as a dual regime seems unnecessary. Another example is CVA exemptions for corporates being offered at a point in the credit cycle when credit risk is increasing for many corporates due to rising interest rates and inflation. In short, capital being reflective of risk should be an inviolate principle. The area of most contention with respect to convergence - unrated corporates- arguably creates controversy because the standardized approach is too rudimentary to robustly approximate credit risk.

To the extent that an improvement to capital calculations is agreed, the case for phasing-in improvements gradually over time rests upon potential disruption from rapid changes. Years ago when the Basel III negotiations began, the European banking sector had a significant gap to the level of the proposed standard. Since that point there has been a notable increase in capital levels. Based on the EBA's analysis, in December 2018 European banks' Pillar 1 Tier 1 aggregate capital shortfall to implement Basel III was EUR 24.1 bn. By December 2021 the aggregate Pillar 1 shortfall for European banks was EUR 0.8 bn. Over that period Tier 1 capital ratios on a Basel III fully-phased basis went from 12.7% to 14.1%.

The resiliency of the European banking sector in improving their capital levels during a period of considerable economic disturbance has been admirable, and suggests that seven years may be excess to requirements for the remaining uplift. One way or another, it would be good to be transparent regarding the purpose of phase-in periods, and then to be data driven regarding how the length of the period has been calibrated.

Third country branches are another area in which the European approach should be assisted by more comprehensive data. Third country branches are an integral part of the international financial system, and are a structure on which European banks rely for their international operations.

Given the intrinsically international nature of the topic, it is particularly important to consider global benchmarking. To the extent that third country branches in Europe acquire financial requirements such as capital or liquidity that are more normally aligned to subsidiaries, an unhelpful precedent will be set that may result in inter alia worse banking outcomes for European corporates and challenges for European banks abroad. It is however clear that cross border financial flows can introduce financial stability risk into Europe, particularly if they are not compliant with existing restrictions.

Increased collaboration between home and host supervisors along with transparency at the pan-European level regarding the activities being undertaken by third country branches would better inform European supervisors and regulators regarding whether a stability risk is being introduced. This data driven approach would also permit a targeted response that addresses any actual risk, rather than an indiscriminate measure which could undermine European competitiveness.

The markets show investor sentiment on banking is global. Consistency in standards is a strength.

In summary, Basel III was a collective international effort in which Europe played a leading role in defining the methodology. Current events remind us that there are always new problems but it is incumbent on us ensure that we do not repeat the old ones.

We should implement Basel III as faithfully as possible as soon as possible, with the knowledge that international banks being well capitalised relative to their risks is a prerequisite for global financial stability.