Impacts of Basel III

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A milestone in stabilising the global financial system

The finalisation of Basel III represents an important milestone for the G20 post-crisis reform agenda and a clear commitment to internationally agreed global standards. As such, Basel III will help stabilise the global financial system and ensure an international level playing field for banks.

The framework must now be transposed into the national legislation of the jurisdictions represented in the Basel Committee on Banking Supervision – fully, consistently and in a timely manner.

In Europe, the first step was for the European Commission to analyse the impact of the remaining elements of Basel III before it comes up with a legislative proposal – presumably in 2020. The results of the impact assessment carried out by the European Banking Authority will form the basis for the implementation of Basel III in European law.

The assessment shows that banks in the EU can cope with the remaining elements of Basel III: while minimum capital requirements will significantly rise for some larger, internationally active banks, the additional demands on smaller banks are on a smaller scale. And even though we recognise the challenges for some bigger banks, the increase is manageable.

The expectation articulated by the Group of Central Bank Governors and Heads of Supervision (GHOS) that finalising Basel III should not, on average, significantly increase overall capital requirements posed a particular challenge while wrapping up the Basel III package. Differences in financial systems across stakeholder countries made it difficult to strike a universally acceptable balance.

A focal point in the discussions of the Basel Committee was the calibration of the output floor. However, in the end, the objective to not significantly increase minimum capital requirements on average was reached at the global level. The latest Basel III monitoring results show a moderate increase in minimum capital requirements worldwide of 5.3% for large institutions and 9.0% for other institutions.

Of course, there is heterogeneity across regions. Large European banks, for instance, face an increase of more than 20%, whereas the increase of 1.5% for large American banks is considerably smaller. But these numbers reflect averages and do not represent the impact on each institution in the sample. On an individual basis, the impact varies significantly depending on each institution's specific business model.

Furthermore, the estimated figures for European banks are far below the numbers from the initial Basel III reform package, which was assessed for the first time in 2012. Back then, respective shortfalls were eliminated within four years. This gives me >>>

>>> confidence that the European banking sector can cope with the additional capital demand this time as well.

It is important to emphasise that changes in individual capital requirements are not unintended side effects. The major goal of the Basel III reform package is to make the requirements more risk-appropriate, restore the credibility in the calculation of risk-weighted assets (RWAs) and improve the comparability of banks' capital ratios. Bank-specific changes in minimum capital requirements reflect these goals.

This is why calls for divergent, more lenient implementation of Basel III are unwarranted. For example, there have been demands to allow for a parallel use of external ratings and own assessments of a borrower's credit quality under the Standardised approach. Others are pushing to maintain the option to apply the advanced IRB approach for exposures to large corporates and banks. These proposals are neither in line with Basel III nor justified from a risk perspective.

It will take some time until the new rules become fully effective. As soon as this is the case, it will be important to monitor whether the objectives of Basel III have been achieved. To that end, the Basel Committee has already approved a comprehensive evaluation work programme.

Before this can happen, full and timely implementation is needed. Laying the foundation for an evolving global economy and a healthy, strong and stable financial sector is essential and has to be underpinned by effective regulation. In order to secure the financial system, collaboration and transparency in international rule-setting are crucial. Achieving effective international regulatory cooperation is of utmost importance. ●

Casper von Koskull

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Basel III: a special consideration for the Nordic economies

The Nordic economies are open, competitive and rank high on economic welfare indicators. They have high employment rates, high incomes, strong social safety nets and solid government finances. In addition, the distinct Nordic legal tradition combines an effective and modern legal infrastructure with a high degree of creditor protection. This combination not only ensures a strong macroeconomic shock absorption capacity, but also financial and economic stability.

It is worrying to now see the potential effects from Basel III on these economies. Assessments from the European Banking Authority (EBA) suggests an average increase of 24.4% in the minimum capital requirement for EU banks, with an even higher increase expected for low-risk markets such as the Nordics. Even more concerning is that fact that regulatory capital requirements will be the result of a regulatory design that does not match the risks banks actually face – thereby distorting the incentives for banks when it comes to business selection and pricing. This can ultimately create a negative impact for the financing of Nordic corporates and households, and ultimately make the Nordic financial system less robust.

With this outset, I would like to suggest the following to European policy makers:

1. **Don't penalise low risk portfolios.** Low risk assets will be particularly impacted by the combined effect of standardised approaches and an output floor. If part of the >>>

>>> intention of Basel III was to further disincentivise the holding of high-risk assets then this will do the opposite, creating a penalising effect for holding assets like low risk household mortgages and loans to high (credit) quality Nordic corporates. One way to mitigate the impact of the output floor is to use minimum Basel capital requirements for the output floor measure – i.e. not impose buffer requirements based on this measure as well. Further, to apply Basel III in a way that accommodates the specific ways in which EU corporates and household are financed.

2. **Ensure we have the same rules for the same risk.** While the regulation of banks has been strengthened considerably with Basel III, the same is not true for other parts of the financial system. As a result, some activities that are key service areas for banks are being taken over by other financial service providers – not all of which are regulated to ensure financial stability. Key examples are market making activities and mortgages. The broader risk is one of regulatory arbitrage. A regulatory system that overcharges for risks for one type of market participant (and not others) will likely see those risks move to where the cost of holding the assets more closely reflect the risk or even undercharges for the risk.
3. **Ensure a better coordinated use of the multitude of capital tools.** The regulatory reforms have resulted in regulators – national as well as European - having a wide range of tools at their disposal. As a result, it has become more complex to decide which tools should be used to address which risks. It has also become more complex to ensure a clear allocation of responsibilities between national regulators and the central union supervisors. This can lead to multiple tools being used to cover a single risk issue and that certain "popular" risks become over-capitalised. I attribute part of this issue to the way in which supervisory responsibilities have been compartmentalised. The addition of Basel III could exacerbate this issue and I therefore recommend the use of existing tools and division of supervisory responsibilities be assessed as part of the implementation.

To conclude: If regulatory implementation is based on an EU average, there is a clear risk that the impact will be unreasonable for the Nordic financial system and the Nordic economies. This can have a direct impact on Nordic corporates and households and even financial stability. Ultimately the result will be a loss of trust in and hence credibility of the EU regulatory system – not just in the Nordics. I therefore urge EU policy makers to deliver a capital framework that (reasonably well) reflects the real risks and which is relevant to the diversity of the financial ecosystems in Europe. ●

Philippe Bordenave

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Let's be serious with CMU

It is ironic that wise ECB efforts to encourage growth are countered by banking supervisors. Indeed, on one hand, the ECB incentivizes banks to grow eurozone lending by the TLTRO subsidized funding. On the other hand, most banking supervisors in the Eurozone worry about excessive credit growth and incentivize banks to reduce lending by setting contra-cyclical buffers. Moreover, the Basel Committee and its EU members announce a further tightening of capital rules, so called Basel IV, with a 24% average impact on EU banks, triggering an anticipation of credit slowdown.

Those contradictory injunctions disrupt the financing of the European economy, which, as we all know, is 70% based on bank finance. European banks suffer from low revenues linked to accommodative monetary policy, increased funding costs due to longer maturities and higher subordination, and excess capital and liquidity sterilized for regulatory purposes instead of being put at work for growth and job creation. Hence, their profitability is insufficient. It is therefore difficult for them to attract fresh capital. In order to reach the Basel IV related additional capital requirements, they will have to severely restrict their provision of credit.

EU Member States, well aware of this dilemma, had set a clear guidance to the EU members of the Basel Committee: Basel IV «would not be expected to result in a significant increase in the overall capital requirements for the banking sector, therefore not resulting in significant differences for specific >>>

>>> regions of the world» [Ecofin, 12th july 2016].

The balance of powers at the Basel table led to ignoring this mandate. Can we still today unlock this situation and relaunch growth while maintaining the high degree of financial stability now reached in Europe?

The only way forward is to accelerate the development of European capital markets, to mitigate the negative consequences of Basel IV on bank lending. It is thanks to highly developed capital markets that the US finance 75% of their economy. In the EU, this requires a decisive action and a major shift from recent trends:

a. Truly encourage securitization. The recent legislation is mostly driven by a desire to reduce risks in securitization transactions. This protective framework should be implemented in a flexible way to allow market development. Moreover, a framework to securitize home loans should be designed, with the sponsorship of a public institution with required expertise (the EIB?) to be the trusted third party that would give confidence to investors. Super-senior tranches of such high-quality home loans securitizations could play a role as « safe assets » in the EU.

"The only way forward is to accelerate the development of European capital markets."

\- PHILIPPE BORDENAVE

b. Stop the ongoing weakening of large European banks active in capital markets. The number of such banks has already decreased a lot, and the trend is to retrench from those activities. This trend should be seen as worrying by European authorities, in a context where Capital Markets are necessary to relaunch the economy, finance low risk assets and energy transition infrastructures. In particular, the "FRTB", which requires a complete overhaul of the surveillance tools to manage market risks, combined with a doubling of the capital charges, should not be made binding in Europe as long as it is not in the US. Otherwise, the US banks, which already have a 50% market share in the EU in these businesses, will soon possess all the keys to provide or deny access to markets to European corporates, financial institutions, and sovereigns.

As the new European agenda for 2019-2024 is to "increase its capacity to act autonomously to safeguard its interests", large international banks should be clearly identified as one of Europe's strategic sectors and a core element of European economic sovereignty. ●

Adam Farkas

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Basel III output floor and EU IRB repair

After the great financial crisis, a general mistrust in the outcome of banks' own models ensued, as internal models were seen as sources of risk underestimation at the root of the financial turmoil. Institutions were believed to use IRB models to "optimise" their risk-weighted assets to achieve capital savings. In analysing the results of the first EU-wide stress test, the EBA flagged the wide dispersion in models' outcomes already in 2011 and launched various efforts to understand the drivers of RWA variability. The objective to "repair" IRB models a joint effort of the EBA and competent authorities to rebuild trust in internal models has been pursued via regulatory and supervisory initiatives.

The results of these initiatives are already evident, as rules on IRB models and their governance have been clarified by the EBA, and the benchmarking exercise helped competent authorities identify any material differences in RWA outcomes. Moreover, model improvements have been required in the euro area to address the deficiencies identified during TRIM reviews.

At the global level around the Basel Committee table, it is well known that regulators held different views on how to restore the credibility and robustness of RWA calculations while maintaining sufficient level of risk sensitivity in the capital requirement framework. The compromise was the introduction and calibration of an output floor – a limit to the outcome of internal models based on the standardised approach – that acknowledges the progress with the "bottom-up" repair of IRB, but also puts a backstop to the outcome of banks' internal models.

So far, shortcomings in internal models or in input data have been partly addressed via Pillar 2, for the part covering model risk, and deploying macroprudential measures, for instance for real estate exposures. Since the introduction of the output floor implies that some of these issues will be addressed under Pillar 1 requirements, the EBA decided to recommend that competent/designated authorities reconsider the calibration of Pillar 2 requirements and macroprudential buffers to prevent any double counting of requirements.

"Basel III implementation to contribute to restoring credibility of banks' internal models."

\- ADAM FARKAS

The output floor was not the European regulators preferred measure, but it is the result of a negotiation and its final calibration reflects EU concerns. It has been also instrumental to preserve global regulatory alignment and the possibility to use internal models. Its full implementation is now necessary to ensure the credibility of the EU >>>

>>> banking sector and a level playing field at international level.

The EBA has conducted an assessment of the impact of Basel III rules on the EU banking sector. The results were published in July. The analysis shows that, using conservative assumptions, the minimum capital required in the sample of banks participating in the exercise will increase and the output floor is responsible for a part of this increase.

The impact however is mostly driven by large and systemically important institutions, while it is limited for medium and small sized banks, as originally intended by the reform. The possible recalibration of Pillar 2 and macroprudential requirements, which would be decided case by case by the competent authorities, would partially mitigate the impact.

Overall, Basel III is a framework that aims to ensure stability of and global level-playing field in the financial system in the longer term. For this purpose, the EU should strive to adopt these rules in full without deviations. ●

Martin Merlin

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Balancing the objectives of Basel III

The overall aim of the final set of prudential reforms agreed upon at international level in response to the global financial crisis – referred to as the "finalisation of Basel III" – is to restore confidence in the calculation of risk-based capital requirements. Empirical studies have demonstrated excessive variability in risk-weighted assets which have given rise to doubts about the reliability and comparability of banks' internal models used to calculate capital requirements. At the same time, existing standardised approaches for calculating capital requirements have been found to lack sufficient risk sensitivity to provide a robust alternative to internal models.

The reform was to be carried out in a manner that would meet this aim without significantly increasing the overall capital requirements. And when the Basel Committee assessed the impact of the reform the results did indeed show that, from a global perspective, the average increase in capital requirements was not significant. However, as is always the case with averages, they do not tell the full story. A closer look at the impact per jurisdiction shows that for some jurisdictions the reforms would actually lead to a reduction in capital requirements, while in others, among which the EU, they would lead to important increases in capital requirements.

"It is essential that we faithfully implement the solutions agreed at international level."

- MARTIN MERLIN

The difference in the impact can to some extent be explained by the fact that the current prudential requirements in those jurisdictions that would see a decrease are stricter than those contained in the reforms. So, the actual difference in the impact will in part depend on the extent to which those jurisdictions will decide to adjust their current prudential approaches towards the new minimum required by the strengthened Basel III framework. From an EU perspective, the actual difference will also depend on the extent to which the outcomes of the ongoing work to strengthen internal models of EU banks, driven by the EBA and the ECB, are taken into account in the analysis. Since that work is expected to lead to a reduction in the excessive variability of capital ratios, it should inevitably reduce the overall impact of the Basel III reforms.

But, in the end, what will be the actual impact of the Basel reforms on EU banks? The Commission asked the EBA to answer this question. The EBA's preliminary analysis shows that, under very conservative assumptions, some EU banks would see large increases in their capital requirements. An important aspect of the work in the coming months will be to identify the drivers behind these increases, to determine whether those increase are justified in view of the actual risks faced by those banks, and to assess whether those increases will have disproportionate negative consequences for the EU economy.

If the analysis shows that certain specificities need to be accommodated, there is some room to do so. But this room is limited if one wants to preserve the integrity of the overall framework. As we in the EU want to maintain a multilateral approach to solving important global issues, it is essential that we faithfully implement the solutions agreed at international level. Only then can we expect that our international partners will do the same. ●

Karin Dohm

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Consistency and flexibility – calibrating Basel III in Europe

The implementation of the G20's Pittsburgh agenda over the last ten years has enhanced the consistency of the international regulatory framework and has made t3he financial system more resilient and transparent.

Greater consistency does not mean though that rules are or should be completely identical across >>>

>>> every jurisdiction. Different markets, banking systems, legal and economic situations mean that greater alignment of regulatory outcomes has to be achieved with some flexibility to suit the local context.

This is especially true for Europe, where banks have historically made greater use of internal models. We in Europe believe that this leads to better risk management and better allocation of risk weights to exposures.

"Protecting Europe's funding model needs to be reflected in the transposition of the final Basel III package."

\- KARIN DOHM

This reliance on internal models means that European banks are more severely impacted by the Basel III reforms, which are designed to limit the use of internal models, through the introduction of an output floor and additional standardisation. The scale of this impact can be seen from a number of impact assessments: BCBS (plus 25%), EBA (plus 28%) and Bundesbank (plus 28%) - all confirm that European banks would be significantly impacted if they had to apply the proposed standardised approaches as input to an output floor calculation.

In Europe banks play a more vital role in financing the economy than compared to other jurisdictions. The EU banking sector provides 75% of corporate and 90% of household financing – more than twice the ratio in the US. Any significant change in capital calculations for credit risk are therefore expected to have a more direct impact on the European economic activity than for instance on the US economy.

For these reasons the implementation of Basel III changes to the credit risk frameworks must be calibrated very carefully in Europe, in order to avoid 'significant increases' in risk weights that could have damaging and unintended implications for the EU economy.

Protecting Europe's funding model needs to be reflected in the transposition of the final Basel III package. In order to do that policy makers should focus on calibration in the following areas:

- **Corporate credit exposures** - most EU corporates don't have an external rating, which penalises them when banks have to apply the standardised approach for the output floor. Risk weights could double or triple. This could be resolved by tailoring the framework for unrated corporate exposures and allow the use of the lower risk weight of 65% which is used in other jurisdictions for unrated corporates.
- **Corporate hedging** - activities are impacted by application of the standardised approach to calculate exposures to derivatives (SACCR). This standard is already overly conservative, but with the output floor capital requirements for Interest Rate, FX or Commodity derivatives could increase by 2.5 to 5 times. The BCBS should review the standard and as this will take time, Europe should set the multiplier, the so-called alpha factor at 1 to avoid unnecessary consequences, until the BCBS has updated the calibration.
- **Real estate** - the Basel framework assigns risk weights to real estate exposures (both residential and commercial) according to Loan-To-Value (LTV) bucketing, with progressively higher RWs. These LTVs are not representative of the LTVs applied in Europe. The LTV buckets are not aligned to European common LTV ranges and the RW assigned per LTV are excessively high and not justified by the good historic loss performance.

Targeted tailoring of these inputs into the calculation of the output floor is key, necessary to ensure funding for European corporates and helps to avoid disproportionate impacts on the risk weights of EU banks and the European economy. ●