BASEL III FINALISATION

THE IMPACT ON EU BANKS AND THE REAL ECONOMY ACROSS SCENARIOS

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Introduction

- Need to make the financial system more resilient and robust post Global financial crisis (2007-09)
- Capital requirements internationally agreed in Basel Committee
- Basel III most recent agreed
- First phase focused on quality and quantity of capital and liquidity (nominator)
- Second phase agreed in December 2017 focuses on calculation of risk-weighted assets (denominator)
- EU is committed to implement the second phase gradually between 2023 and 2028 (incl. one-year Covid-19 extension)
- This study assesses the impact of the finalised Basel III reforms (second phase) on EU banks and the real economy

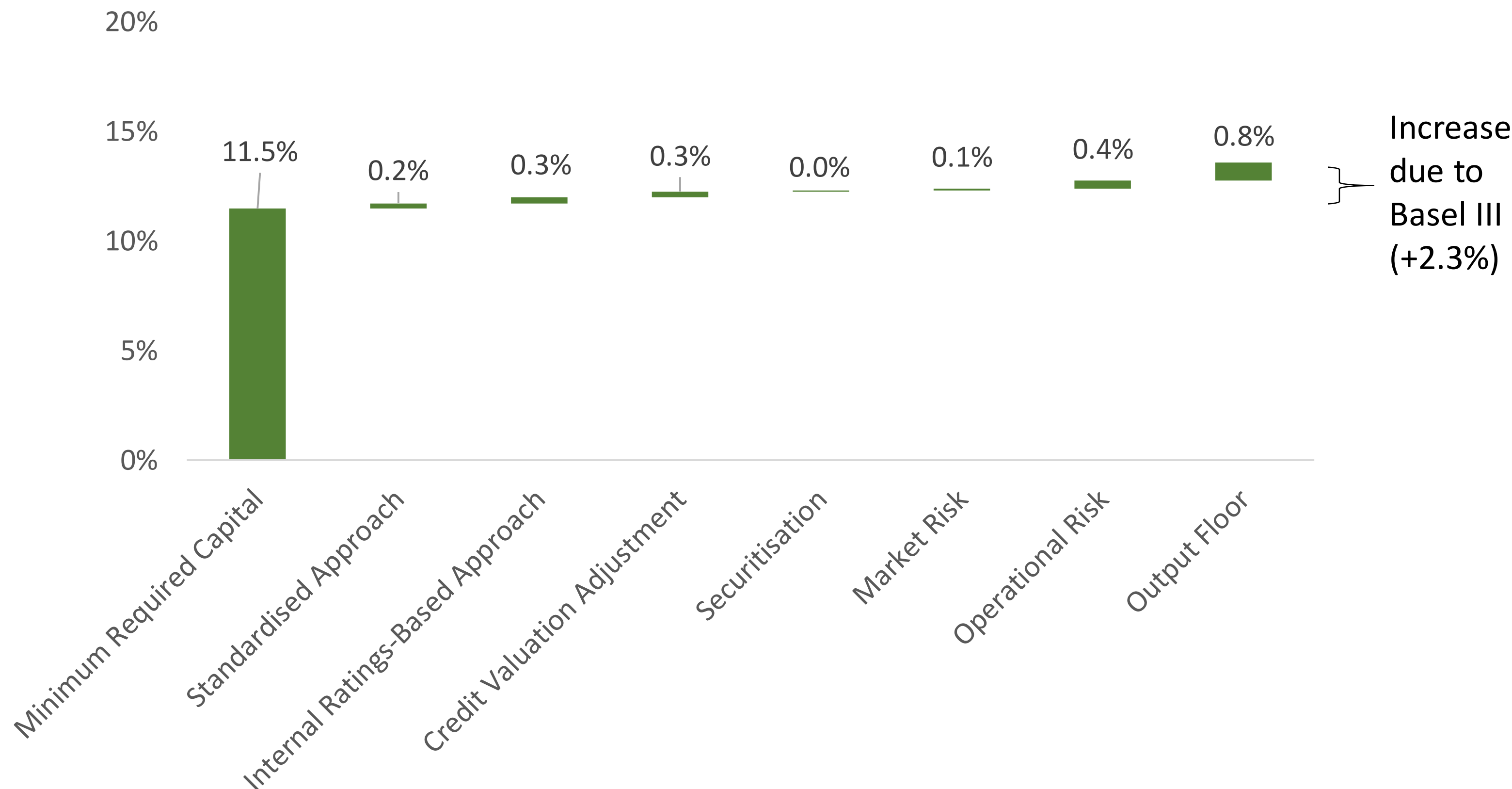
Methodology – Impact Basel III model

- Model based on results updated EBA (2020) impact assessment
  - Impact by reform measure defined at country-level (EBA, 2020)
  - If not available, impact determined based on bank-size (EBA, 2020)
    - **Large**: Total assets >=30 EUR bn
    - **Medium**: Total assets between 5 EUR bn and 30 EUR bn
    - **Small:** Total assets <=5 EUR bn
  - Distributed across banks within group based on distribution key
  - Specific adjustments
- Impact EBA impact assessment ≈ CEPS study (business-as-usual)

Methodology - Data

- Sample
  - 30 June 2021
  - 135 EU banking groups (smaller in number than EBA exercise)
  - 27 countries (EEA+UK)
  - > 70% EU banking assets
  - Data from EBA's "2020 EU-wide transparency exercise - Autumn 2020 exercise", ECB's "SREP 2019" and annual reports

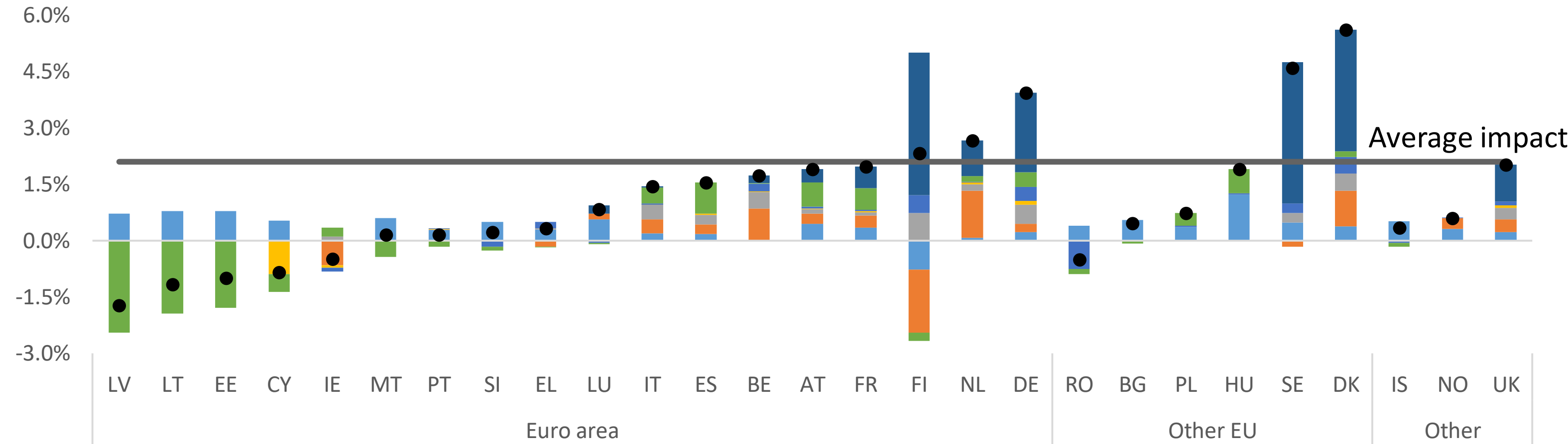
BAU: Impact final Basel III - Measures

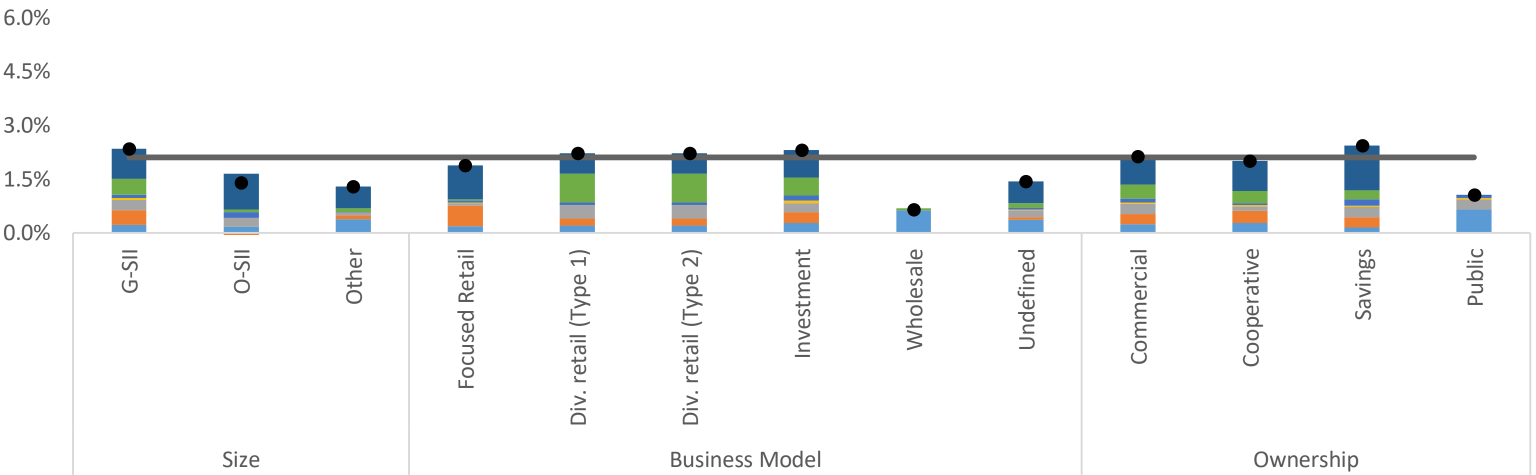


- Impact of finalisation of Basel III measures, assuming no change in balance sheet
- Overall impact based on assumptions like EBA impact assessment (excl. CCP 0.0% of MRC, LR -0.2% of MRC)
- Average increase to cumulative measures would be around 2.3% of RWA, which is higher than most buffers
- Output floor accounts with about one-third of the total cumulative impact for the lion-share of the impact of Basel III measures (above EBA estimations due to adjustment for Denmark)

BAU: Impact final Basel III - Measures

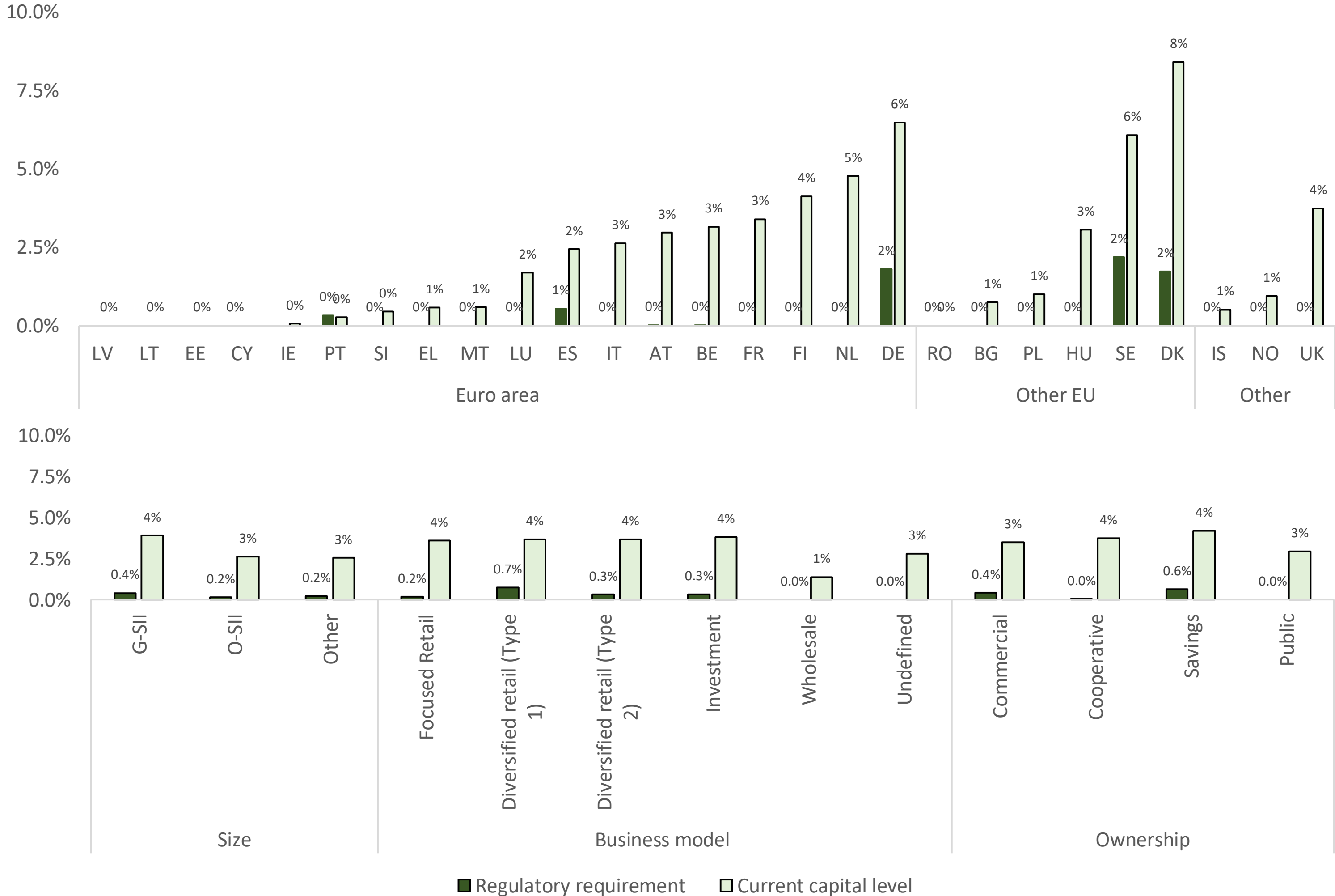
Increase in capital requirements (as share June-2020 RWAs)





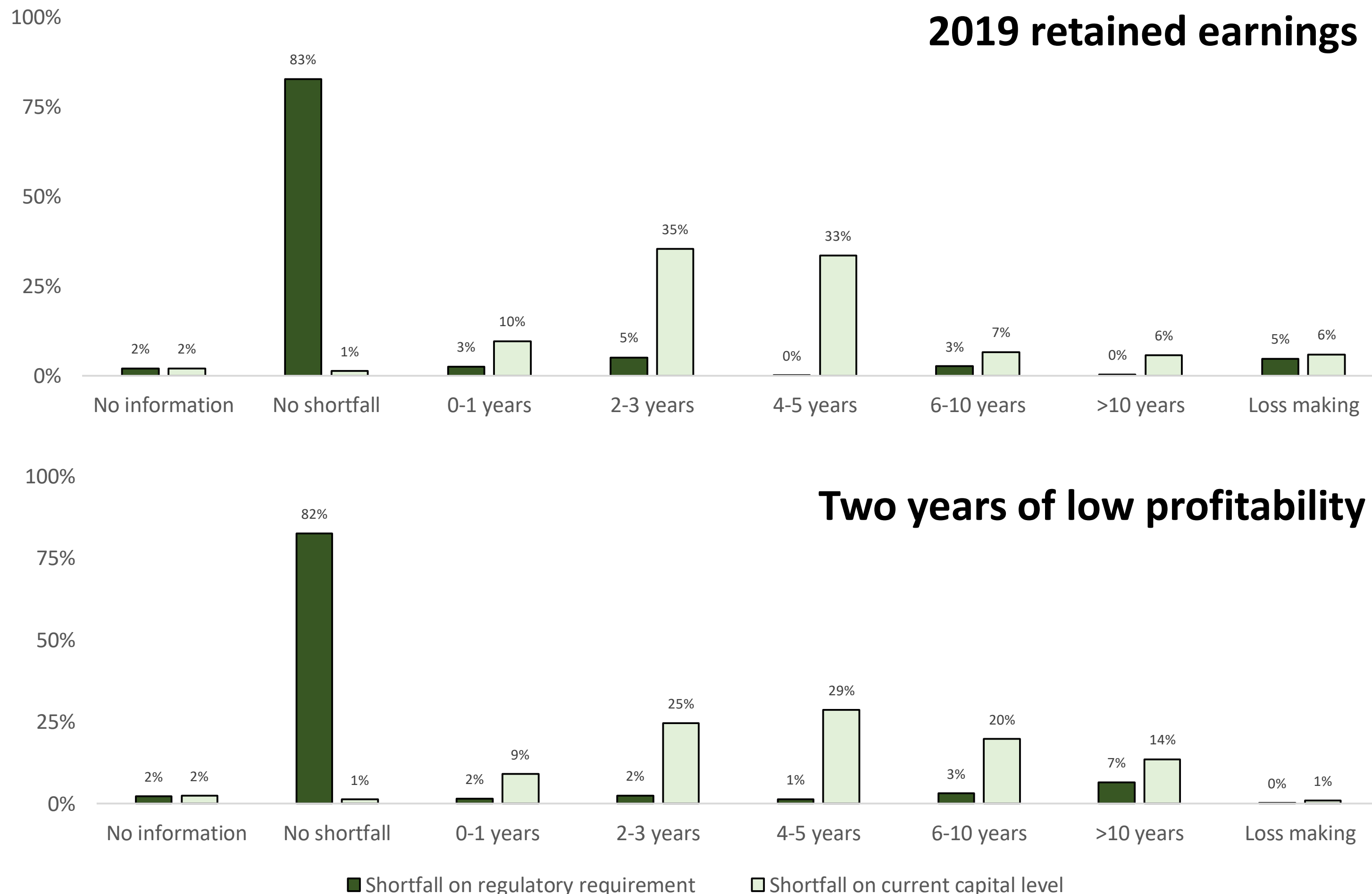
- Impact differs largely across countries, sizes, business models and less across ownership types (excl. public banks)
- Impact largest in DE, DK, FI, FR, NL, SE and UK that have banks using internal models with relative lower rates for retail/corporate exposures (large impact output floor)
- G-SIIs experience larger impact than O-SIIs, primarily due to large impact operational risk adjustments and introduction output floor
- Div. retail and investment relatively more affected than focused retail and wholesale

BAU: Impact final Basel III – Shortfalls



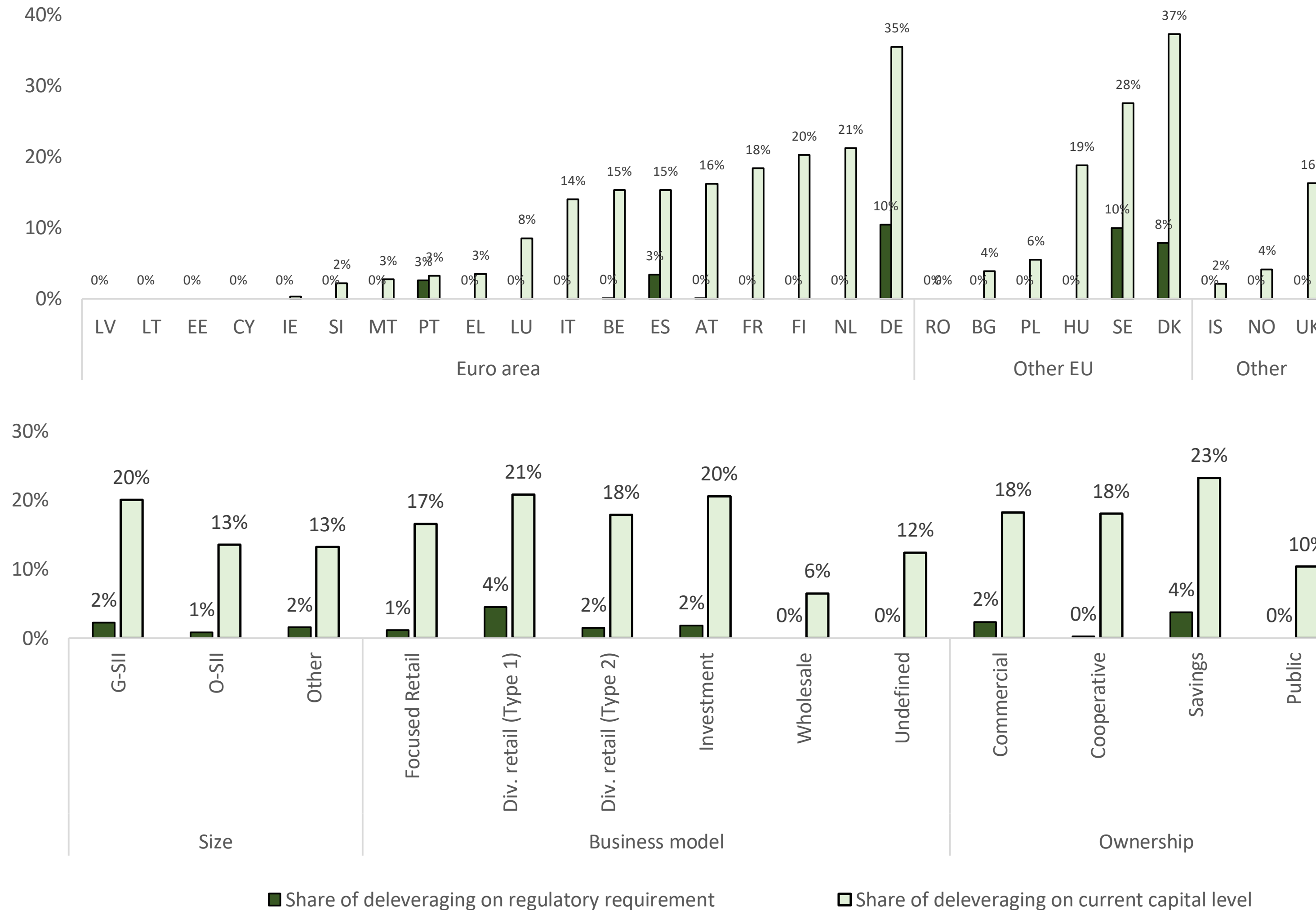
- The number of banks experiencing a shortfall ranges between 18 (13%) considering regulatory requirements and 118 (87%) considering current capital levels
- The total shortfalls range between a modest EUR 38 bn (about 0.4% of RWAs) considering regulatory requirements and EUR 386 bn considering current capital levels (about 3.6% of RWAs)
- Shortfalls show similar pattern across countries and types of banks cumulative impact of measures

Scenario 1: Retained earnings – Shortfalls



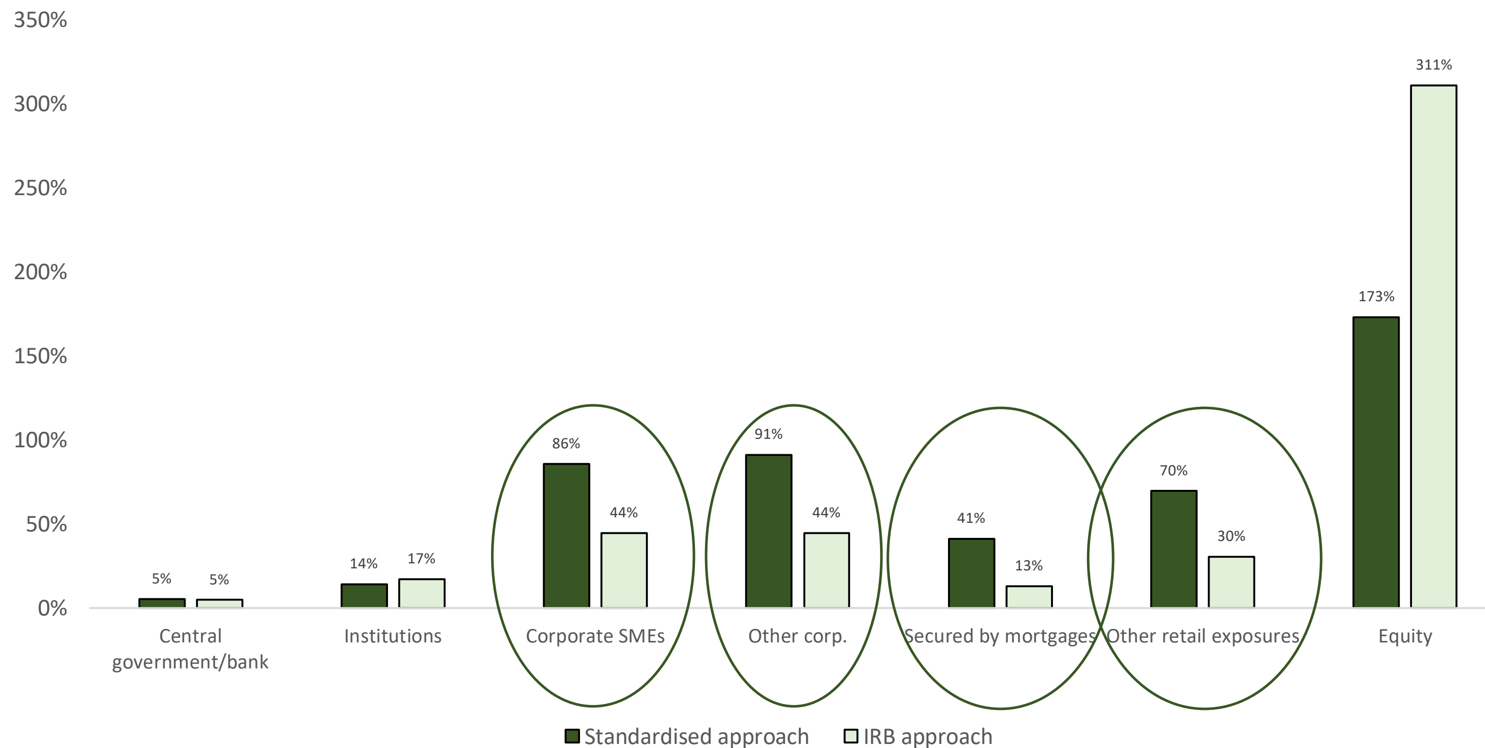
- Nearly all the banking sector (90%) can absorb the shortfalls on regulatory requirements by retaining profits up to 3 years
- A substantial minority representing about 7% of the banking sector would require longer than the transition period
- The time required to restore the capital levels to the current levels is substantially longer (about 18% would need more than 5 years of profit retention assuming 2019 profitability and 34% considering two years of low profitability due to Covid-19)
- Substantial share of the banks might thus be likely to look for alternative scenarios to restore current capital levels

Scenario 3: Deleveraging – Shortfalls



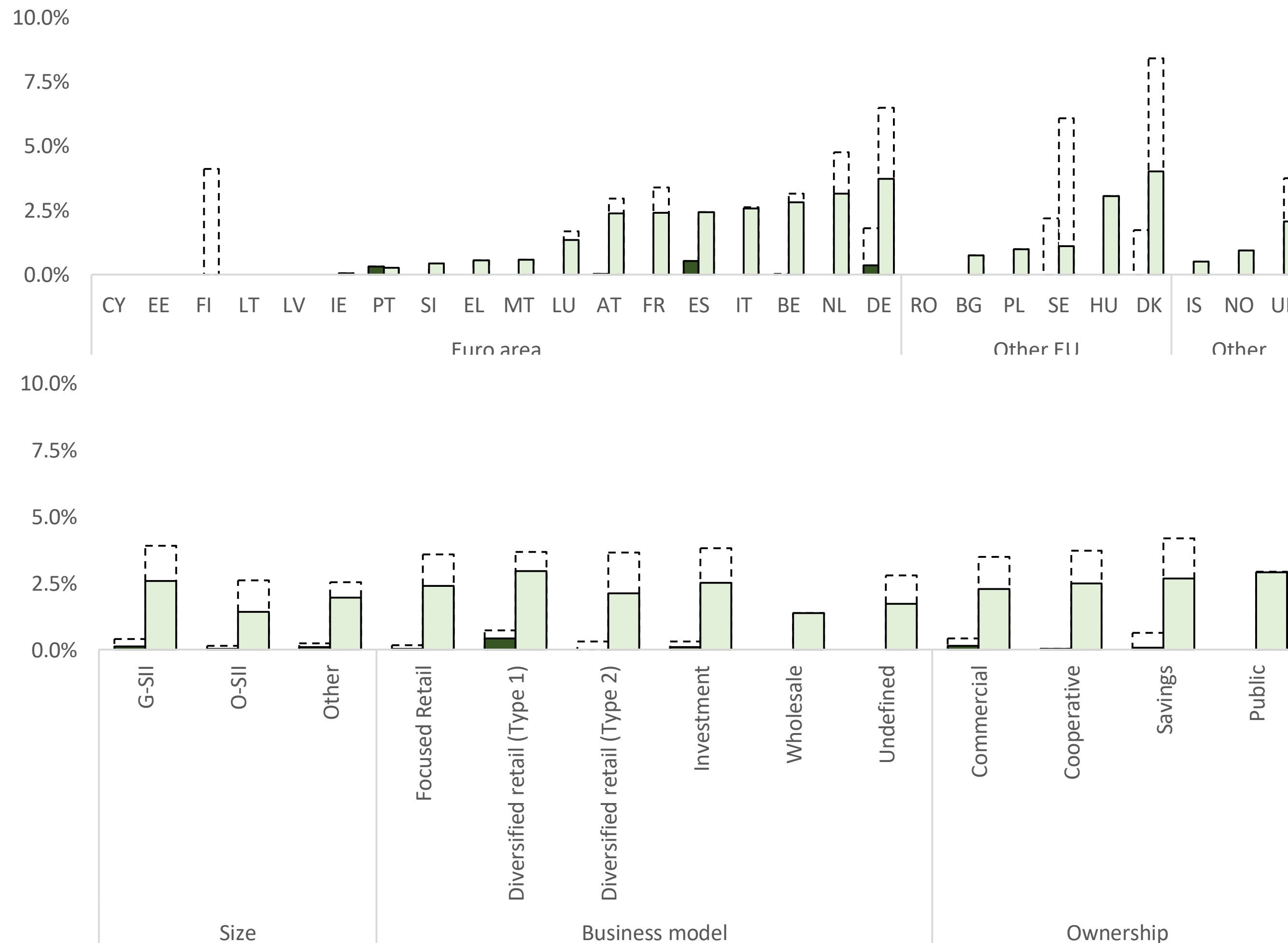
- Calculations based on 2020 exposures, assuming reduction in exposures is fully due to credit risk and pro-rata
  - In practice banks are likely to deleverage primarily exposures with higher risk-weights and shorter maturities (see Scenario 4)
- Large differences depending on the capital ratio that banks will hold
  - Especially banks in the countries with higher relative shortfalls would need to reduce their balance sheet substantially
- Deleveraging
  - Regulatory requirements (EUR 720 bn or 2% of total assets)
  - Current capital requirement (EUR 6.5 trn or 19% of total assets)

Scenario 4: Portfolio rebalancing – Risk-weights



- Post-crisis global financial crisis banks initially kept their exposures constant, but reduced the risk-based exposures
- This scenario assumes that the exposures remain the same, but the shortfalls are addressed by rebalancing the exposures
- The output floor will be an important driver of the potential rebalancing
- There is especially a large difference in average risk-weights between standardized and IRB concerning corporate (SMEs and non-SMEs) and retail exposures (secured and other)
- Potential re-allocation from corporate and non-secured retail exposures to central government/institutions

Scenario 5B: Decoupling Pillar I and non-Basel buffers



- This scenario assesses the consequences if the supervisory add-ons and non-Basel buffers (systemic risk and O-SII) would only be applied pre-output floor
- Change in the application of the Pillar II and buffers has a large impact on the calculated shortfalls
  - Regulatory capital from EUR 38 bn to EUR 12 bn (-68%)
  - Current capital from EUR 386 bn to EUR 254 bn (-34%)
- Decoupling has less impact on the number of banks experiencing shortfalls
  - Regulatory capital from 18 to 8 (-56%)
  - Current capital from 118 to 115 (-3%)

Conclusions

- Basel III finalisation measures are addressing some of the missing elements in the previous Basel capital reforms (RWA focus)
- EU implementation is likely to have a significant impact on the EU banking sector, especially the most significant banks (DE, DK, FI, FR, NL and SE)
- Without adjustments to the requirements or implementation the impact of the measures in practice is likely to be larger than calculated by the EBA even when considering EU-specific adjustment
  - Shortfall is likely to be about ten times as much if the market and banks continue to demand pre Covid-19 capital surpluses

Conclusions

- Banking groups can address the shortfalls in various ways (retaining earnings, issuing new capital, deleveraging, rebalancing, different application of requirements)
- Retaining earnings is feasible for the largest share of the banking sector, assuming recapitalisation to just the minimum regulatory required capital levels, which is unlikely (Scenario 1)
- Issuing new capital instruments seems for most of the banks confronted with capital shortfalls a possibility without changing their current structure, though relatively expensive due to market valuation (Scenario 2)
- Deleveraging could contribute to addressing the shortfalls, but if addressing the shortfalls in full it might lead to reduced access to finance in certain areas (Scenario 3)
- Like deleveraging portfolio rebalancing can contribute to addressing the shortfalls to a large extent, but might reduce access to finance (Scenario 4)
- Applying the Pillar II requirements and guidance on the pre-output floor RWAs reduces the impact of the Basel III finalisation substantially (Scenario 5)

Policy recommendations

- Apply the Pillar II requirements on the pre-output floor RWAs
  - Output floor is a valuable backstop to the optimisation of the internal model, but also reduces the risk sensitivity of the RWAs
  - Pre-output floor RWAs should thus in principle be leading -> focus on improving the quality of the internal models
- Given the potential (skewed) impacts on the banks there is a need for regulators and supervisors to closely monitor the transition to the Basel III final framework
- Need to assess the impact on the access to finance under the various scenarios (retained earnings, deleveraging and rebalancing)
  - To assess whether there is a need for potential mitigating measures

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Thank you!

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