Box 3.2

UPDATED IMPACT OF THE FINALISATION OF THE BASEL III FRAMEWORK ON THE BANKING SECTOR

In response to a new request from the European Commission, on 15 December 2020 the European Banking Authority (EBA) published the updated impact analysis of Basel III capital regulation reform on European banks[1]. The report updates the starting point of the June 2018 analysis to December 2019 and considers two scenarios: (i) implementation of Basel III with no deviations ("Basel III scenario") and (ii) the so-called "EU-specific scenario".

The first scenario corresponds to the final Basel III framework with no deviations. This framework imposes on banks a series of restrictions and common standards in the calculation of risk-based capital requirements, limiting the use for regulatory purposes of the internal models of these entities. This reform would thus make regulatory risk metrics more comparable across entities, reinforcing also the minimum degree of prudence embedded in the requirements. This scenario includes, in particular, the new frameworks for: i) credit risk risk (new standard method and restrictions on internal models[2]); ii) operational risk (full exclusion of internal models and introduction of a new standardised approach, based on a business volume indicator and the use of historical losses); and iii) market risk and capital requirements linked to the credit value adjustment[3] (CVA).

The second scenario includes deviations from Basel III in the SME supporting factor[4] and excludes certain counterparties from the capital requirements due to the CVA calculation. It also considers the exercise of national discretion to exclude historical losses from the calculation of the capital requirements for operational risk, which would depend only on the business volume indicator of each bank, and other adjustments[5].

Lastly, and for both scenarios, the EBA considers three implementation options for the output floor, that is, a restriction such that bank capital requirements calculated with internal models do no fall below a certain percentage of requirements under the standard method.[6]: The three options are: (i) the main Basel III approach, whereby the output floor would be applied to the full stack of requirements; (ii) an alternative approach, whereby the output floor would not be applied to to all requirements, excluding Pillar 2 requirements (P2R) and the Systemic Risk Buffer[7]; and (iii) the so-called parallel stack approach, which the EBA considers to be non-compliant with Basel III[8].

The Basel III impact (in 2028) is expected to be lower, based on December 2019 data, than that obtained using June 2018 data. Under the Basel III scenario, the Tier 1 requirements would now increase by 18.5%, compared with a rise of 24.1% based on June 2018 data (see Chart 1). This is primarily attributable to the lower output floor impact and the application of the new CVA framework, revised by the Basel Committee in July 2020. The capital shortfall[9] is reduced from €109.5 billion (based on June 2018 data) to €52.2 billion (based on 2019 data), due to the smaller increase in the requirements and to institutions' higher capital position. Of this shortfall, 83% is concentrated in global systemically important institutions (G-SIIs).

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1 See the EBA's Basel III impact study.

2 The regulatory reform imposes floors to the inputs, that is, minimum acceptable values for credit risk parameters (probability of default, loss given default, etc.), with specific restrictions applying to some credit portfolios.

3 The CVA modifies the value of an asset holding to recognize the credit risk arising from the potential default of the counterparty that has issued the assets. This adjustment, which also has a direct effect on the income statement, is incorporated into the capital requirements to capture the variability of its impact.

4 The SME supporting factor entails applying a factor of 0.7619 to RWAs – under both the standardised and the IRB approaches – for exposures of less than €2.5 million. CRR2 also considers a factor of 0.85 for SME exposures exceeding this threshold, although the EBA was unable to take this second factor into account in its report. .

5 Exemptions for non-financial counterparties, intragroup counterparties, CCPs, pension fund counterparties and sovereign counterparties (Article 382 of the CRR).

6 The EBA's exercise also considers, under the EU-specific scenario, some of the adjustments introduced by the European authorities in response to COVID-19 (specifically, the new prudential treatment of software assets and the change in P2R composition).

7 The Pillar 2 requirement (P2R) is specific to each bank and it is determined by the microprudential supervisor to cover risks not considered in the common Pillar 1 requirements (P1R). The System Risk Buffer is of macroprudential nature, and its goal is that entities with the potential to destabilize the whole financial system have enough resources to absorb shocks so that this eventuality is avoided.

8 This approach would set the requirements at amounts equal to the higher of: (a) the Basel requirements (without additional European requirements) for floored RWAs and (b) the total capital requirements applied to RWAs calculated using internal models. Such approach is complex and could limit the output floor impact, going against the purpose of this regulation.

9 Additional capital required to maintain the minimum total capital ratio (including Pillar 1, the combined buffer and P2R).

Box 3.2

UPDATED IMPACT OF THE FINALISATION OF THE BASEL III FRAMEWORK ON THE BANKING SECTOR (cont'd)

Chart 1
INCREASE IN TIER 1 CAPITAL REQUIREMENTS AND ASSOCIATED CAPITAL SHORTFALL
European banks (a)

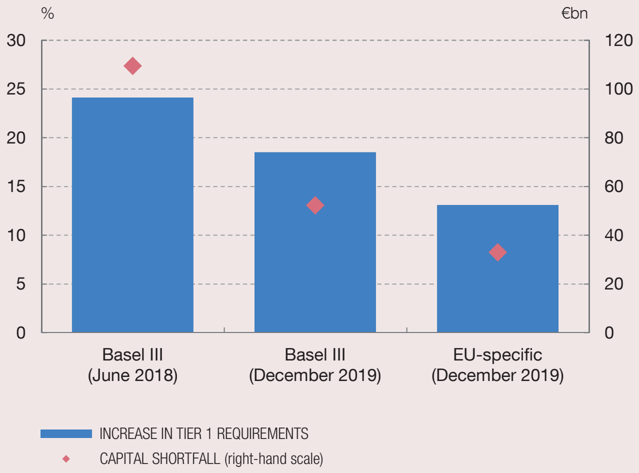
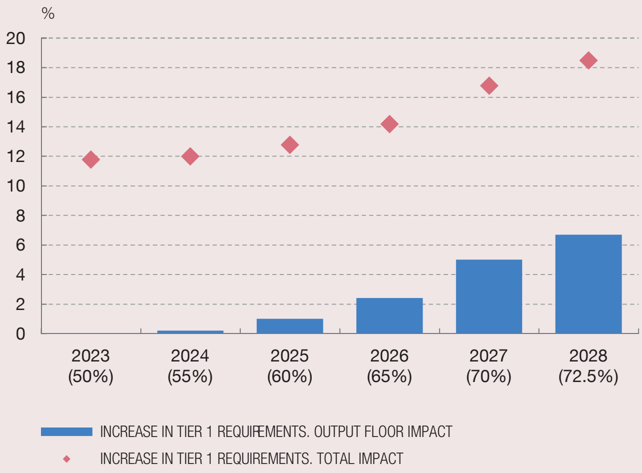


Chart 2
INCREASE IN TIER 1 CAPITAL REQUIREMENTS IN THE STANDARD IMPLEMENTATION OF BASEL III
European banks (a)



SOURCE: Banco de España.

a The study is based on a sample of 99 banks with data as at December 2019.

Owing to the exemptions and discretionalities explained above, the impact under the EU-specific scenario, using the main approach to implement the output floor, is expected to be reduced by 5.4 pp to 13.1% relative to the Basel III scenario. The capital shortfall is also reduced from €52.2 billion to €33 billion, with G-SIIs accounting for 77% (see Chart 1).

Considering the different output floor options separately, and without including the other EU specificities, the capital shortfall would be €45 billion under the alternative approach and €32 billion under the parallel stack approach (the option with the most significant differential impact). In any event, when assessing its impact (and given its importance in the total impact of the reform), it should be noted that a phase-in period of five years has been envisaged for the full implementation of the output floor. Thus, the output floor impact would not be especially significant until the fourth year, i.e. 2027 (see Chart 2).

Under the Basel III scenario[10], cross-country heterogeneity is observed both in total impact and in the materiality of each element of the reform. However, as occurs at the aggregate level, the most important factors are the output floor and the operational risk adjustments. Broadly speaking, three groups of countries can be identified:

— Countries where the impacts are higher than the average of 18.5%, essentially owing to the output floor. These are Germany and Sweden, followed by the Netherlands, Denmark and France.

— Another set of countries where the impact is below, but closer to, the average: Belgium, Spain and Italy. In Belgium, the impact is essentially attributable to credit risk, CVA and, to a lesser extent, the output floor. Meanwhile, in Spain and Italy there is no appreciable output floor impact, and the impact of operational risk is higher than in other countries, comparable only to France.

— A third group (Greece, Ireland, Poland and Portugal), where the impacts are less than 10%; these countries are unaffected by the output floor.

As described for the aggregate level, an across-the-board reduction is observed in the impacts under the EU-specific scenario. Although there are cross-country differences in how sharp this reduction would be, the countries rank in an order similar to that under the Basel III scenario.

10 See Figures 1 and 2 of the EBA's report "Basel III Reforms: Updated Impact Study" EBA/Rep/2020/34.

Box 3.2

UPDATED IMPACT OF THE FINALISATION OF THE BASEL III FRAMEWORK ON THE BANKING SECTOR (cont'd)

Analysing the results for Spain in somewhat greater detail, it can be observed that:

— Under the Basel III scenario, there is no output floor impact. The greatest impacts stem from operational risk, Spain presenting the highest impact in this regard, followed by credit risk and CVA, with similar magnitudes.

— Under the EU-specific scenario, using the output floor main approach, there is a sharper reduction in the impact for Spain than for the European average. This is because the EU specificities – SME supporting factor, CVA exemption and operational risk discretion – cause a relatively greater reduction in the requirements and adjustments other than the output floor (which has no impact for Spain). However, if the parallel stack approach to the output floor is applied to the EU-specific scenario, the impact for Spain would be reduced somewhat less compared with the European average.

The EBA considers that the results of this report do not alter the conclusions drawn in its previous analyses. In summary, the EBA concluded that the benefit in terms of reducing unwanted RWA variability, as sought by Basel III, would outweigh the savings in capital requirements derived from accepting deviations in Europe[11]. As regards the EU specificities that are analysed in its latest report and discussed in this box, the EBA does not support their implementation. The EBA also prefers applying the so-called main approach to implement the output floor.

The banking sector faces the COVID-19-induced crisis from a more solid starting position, largely thanks to the Basel III reforms. In this regard, and as reiterated by the Basel Committee and by the Group of Central Bank Governors and Heads of Supervision (GHOS), fully, timely and consistent implementation of Basel III by member jurisdictions, is key to ensuring that the banking sector continues to be resilient to future crisis scenarios.

11 See the EBA's previous impact study August 2019.