Finalisation of Basel III post-crisis reforms

This note is mainly based on documents published by the Basel Committee on Banking Supervision (BCBS) on 7 December 2017 under the header Finalising Basel III post-crisis reforms, namely the High-level summary of Basel III reforms and the full text of the reforms. EGOV has previously published a briefing specifically on the role of the BCBS.

The overall aim of the reforms that have now been finalised is to restore credibility in the calculation of risk-weighted assets (RWAs) and improve the comparability of banks’ capital ratios. Empirical studies have given rise to doubts about the comparability and fairness of banks’ internal models used to calculate RWAs (see, for example, the study by Breuer: “What conclusions can be drawn from the EBA 2016 Market Risk Benchmarking Exercise?”).

The agreed reforms:

- improve the standardised approaches,
- constrain the use of the internal models,
- improve the operational risk framework,
- introduce a leverage ratio buffer,
- and introduce a different output floor.

Standardised approaches

As regards the improvement of the standardised approaches, the reforms shall make them more robust and risk sensitive. For example, instead of using a flat risk weight to all residential mortgages as under Basel II, the revised approach depends on the loan-to-value ratio of the mortgage. The reform also introduces a more granular approach for unrated exposures to banks and corporates, and specific risk weight for exposures to small and medium-sized enterprises (SMEs). In addition, the revised standardised approach includes a standalone treatment for exposures to project finance, object finance and commodities finance.

Internal models

As regards the improvement of the internal model approaches, banks may for example for their exposures to large and mid-sized corporates no longer use own estimates for two parameters (the loss-given-default and exposure at default) but rather use fixed values instead. Moreover, after the reform internal ratings-based approaches will no longer be allowed at all for exposures to equities.

Operational risk framework

The operational risk framework addresses losses that stem from misconduct, inadequate systems and controls etc., which in the past were often not adequately covered. The new standardised approach determines a bank’s operational risk capital requirements based on two assumptions, namely that operational risk increases at an increasing rate with a bank’s income, and that operational risk losses seen in the past go along with a higher likelihood of operational risk losses in the future.
Leverage ratio buffer

The finalised Basel III reforms introduce a leverage ratio buffer for global systemically important banks (G-SIBs) which comes on top of the minimum leverage ratio requirement for all banks: The leverage ratio G-SIB buffer must be met with Tier 1 capital and is set at 50% of a G-SIB’s risk-weighted higher-loss absorbency requirements. For example, a G-SIB subject to a 2% risk-weighted higher-loss absorbency requirement would be subject to a 1% leverage ratio buffer requirement.

Output floor

The Basel III reforms replace the existing output floor, which is still based on Basel I standards.

The revised output floor - set at 72.5% - places a limit on the regulatory capital benefits that a bank using internal models can derive relative to the standardised approaches, which helps to maintain a level playing field between banks using internal models and those using standardised approaches.

Implementation dates

The revised standardised approach, internal models, operational risk framework, and G-SIB shall all become applicable as of 1 January 2022.

The output floor, however, will be phased in and will only become fully effective as of January 2027 (2022: 50%, 2023: 55%, 2024: 60%, 2025: 65%, 2026: 70%, 2027: 72.5%).

However, in addition, supervisors may at national discretion cap the increase in a bank’s total RWAs that results from the application of the output floor during its phase-in period.

More generally, a jurisdiction which does not implement some or all of the internal-modelled approaches but instead only implements the standardised approaches is compliant with the Basel framework.

Estimated impact

The cumulative quantitative impact study published by the Basel Committee for Banking Supervision on 7 December 2017 concludes that the finalisation of Basel III will result in no significant increase in overall capital requirements, looking at the effect in truly international terms for banks inside and outside of Europe. However, the effects vary across banks, and banks that have shown a more aggressive modelling behaviour in the past will see a stronger impact.

The European Banking Authority (EBA), which welcomed the finalisation of the Basel III framework, provided an overview of the impact on banks in the EU: The minimum required capital for the EU sample would on average increase by 12.9%, and large internationally active banks in the EU would even see an increase by 14.1%.

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