AT A GLANCE

Banking Union: Postponed Basel III reforms

This briefing summarises the Basel Committee's decision to postpone the implementation of the outstanding Basel III standards, their main content, and their estimated impact on banks' capital needs.

Basel Committee postponing the Basel III reforms

On 27 March 2020, the Basel Committee's oversight body, the Group of Central Bank Governors and Heads of Supervision, responded to the challenges of the Covid-19 crisis and endorsed changes to the implementation timeline of the outstanding Basel III standards:

- The implementation date of the Basel III standards finalised in December 2017 was deferred by one year to 1/1/2023, which also affects the transitional arrangements for the output floor, deferred to 1/1/2028.
- The implementation date of the revised market risk framework finalised in January 2019 was deferred by one year to 1/1/2023.
- The implementation date of the revised Pillar 3 disclosure requirements finalised in December 2018 was deferred by one year to 1/1/2023.

Key features of the postponed Basel III reforms

The reforms of the Basel III standards are meant to reduce excessive variability in risk-weighted assets (RWAs) and to improve the comparability and transparency of banks. To that end, the reforms notably include an "**aggregate output floor**", which means that **banks using internal models** to determine the amount of RWAs may only deviate to a certain extent from the amount calculated by the standardised approach.

The output floor was introduced as a response to lost faith in the robustness of internal models, given the inconsistencies in RWA calculations that seem unjustified by risk fundamentals (see, for example, Breuer on the results of the European Banking Authority's market risk benchmark exercise), and it shall prevent that RWAs fall below levels deemed inappropriately low. That safeguard is gradually phased in over a six-year transition period. At the start, the output floor limits the deviation to not go below 50% of the standardised calculation, the binding lower threshold then gradually increases over time and finally reaches 72.5% when fully phased-in (during the phase-in period supervisors can, at national discretion, cap an output floor-induced increase of a bank's RWAs).

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The revised market risk framework, inter alia, introduces a simplified approach for banks with small or non-complex trading portfolios, revises the treatment of foreign exchange risk, and revamps the risk assessment process for individual trading desks and internal models.

The revised Pillar 3 disclosure requirements, inter alia, define what information has to be disclosed about the calculation of RWAs (bank's internal models versus standardised approaches), the level of asset encumbrance and, where applicable, on capital distribution constraints.

Expected impact of the Basel III reforms

EBA's updated impact study, published in December 2020, estimates that the total capital needs stemming from the reforms are much lower than previously assumed, amounting to EUR 33 billion in total in the scenario that incorporates EU specific elements (e.g. the SME supporting factor; the updated EBA study also shows the impact of a couple of alternative scenarios). The output floor is the main driver of the impact, and the effect of the reform was found to be considerably higher for large and systemically important institutions than for medium-sized or small banks.

The previous version of EBA's impact study assumed a considerably larger impact of the reforms (EUR 135 billion in total). Despite higher capital needs, profitable banks were found capable to cover them solely by retaining profits, while capital shortfalls were almost entirely attributed to non-profitable institutions. The updated impact study no longer shows which banks could internally generate the required capital.

The updated impact study, on the other hand, contains a preliminary analysis of the effects of the COVID-19 crisis and its interaction with the Basel III reforms. Since the effects of the crisis have not yet fully surfaced, EBA calls it a somewhat speculative exercise, based on many assumptions. The impact of the COVID-19 crisis will affect banks mainly through the recognition of impairment losses and valuation adjustments. Despite all uncertainties, EBA stated that the analysis allowed to draw at least one clear conclusion: the effects of COVID-19 are not simply additive to the effects of implementing Basel III, some effects rather offset each other. For instance, an increase in risk weights due to COVID-19 limits the impact of the output floor for banks using internal models. The combined effect (total capital shortfall) is assumed to range between EUR 30 billion and EUR 60 billion (with many caveats), which according to EBA's previous impact study could in any case be covered by retaining profits.

The Commission's CRR3/CRD6 proposals

The Commission's legislative proposals by which the Basel III reforms are transposed to EU law (CRR3 and CRD6) were initially expected for July 2020. However, the Commission stated on 28 April 2020 that it will use the additional time freed-up by the postponement to take the impact of the Coronavirus pandemic on the banks' financial situation into account for its forthcoming proposal on the Basel III reforms. The Commission further indicated it remains committed to implementing the final Basel III standards in the EU. In her confirmation hearing, Commissioner McGuinness noted that *''there are some concerns about its impact on our businesses and the financial sector now, but I think we have to implement it faithfully and also take account of the specificities of the European market.''*

The rating agency Standard & Poors already pointed in January 2020 to the risk of missing the deadlines of the Basel III reforms, assuming strong resistance against those reforms from banks across Europe. Other market participants speculate whether a further delay in publishing the Commission's CRD6/CRR3 proposals may eventually result in a postponement of the reforms' implementation date until 1 January 2024 instead of 1 January 2023 (see for example an article by the Dutch bank ING).