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Finance for Europe

Association for Financial Markets in Europe

CRR3: Implementation of Basel III reforms in Europe

AFME position paper

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AFME's mission: supporting deep and integrated European capital markets to serve the needs of companies and investors for economic growth.

Introduction

On December 7 2017 the Global Governors and Heads of Banking Supervision agreed a final set of measures establishing a framework of common standards for internationally active banks to adhere to and operate by – "Basel III". These Basel III reforms, are in fact a fourth revision to the global standard and represent an important step forward in terms of the finalisation of the G20 reforms following the financial crisis, and for banks which participate in the global financial system, by making it more resilient to future shocks.

For AFME members it is crucial the implementation of the Basel III standard in Europe is done so in a risk-sensitive way that results in a robust and effective banking sector, and which supports growth and the real economy such as SMEs, funding of corporates, infrastructure and households. This should be done against the backdrop of first the European Council and Basel Committee's overarching commitment to not significantly increase capital requirements, and second, the EU's impact analysis which should go beyond the aggregate analysis undertaken by the Basel Committee. Furthermore, the granular nature of the Basel III reforms will affect many products and economies in different ways. It is essential that the European Commission and the EBA understand the potential effects on specific products and the financing of the real economy across Member States. Given the central role of banking in the EU economy and the role it plays in supporting EU's capital markets activity, we have therefore set out a number of principles which we would like to see embedded in the development of CRR3 proposals, which should go hand in hand with the development of the CMU and Banking Union in the next Commission mandate.

Commitment to no-significant increase in capital

In July 2016 European Finance ministers agreed in the conclusions of ECOFIN that to reach agreement on the Basel III finalisation *"the reform package 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."* This international commitment was reiterated by the Global Governors and Heads of Banking Supervision upon reaching the final Basel III agreement in December 2017. The EBA's assessment of the Basel III monitoring exercise based on data as of 30 June 2018, demonstrates that, on the basis of the Minimum Required Capital (MRC), European banks' minimum Tier 1 capital requirement would increase by 19.1% at the full implementation date (2027). Tier 1 capital is the Minimum Required Capital (MRC), a more conservative calibration that the total capital banks will hold in practice (i.e. for Pillar 2 and buffers). Moreover, this analysis does not take into account the impact of Market Risk reforms only agreed in January 2019, nor does it reflect that banks do not set their capital based on minimum regulatory capital

requirements, but rather set it based on economic capital in excess of regulatory capital, taking into account market expectations as well as their own bank specific risks. When these other elements of the prudential framework are factored in, we would therefore expect this to be much higher. The overall impact of the risk-based reforms is 25.4%, of which the leading factors are the output floor (8.0%) and operational risk (5.5%). The fact that leverage ratio is currently the constraining (i.e. the highest) Tier 1 requirement for some banks in the sample but will not be as constraining under the final Basel III, explains why part of the increase in the risk-based capital metric (-6.2%) is not to be accounted for as an actual increase in the overall Tier 1 requirement.

Change in total T1 MRC, as percentage of the overall current Tier 1 MRC, due to the full implementation of Basel III (2027) (weighted averages, in %)

Bank group	Credit risk				Market risk	CVA	Op risk	Output floor	Total risk-based	Revised LR	Total
	SA	IRB	Sec.	CCPs							
All banks	2.2	2.0	0.7	0.0	2.3	4.7	5.5	8.0	25.4	-6.2	19.1
Group 1	1.8	1.7	0.8	0.0	2.5	4.9	6.1	8.5	26.3	-6.0	20.3
Of which: G-SIIs	2.2	2.1	1.1	0.0	3.3	5.4	7.4	7.3	28.8	-0.3	28.4
Group 2	4.3	3.7	0.1	0.0	0.9	3.6	1.7	5.1	19.4	-7.7	11.8

Source: EBA QIS data (June 2018)[1]

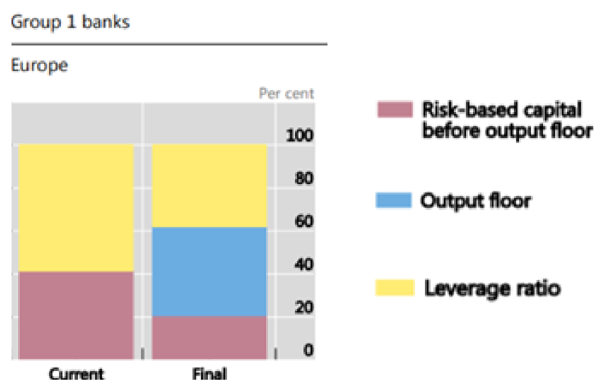
AFME therefore strongly urges European regulators to closely assess the implementation of the Basel III reforms against the underpinning commitment of supervisors and finance ministers to no further significant increase in capital requirements.

Risk Sensitivity

In light of the potential for Basel III to significantly increase capital requirements, we recommend that the European Commission and EBA consider how to build in risk sensitivity to the different risk components. This is essential in relation to the introduction of the output floor, an entirely new component of the Basel III. According to the Basel III Monitoring report, the introduction of this measure will result in a strong regional increase for Europe in MRC of 21.3%, and overall represents 41.4% of the total impact of Basel III for EU Group 1 banks.[2] Counter to the Basel III objective of risk being the main capital constraint on banks, the chart below demonstrates that essentially, nearly 80% of Group 1 European Banks will be bound by the Output floor or Leverage Ratio. Consequently, the European Commission should investigate and explain by June 2020 at the latest why the output floor is so binding for EU banks relative to other parts of the framework. This could be undertaken as part of the impact analysis the Commission is required to do prior to the publication of the CRR3 proposals. In light of this, they should also consider whether there are any global consistency implications in terms of outcomes. If any are identified, the EU should consider re-addressing these at the global level, failing which it should be addressed in the EU**.**

[1] Source https://eba.europa.eu/documents/10180/2551996/Basel+III+Monitoring+Exercise+Report+-+data+as+of+30+June+2018.pdf

[2] 2 "Group 1" banks are defined as internationally active banks that have Tier 1 capital of more than €3 billion and include all 29 institutions that have been designated as global systemically important banks (G-SIBs). https://www.bis.org/bcbs/publ/d461.htm



To further mitigate the impact of the introduction of the output floor there are a number of areas where the Commission can consider refining and implementing a more granular, risk sensitive framework such as in the treatment of Corporates, SFTs or Specialised Lending transactions, which are explored in depth in our risk-specific papers. The commitment to risk sensitivity should also include a review of Pillar 2 requirements, where the Pillar 1 framework will cover risks previously addressed by supervisors in Pillar 2, buffers, TRIM and other supervisory add-ons. It is also important to address the impact of capital increases arising out of the non-risk sensitive output floor requirement as this could result in mechanistic increases to other aspects of the CRR and BRRD such as MREL.

International consistency

AFME considers it essential that international standards such as Basel III are applied in a way that achieves consistent and equivalent outcomes across all jurisdictions, enabling banks to operate on a global level-playing field whilst also reflecting the specific financial and economic circumstances of Europe (e.g. the higher reliance of corporates and residential mortgages on bank funding). Equivalent outcomes should be measured after taking account of genuine structural differences in markets and business models but so that all players operating in the EU can play an equal and effective role in deepening and integrating EU capital and banking markets. Furthermore, it is important for globally active banks that international standards are implemented following a consistent timeline across jurisdictions, including transitional arrangements and with a reasonable implementation period for banks once the legislative process is finalised. If the internationally agreed timeline for the process of Basel III legislation and implementation (or parts of it) looks likely to extend beyond 2022, we urge the Commission to lead timely efforts to revise the timeline at a global level in an open and transparent way with international counterparts to ensure international alignment. This is especially important in the context of equivalence decisions and supervisory deference where misaligned implementation could have major consequences for banks operating cross-border. Furthermore, where concerns arise with the Basel standards in the process of implementing Basel III in the EU, the Commission should seek to have these re-addressed as a priority at an international level to maintain a consistent approach – this is already the case for SA-CCR and CVA which we welcome. Indeed, if regulators and supervisors are committed to addressing the challenges of market fragmentation as recently set out in the FSB Report on Market Fragmentation[3], then commitment to an internationally aligned implementation of Basel III and other globally agreed standards should be the cornerstone.

Integrated and consolidated application of prudential requirements and supervision, recognising the importance of the Banking Union, to avoid further fragmentation in EU capital markets

The European regulatory framework should allow capital and liquidity to flow as freely as possible within banking groups, and supervisory authorities should implement the regulatory framework in a way that achieves this outcome across the global, intra EU, and intra Banking Union contexts. In the context of CRR2 no progress was made in removing regulatory barriers to the free flow of capital and liquidity. In fact, in some cases CRR2 marked a backward step such as setting the internal TLAC requirement at the most

[3] https://www.fsb.org/2019/06/fsb-publishes-report-on-market-fragmentation/

conservative end of the international standards. However, if we are to achieve a genuine single market in financial services in Europe, with exposures more diversified across borders and reduction in the persisting home bias of European banks, the European supervisory framework and the system of capital and liquidity waivers will need to be considered in CRR3 to ensure it is efficient and effective. This is central to establishing a well-functioning Banking Union and Capital Markets Union, which in turn will attract cross-border investors and help banks to fund enterprises effectively, whilst avoid trapping capital where it cannot support real investment in the economy. In this context we also urge regulators to consider applying Basel requirements at the level of the consolidated group as is foreseen in the implementation of Basel standards. As such, AFME urges EU regulators to reflect on the requirement for the level of application of the output floor at the global consolidated group level in CRR3, indeed, in the interests of international consistency, we believe this should be the approach of all global regulators such that it is therefore not necessary to apply at the level of each jurisdiction in which the bank has an entity.

The risks and consequences of segmented finalisation:

We fully appreciate Basel Committee's post-crisis reform package was finalised, by necessity, on a piecemeal basis over 2010 – 2017 and that the Basel Committee recommends a phased implementation globally to lessen the burden on banks. The numerous elements of the Basel III package are however not independent from each other as several standards refer to requirements set in other part of the overall framework. Unfortunately, the segmented approach to rulemaking means elements of the Basel III package will be implemented at different stages in different jurisdictions, which will result in unexpected impacts on products and business lines. This approach has not allowed policy makers and the industry to date to either develop in-depth understanding of the interactions between the various elements of the overall Basel III package nor to holistically assess the impact on financial stability and financing the economy. In the global dimension, international standard setters (FSB) are already working on addressing fragmentation as a result of uneven regulatory implementation thus far, and we would strongly encourage that EU regulators and supervisors put into practice more collaboration in the rule-transposition and implementation phases. We therefore welcome the Call for Advice exercise by the EBA that assesses the impact of Basel III. However, regulators will have to carefully monitor the interactions of its various components including those already implemented. One area for instance that is largely untested and unevaluated is the SA-CCR. This was calibrated before many of the reforms were implemented such as the development of CCP clearing, and without any analysis of the interaction with CVA risk, the leverage ratio or the large exposures framework. Therefore, once the final agreement on Basel III has been legislated for, we urge the EU to undertake a review of the consistency of implementation and cumulative impact of the measures, where necessary re-considering measures that have an adverse impact on financing the economy and, where appropriate, proposing that the Basel Committee looks at potential changes to the measures to improve their efficiency.

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