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Finance for Europe

# CRR3: Implementation of Basel III reforms in Europe in the context of Covid-19


**Executive Summary**

The Covid-19 pandemic has had a profoundly negative impact on individuals, businesses and economies - and its multifaceted consequences have still to be understood. European banks are playing a pivotal role in seeking to channel effective and speedy financial relief to where it is most needed. Their ability to do so has been assisted by a combination of regulatory and supervisory relief, as well as action by central banks. However, the upcoming CRR3 legislative proposal, implementing Basel III in the EU, was already set to raise banks' capital requirements substantially, potentially curtailing their ability to support their customers (or increasing costs for end users). The financial fallout from Covid-19 is expected to exacerbate this partly through deteriorating credit quality amongst banks' customers, which will add to capital requirements. A proper understanding and quantification of these additional impacts and, more importantly, a well-calibrated implementation of Basel III in Europe, consistent with international obligations, is necessary if banks are to continue to play their vital role in supporting customers and markets. To this end, the European Commission has commissioned the EBA to undertake an impact analysis of the effects of Covid-19 on the implementation of Basel III in Europe. Unfortunately, this will be based on end 2019 data which will be unable to capture the impact of the pandemic.

**It is therefore vital that the European Commission undertakes a further thorough impact analysis of the Covid-19 impact using year-end 2020 data, which should be reviewed and updated throughout the CRR3 process, as new data becomes available. Based on this analysis, the Basel III reforms should be tailored in CRR3 to ensure banks can continue to contribute to a smooth recovery from the economic shock of Covid 19 and support deep and integrated European capital markets to drive 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 to mitigate risk – "Basel III". These Basel III reforms represent an important step in terms of the finalisation of the G20 reforms, and to make banks and the financial system more resilient to future shocks. However, due to the impact of the Covid-19 pandemic, Europe along with the rest of the world, now finds itself in a very different economic environment to early 2020 when, following an extensive industry consultation, the Commission was preparing to propose measures to implement the final Basel III reforms as part of the upcoming CRR3 proposal. In this new context, it is important to understand the way in which the EU economy has been impacted and how this may affect banks' ability to continue to support their customers and the recovery, while not being unduly constrained by the Basel reforms.

**Impact of Covid-19 and immediate policy response**

The Covid-19 pandemic has given rise to unprecedented challenges. Businesses across all sectors have faced a massive macroeconomic shock, which has significantly tested their financial and structural resilience. While banks have been a source of relative stability during the pandemic, demonstrating the considerable success of the post-crisis reforms, they have not been immune to recent market liquidity stresses, including multiple days through March to May of historic price volatility amidst diminishing market depth and high transaction costs. Moreover, the Commission's Summer 2020 Economic Forecast projects that the euro area economy will contract by 8.7% in 2020[1]. The third quarter EU GDP data published by Eurostat in October showed a strong rebound over the Summer, but the is uncertainty surrounding the duration of the second wave of the pandemic make these improvements very fragile.

International and European authorities, as well as central banks, have responded by providing substantial fiscal, monetary and regulatory relief, including a degree of flexibility on regulatory and supervisory requirements. Interventions by central banks reduced market volatility, and relief measures, such as use of capital buffers and changes to the leverage ratio, enabled banks to free up additional balance sheet capacity to facilitate client transaction and extend lending to real economy. Several of the regulatory adjustments were implemented as part of the CRR Quick Fix[2] which entered into force on June 26. These measures have been complemented by additional administrative measures, such as the adoption of moratoria and mortgage holidays, aimed at alleviating the impact of the economic downturn on businesses and individuals. Some flexibility was also provided by resolution authorities to seek to ensure that MREL requirements do not overly constrain lending to support the economy. On top of the various regional relief measures instituted in response to the effects of Covid-19, the Group of Central Bank Governors and Heads of Supervision, Basel's oversight body, have agreed a postponement of the implementation of Basel III by one year, to 1 January 2023.

AFME strongly welcomes the quick interventions of central banks and rapid regulatory responses in making these necessary changes. Nevertheless, given the still-considerable uncertainties surrounding both the short term and medium/long term economic impacts from Covid-19, it will be important to review the adequacy of this regulatory support and, specifically, the impact of applying the final Basel III reforms in the new economic environment. In particular, we would note that the one-year delay to the international implementation deadline for Basel III was set at a time when the duration of the Covid-19 pandemic and its impacts were both considered to be relatively short term. Subsequently it has become apparent that the economic disruption caused by the pandemic will be longer lasting and in due course this may warrant a reconsideration of whether the implementation timeline for Basel III should be extended further. At an EU level, the CRR3 proposals could also embed appropriate phasing in of certain elements of the new measures.

**Understanding the Covid 19 impact for banks**

As part of its initial Impact Assessment of Basel III for EU banks in 2019, the EBA undertook extensive data collection exercises and impact analyses. The most recent of these[3] showed the reforms would result in an overall increase of 19.3% to the Minimum Required Capital, despite the commitment of European Finance ministers in the July 2016 conclusions of ECOFIN that *"the* [Basel III] *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."* In this respect it should be recalled that the actual increase in capital requirements would be still greater as banks maintain a capital buffer above these minimum requirements. No further analysis of the Basel III impact in the Covid-19 context has been possible

[1] https://ec.europa.eu/ireland/news/summer-2020-economic-forecast-an-even-deeper-recession-with-wider-divergences_en
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0873&from=EN
[3] https://eba.europa.eu/sites/default/documents/files/documents/10180/2551996/4686802a-94b7-474e-b937-adaa4e6faa26/Basel%20III%20monitoring%20exercise.pdf

in 2020, as the regular quantitative impact analysis and data collection exercises were suspended to allow banks to focus on responding to the pandemic.

While the reprieve from data collection was necessary at the time, an important set of data collection has been missed, and little is understood of the impact of Covid-19 on the economy and bank balance sheets at the height of the pandemic. Furthermore, many of these impacts, which affect banks' capacity to support their customers and finance their recovery, will only be seen with a lag of between twelve and twenty-four months. As a result, we expect the impact of Covid will exacerbate the already significant increase in required capital from Basel III through a rise in risk weighted assets, which is a consequence of deteriorating credit quality. Indeed, this view is confirmed in the ESA's latest report on risks and vulnerabilities in the financial sector, which highlights the impact of the pandemic on credit quality as a key concern, noting that on average, around 57% of EU banks' loans to non-financial companies were towards the sectors most affected by the pandemic, i.e. accommodation, food services, manufacturing, transport and storage, and electricity.[4]

The Commission has sought to address the data gap by calling on the EBA to provide further advice[5] which will use year-end 2019 data to re-assess among other things the impact of Basel III against the current EU specificities for banking regulation (such as support for SMEs and infrastructure) and also to extrapolate this data to assess impact of Covid-19 under specific scenarios. While it is welcome that some further analysis is now underway, this will fall far short of providing an understanding the true impact of the pandemic, given it will not consider any data from this year, let alone from 2021. AFME therefore recommends that, at a minimum, the European Commission and the EBA undertake a full Impact Assessment in Q1 2021, for which Q4 2020 data will be available and this should be updated regularly throughout the CRR3 process to ensure a comprehensive assessment of the crisis consequences. While we expect much of the impact to filter through later in the cycle, using 2020 data will still give a more accurate account of what the consequences of the pandemic have been for bank capital requirements and asset quality. In addition to the capital impact, it is also very important to carefully consider the impact on MREL/TLAC requirements arising from the expected RWA inflation.

This analysis is crucial, considering that the European economy continues to be predominantly reliant on bank lending, despite data pointing to a slow diversification of lending sources in recent years.

**Tailoring the CRR3 proposals to mitigate the impact of Basel III**

While precise near-term quantification of the impact of Covid-19 will not be possible within the aforementioned timeframe, there is as discussed above no doubt that, through the impact of the pandemic on credit quality, the effect will be to raise banks' capital requirements beyond the already high estimated impacts which preceded the pandemic.

Therefore, it will be crucial that the final CRR3 proposals be tailored to ensure that Basel III be implemented in the most appropriate way, until more informed analysis on Covid-19 can be done. This will allow banks to continue to lend and support growth and capital markets, in order to limit the impact of the pandemic on the European economy in the longer term. AFME's position papers on the specific elements of CRR3 set out several ways in which CRR3 can be tailored in this context, but, in brief, the EU legislators should:

[4] See page 12
https://eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20Assessment%20Reports/2020/932012/JC%202020%2067%20Autumn%202020%20Report%20on%20Risks%20and%20Vulnerabilities.pdf

[5] https://eba.europa.eu/sites/default/documents/files/document_library/About%20Us/Missions%20and%20tasks/Call%20for%20Advice/2020/930890/CfA_Finalisation%20of%20Basel%203_Update_final.pdf

- Implement the calculation of the output floor according to the "parallel stack" method (as set out in our separate paper on the output floor, this would compare the Basel floored capital stack to the non-floored EU capital stack and applying the higher of the two), and apply it at the global consolidated level.
- Explore different options for the treatment of unrated corporates (as set out in our Credit Risk paper) with the objective of ensuring the same capital requirements be applied to borrowers of equivalent risk, irrespective of the rating methodology used.
- Maintain EU specificities already embedded in the CRR.
- Set the Internal Loss Multiplier to 1 for the calculation of capital requirements linked to operational risk, with Pillar 2 capital to complement the Pillar 1 framework.
- Recalibrate the treatment of specialised lending in the standardised and advanced approaches.
- Review the design and calibration of SA-CCR and reflect market developments, considering its total impact in the prudential framework, including from its use in the calculation of risk-based capital requirements, the Leverage ratio, Large exposure framework and the Output floor.
- Review and potentially recalibrate elements of the FRTB market risk framework to mitigate potentially significant impacts on market liquidity in some asset classes.

**International alignment and review**

The required time necessary for an impact analysis in preparation for a well-founded CRR3 proposal, in conjunction with the expected negotiation timeframe, means that the ability of the EU to meet even the revised international deadline may be challenging. If the EU process means that there is a need to adapt the timeline for implementation, we recommend that the EU seek to do so in an internationally coordinated way, through a decision at Basel-level. It is important for globally active banks that international standards be implemented following a consistent timeline across jurisdictions, including transitional arrangements, and with a reasonable implementation period for banks once the legislative process is finalised.

Furthermore, the global pandemic has tested the financial system in unexpected ways, which could be a useful catalyst to re-examine some parts of Basel III in a more fundamental way once more data becomes available. Indeed, the BCBS has undertaken to closely monitor the impact of Covid-19 on banks and respond as necessary, in coordination with the FSB and other standard setting bodies. From an EU perspective, they should support a Basel review which considers measures that have had an adverse or pro-cyclical impact on financing the economy. This should include an analysis of: the extent to which reduced market liquidity at the height of the pandemic has been driven by post-crisis reforms; calibration and usability of capital buffers[6]; IFRS9; credit quality deterioration and rising NPLs; and regulatory fragmentation. The review should also take account of whether the temporary measures adopted – such as the exemption of central bank deposits from the leverage ratio – should be considered on a more permanent basis. Alongside this, it will be important to integrate the longer term macro-economic impacts of the pandemic in respect of Basel III and more generally explore the consistency of implementation and cumulative impact of the reforms. Indeed, we understand that the BCBS will review the post crisis reforms and how the capital and liquidity frameworks functioned during the stress events of March and April, which is welcome. Consequently, the EU should incorporate flexibility in the CRR3 proposals to take account of international efforts to review the framework in light of Covid-19.

[6] For example, Covid-19 has demonstrated that banks have much less flexibility than expected / desirable to use their capital in times of stress. In this respect, issues to consider include the composition of the buffers, the design of the MDA framework.