BPFI position paper - Implementing Basel iii in a way that preserves the competitiveness of the Irish & EU Banking sector

Executive summary

2020 was the first "real life stress test" for the EU banking sector since the financial crisis. Banks proved remarkably resilient throughout this period, continuing to be in a strong position to support customers, employees and the economy. The robust capital position of the sector combined with the supportive fiscal and monetary measures enacted by the EU and national Governments ensured that the initial economic impact of the pandemic has been relatively contained. As the EU now looks to lay the foundation for a strong and sustainable economic recovery, it is crucial that the EU banking sector can continue to support customers and businesses in the months and years ahead, particularly against the backdrop of an expected rise in NPLs and the continued low interest rate environment.

The transposition of the final Basel III reforms into EU law will therefore play a key role in determining the future direction of the EU banking sector and its contribution to a strong and sustainable economic recovery and bring to a close the post-financial crisis regulatory reforms.

While BPFI Membership fully support the objectives of the Basel agreement and believe that it needs to be implemented faithfully by the EU, the economic environment has undoubtedly changed since 2017. This needs to be taken into account by EU policymakers and we would suggest that the following key objectives are reflected upon:

1. **Ensure that the regulatory framework is flexible** to deal with any potential economic downturn and that lessons are learned from the last financial crisis.
2. **Ensure the specificities of the EU banking sector are taken into consideration** when transposing the agreement and that the rules do "not lead to a significant increase in overall capital requirements"[1][2].

[1] BIS press release on the new Revised market risk framework and work programme for Basel Committee, 2016. https://www.bis.org/press/p160111.htm
[2] European Commission follow-up to the European Parliament resolution of 23 November 2016 on the finalisation of Basel III, 2016. https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2016/2959(RSP

In anticipation of a strong and sustainable recovery, the European Commission's ambitious plans in the area of climate change and digitalisation can only be realised with the support of a well-functioning and sustainable banking sector. European policymakers should therefore pay particular attention to the potential negative impacts certain measures could have on the EU sector, if not implemented in a proportionate manner.

With a view to achieving the above objectives, below we have laid out in detail a number of suggestions as to how policymakers could implement the Basel III standards, while limiting any negative or unintended impacts on market participants. These should focus on the following **key areas:**

- **Utilizing all Basel discretions when implementing the new standardised approach for calculating operational risk.** Specifically, by setting the ILM at 1 EU policymakers would ensure that EU banks' risk standards are sufficiently sensitive and that it limits the capital impact on EU banks.

- **Calculating the Output Floor (OF) based on a "parallel stack" approach and applied on a consolidated basis across the EU banking groups.** This will ensure that the EU banking sector remains globally competitive and in line with the political commitment to not significantly increase capital requirements. To avoid an overlap of capital requirements, the introduction of the OF should be accompanied by a revision of the Pillar 2 framework that clearly outlines areas where capital add-ons can be applied.

- **Retain the supporting factors already in place for SMEs and infrastructure projects.** Since the pandemic these support measures proved significantly valuable, for customers and from a capital and lending perspective, ensuring banks could continue to support the economy.

- **Continue to apply the CVA exemption** as a way to ensure EU companies remain globally competitive.

Below please find an overview of the impact of Basel III on the Irish and EU Banking sector, an overview of the current trends in the Irish Banking market and our four key recommendations to ensure Basel III is implemented in Europe in a way that avoids broad-based increases in

capital requirements and ensures EU and Irish banks can remain competitive while fulfilling their primary function as a lender to the real economy.

1. The Impact of Basel III on the Irish & EU Banking Sector

The 2017 Basel Accord marked a turning point in the post financial crisis regulatory reforms. The publication of these standards is a welcome step forward in helping to address the variability between banks' internal models and builds on the work already undertaken by the EBA and ECB.[3]

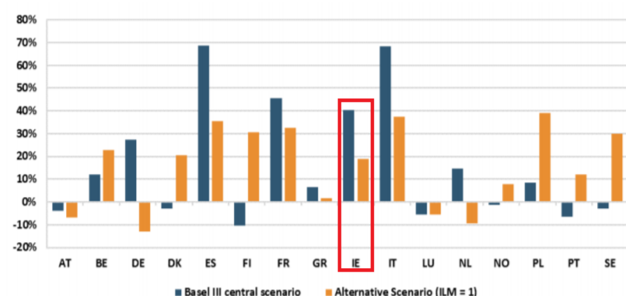
However, the impact analysis published by different authorities – including the EBA and Copenhagen Economics – illustrates that the standards could **have a disproportionate impact on the EU banking sector compared to other jurisdictions.** In light of this, we thought it would be useful to highlight the following findings:

- Based on the impact assessments by both the European Banking Authority (EBA) and Copenhagen Economics, the **implementation of Basel III will result in a significant capital shortfall for EU banks.** Estimates range between **EUR 52.2bn[4] to EUR 230 bn[5].**

- While the impact of the package is very heterogeneous across Member States and the sector, it is clear that the **two main drivers of capital is the output floor and the new standardised calculation for operational risk.**

- **Changes to the calculation of operational risk is expected to increase Risk Weighted Assets (RWAs) across the EU relative to existing RWAs.** Based on the EBAs initial assessment[6], the increase will be roughly 40% in Ireland. While the EBAs updated advice does not provide such granular detail, the impact on the Irish market is not expected to change.

EBA impact assessment of new operational risk framework



Sources: EBA 2018-Q2 QIS data and EBA calculations.
Notes: Based on a sample of 193 banks: AT (15), BE (4), DE (38), DK (7), ES (11), FI (5), FR (14), GR (5), HR* (2), HU* (1), IE (11), IT (24), LU (6), LV* (1), MT* (1), NL (11), NO (7), PL (11), PT (8), SE (11).
* Not shown in the chart because fewer than three entities in the cluster.

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3 EBA work on repairing internal models and the ECBs TRIM exercise.
4EBA updated impact of the implementation of Basel III, December 2020: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2020/961423/Basel%20III%20reforms%20-%202019Q4%20update%20and%20Covid%20impact.pdf
5 This figure assumes that EU banks will retain current capital buffers as part of the daily business and due to expectations from supervisors as well as investors. This figure is based on a Copenhagen Economics Study on Basel iii from June 2021: https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/7/567/1623153264/copenhagen-economics_eu-implementation-of-the-final-basel-iii.pdf
6 EBA impact assessment and recommendations on the implementation of Basel iii, August 2019: https://www.eba.europa.eu/sites/default/documents/files/Basel%20III%20reforms%20-%20Impact%20study%20and%20key%20reccomendations.pdf

- According to the Basel Committee (BCBS), **the new operational risk calculations will impact the EU banking sector disproportionately** in comparison to other jurisdictions. For example, US banks are expected to see a reduction in operational risk capital of approximately 19.6%, whereas EU banks will see an increase of 30+% (BCBS estimates 31.3%).

BCBS analysis on the impact of operational risk EU Vs US

Changes in operational risk capital requirements

In per cent — Table 12

	Change in Tier 1 MRC[1]	Number of banks migrating from AMA	Number of banks migrating from other approach
Group 1 banks	−5.1	43	56
Of which: AM	−19.6	14	4
Of which: EU	31.3	15	21
Of which: RW	−16.7	14	31
Of which: G-SIBs	−9.2	20	9
Group 2 banks	17.7	6	62

[1] Figures may not show supervisor-imposed capital add-ons. Therefore, increases in MRC may be overstated and reductions may be understated.

Source: Basel Committee on Banking Supervision.

- The original EBA assessment finds that if **the discretion to set the ILM at 1 is exercised the impact on capital requirements would more than halve the increase**, to around 17% (compared to 37%).

- Based on the EBA's initial impact assessment, **retaining the SME supporting factor would also lead to a reduction of the impact on the total minimum regulatory capital (MRC) by around 1.5% and a reduction of EUR 6.8 bn in the total capital shortfall.** In Ireland, the early introduction of these supporting factors has shown to have had a considerable impact on banks' ability to lend during the current pandemic.

- The impact of **Basel III will disproportionately impact EU banks compared to US peers,** with Copenhagen Economics' study estimating a 0.3% decrease for the US and a 16.9% increase for the EU.

2. An overview of the Irish banking market

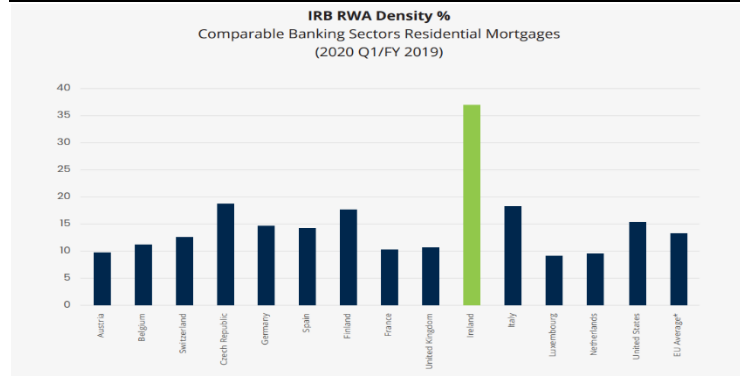
- NPL ratios across the EU banking sector have progressively reduced over the past number of years. As of Q2 2020, the weighted **average NPL ratio was below 3% in the Eurozone, compared with over 7% as of June 2015.** In Ireland, banks have reduced NPLs over this period by roughly 15%.

- **Return on equity in Ireland stood at -4.15% as of Q3 2020[7] compared to a Eurozone average of 2.12.** Full implementation of Basel therefore needs to take account of the impact increased capital requirements could have on the sector and its ability to support a swift economic recovery.

[7] Ibid

- **Risk Weighted Asset (RWA) density on mortgage loans in Ireland is approximately three times higher[8] than the average for comparable European countries.** Average RWA density for mortgages in the Irish banking sector has reached 37%, compared to European averages at around 13.3% as of end 2019.

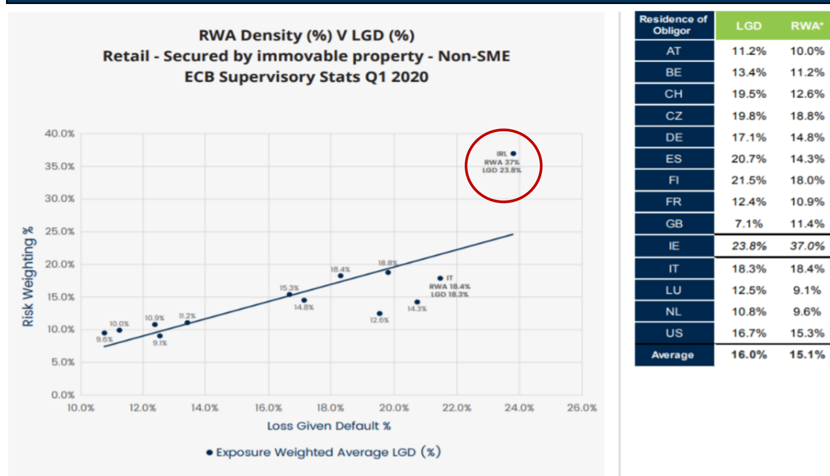
ECB & BPFI analysis of RWA density in mortgages



- **This higher RWA density in Ireland now represents a €2.5bn additional capital** requirement for the five retail banks for "unexpected losses" on the €83 billion of Irish mortgages calculated using internal models, when compared to the Eurozone average.

- The key factor driving high **RWAs within the Irish market is largely due to the calculation of downward Loss Given Default (LGD)** from the experience of 2007 to 2013. In particular, the low levels of recovery of collateral[9] and how the impact of short-term forbearance measures offered by Irish retail banks to customers is treated under EU rules, such as the discount rate of 5% + the EURIBOR 3-month rate at the time of default[10]. This has resulted in "trapping" the last crisis into banks capital requirements today, despite significant improvements in underwriting standards as a result of macroprudential rules.

ECB & BPFI analysis of RWA density V LGD



Residence of Obligor	LGD	RWA*
AT	11.2%	10.0%
BE	13.4%	11.2%
CH	19.5%	12.6%
CZ	19.8%	18.8%
DE	17.1%	14.8%
ES	20.7%	14.3%
FI	21.5%	18.0%
FR	12.4%	10.9%
GB	7.1%	11.4%
IE	23.8%	37.0%
IT	18.3%	18.4%
LU	12.5%	9.1%
NL	10.8%	9.6%
US	16.7%	15.3%
Average	16.0%	15.1%

[8] BPFI study on RWA density in the Irish mortgage book: https://bpfi.ie/wp-content/uploads/2021/02/Final-BPFI-RWA-Report.pdf

[9] A 2020 EBA study has recently shown, Ireland has one of the worst outcomes in Europe in the recovery of security for mortgages under judicial processes. For example, the average recovery rates at the end of enforcement through the judicial process is around 11% compared with 46% in Europe, while the length of time to recover is 3.7 years against 3.1 years for the EU average.

[10] EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted assets, 2017: https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2033363/6b062012-45d6-4655-af04-801d26493ed0/Guidelines%20on%20PD%20and%20LGD%20estimation%20%28EBA-GL-2017-16%29.pdf?retry=1

3. Four key recommendations for implementing Basel III

Notwithstanding the fact that Basel III will result in higher capital requirements, there are several options available to mitigate the impact as noted by the EBA in its own assessment. Below we have put forward four key areas for consideration by policymakers which if adopted will avoid broad-based increases in capital requirements and ensure EU and Irish banks can remain competitive while fulfilling their primary function as a lender to the real economy at a time of economic recovery.

1. Ensure all Basel discretions are utilized in the calculation of operational risk

Under the new Basel III agreement, the existing methods are replaced with one standardised approach which will be one of the key drivers of capital for EU banks, with MRC expected to increase by 3.8% across the EU under the EBAs updated advice. As the changes to the operational risk calculation is concentrated in some Member States, it is expected to have a significant impact on Irish banks. The EBAs initial impact assessment outlined that operational RWAs could potentially rise by roughly 40% in Ireland if no Basel iii discretions were utilised.

Although the updated advice does not provide a similar detailed breakdown on the impact of operational risk, our members do not expect a significant change compared to the initial advice. Given this significant rise, and associated costs to the sector, particularly when compared to other jurisdictions such as the US, we believe consideration must be given to how the standard should be applied within the EU. As shown by the EBA in its own analysis[11], setting the ILM at 1 for all banks will help reduce the capital impact by close to half (e.g. 37% to 17%).

The new standardized approach establishes a methodology that follows the "one-size-fits- all" principle without taking into account local legal specificities, business models, risk profiles and operational risk controls, measurement and management frameworks implemented by the entities or the risk mitigation measures that each entity has been able to implement.

[11] EBA impact assessment and recommendations on the implementation of Basel iii, August 2019: https://www.eba.europa.eu/sites/default/documents/files/Basel%20III%20reforms%20-%20Impact%20study%20and%20key%20reccomendations.pdf

In addition to this, question marks remain over the appropriateness and accuracy of the new standard model for predicting future operational loss events if applied strictly. For instance:

- **There is no distinction between loss frequency and severity** under the proposal and its impact on the risk profile of the organisation in question. Losses are either included or excluded, whereas tail risk events could be more problematic but not predictable based on past events.

- Linked to the above, it is **unclear if past losses are good predictors of future losses**, particularly the proposal to use the loss history over a 10-year period. These concerns have been raised by the US Fed previously[12]. Equally, by assessing losses over a long observational period, **the ILM does not take into account changes in the risk profile of an organization** in the years following an incident.

- While some studies have argued a correlation exists, **operational risk events rarely re-occur in exactly the same manner**, so using past events as a proxy makes it very hard to identify specific types of future events. For example, previous operational risk loses may have been as a result of compliance failings, but with the rise towards digitalization, future events could arise in ICT failings.

- There are concerns that the **new standardized model disproportionately impacts retail banks** because of the way its structured. For instance, **it focusses on the volume of losses but not the volatility attached to certain events,** which can be significantly different between retail and wholesale banking. This means that when the distribution of losses is statistically different from the averages of banks taken into consideration by the Basel Committee in its assessment (featured by higher loss recurrence but lower average severity per loss event) the formulation based on **the ILM produces very demanding capital requirements which do not represent the real risk profiles** of the entities.

- In addition, this approach **does not take into account remedial measures adopted within institutions** to resolve weaknesses in risk management oversight.

[12] US Federal Reserve notes, Marco Migueis, Is Operational Risk Regulation Forward-looking and Sensitive to Current Risks? https://www.federalreserve.gov/econres/notes/feds-notes/operational-risk-regulation-forward-looking-and-sensitive-to-current-risks-20180521.htm

- Internationally there has been **a gradual reduction in operational loss events** and their gross value according to the industry database ORX.

i. Proposal

i. Set the ILM at 1 for all banks

Due to the above shortcomings in the new operational risk methodology, we would urge policymakers to **set the ILM at 1 for all banks** (e.g. bucket 1, 2 and 3) as laid out in the Basel agreement, for the following reasons:

- **This would significantly reduce the capital impact on EU banks**, while retaining a risk sensitive framework considering the BIC would act as a proxy to the "riskiness" of an institution in a linear fashion (e.g. operational risk increases progressively for larger institutions due to the increasing co-efficient). By having progressive coefficients applied to larger banks invariably ensures that it is in a strong capital position to withstand an operational risk event. This view has been supported by some researchers.[13]

- Given the current economic environment, this approach would help ensure that banks are not constrained in their lending to customers.

- This approach is in line with the final Basel agreement, which recognizes that supervisors can set the ILM at 1 for all banks in its jurisdiction.

2. Implement the Output Floor at a consolidated level & apply it to only Basel buffers

As outlined in the EBA's updated impact assessment, the implementation of the output Floor (OF) will be the main driver of capital shortfall across the EU (e.g. approx. 6.7%). By aiming to reduce the variability in risk-weighted assets, it will support comparability of capital ratios and build on the considerable work already underway at EU level by the EBA and ECB.

While the impact of the OF varies across the EU and business models, in Ireland its introduction will have a material impact on the operations of global banks, raising concerns around the long-term attractiveness of the EU.

13 Curti and Migueis (2016): "Predicting Operational Loss Exposure Using Past Losses" Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C.

The impact, however, could be significantly reduced dependent upon how it is implemented, as acknowledged by the EBA. Below we have provided two alternative approaches which would ensure the EU remains in line with the spirit of the agreement and preserves the competitiveness of the EU banking model. Most importantly, we believe that **the OF should only be applied at a consolidated level to avoid any further "trapping" of capital within banking groups.** While we understand that there are genuine concerns from some Member States around this approach, we would urge policymakers to use the introduction of Basel as way to make further progress to creating a truly single market for bank capital.

The transposition of the OF also offers an opportunity for the EU to **rethink some the existing capital structures** such as the systemic risk buffer (SRB) and the Pillar 2 requirements (P2R) considering both aim to address perceived deficiencies in banks' capital requirements.

ii. Proposal

Implement that Output Floor as a Parallel stack

- We believe that in order for EU policymakers to implement the agreement in line with the political commitments made, that it should only transpose the OF to the Basel framework. As such, we would support the approach put forward by certain industry stakeholders whereby there would be a comparison between the two different sets of capital requirements calculated using the OF and IMs, with the OF only applying if its calculation would result in higher requirements (e.g. as a backstop). Specifically, we would see this approach operating in the following way:

  a. **Application**: Apply the OF at the highest level of consolidation, in line with the Basel agreement. This would ensure no "trapping" of capital and align with the principle of completing the banking union.

  b. **Scope**: The OF should only be used to calculate the internationally agreed Basel buffers as a first step and then compared to the capital requirements using internal models for all existing structures (e.g. Pillar 1 & 2).

Revise Pillar 2 requirements to avoid any double counting of capital

- In order to avoid any doubling of capital requirements, we believe policymakers should consider **off-setting the impact of Basel III by reducing capital add-ons via Pillar 2.** Such a proposal has been raised publicly by Mr Andrea Enria, Chair of the Supervisory Board of the ECB[14], and Mr Jose Manuel Campa, Chairperson of the

14 Speech by Mr Andrea Enria, Chair of the Supervisory Board of the ECB on Basel III, November 2019: https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp191112_1~01be3b89b0.en.html

European Banking[15] and which in our view is appropriate. We would therefore urge that **in CRD clarification around the scope of Pillar 2 requirements is included** to ensure there is no overlap between the application of the OF on the one hand and P2R on the other. Such an amendment could specify the types of risk (e.g., model risk) that should be captured by the OF and not included in P2R. To provide further transparency and predictability to industry, we would also suggest further clarification be included in CRD in respect to how Pillar 2 guidance should apply, ensuring there is level playing field for market participants across the EU banking sector.

3. Retain the SME & Infrastructure supporting factors

The early introduction of the SME and infrastructure supporting factors have proven to be instrumental during the pandemic by ensuring banks have adequate lending capacity. By retaining both supporting factors, EU policymakers will help to reduce the total impact on capital requirements in the EU (e.g. approx. 1.6%). As the EU looks to kick-start a strong and sustainable economic recovery post-pandemic, these two measures can play a vital role ensuring key sectors – but in particular SMEs – can be supported.

iii. Proposal

We would therefore urge policymakers to maintain both measures as introduced in CRR. Our members see the significant value of the instruments in helping to lend to the real economy, which will prove vital over the coming months/years. In our estimation, any removal is very likely to lead to increased RWAs for SME lending exposures, which in turn, could lead to an increased cost of lending.

4. Retain the CVA exemption

The removal of the CVA exemption (Article Art. 382 of CRR) would have a significant impact on the effect of Basel III in the EU. The EBA's initial impact assessment concluded that the removal would amount to an average increase in capital of 3.9% as it would force banks to charge higher transaction costs for derivatives to Non-Financial Counterparts (NFC) – even though these counterparties very often use these products to hedge against price volatility in currencies, interest rates and commodities.

15 Speech by Mr Jose Manuel Campa, Chairperson of the European Banking on Basel III, November 2019: https://eba.europa.eu/calendar/jose-manuel-campa-speaks-european-commission%E2%80%99s-conference-%E2%80%9Cimplementing-basel-iii

In this regard, it should be noted that the current exemption for CVA charges for OTC derivative transactions is directly linked to the exemptions in Article 3 & 10 of the European Market Infrastructure Regulation (EMIR) from the clearing obligation for NFCs below the clearing threshold and intragroup transactions.

As such, any removal of the CVA exemption – even on a phased basis as called for by the EBA – could have significant implications for the pricing of commercial hedging, which is a crucial tool for EU companies operating in the global market. Additionally, by imposing higher CVA charges for currently exempted transactions, it would mean that the effect of the exemptions in EMIR would be largely eliminated, which could impact the number of banks from offering derivatives services to NFCs due to the higher costs associated with the transactions.

It should be noted that EU NFCs rely heavily on hedging commercial risk compared to US peers given that a large amount of supply chain products are priced in US dollars, meaning EU companies are forced to hedge against currency fluctuation. In this sense, the derivative trades that benefit from the exemption do not represent a systemic risk given they are linked to hedging activities of companies operating in the real economy.

We would also like to underline that for institutions that are part of banking groups and who conduct derivative transactions on an intragroup basis, the removal of the exemption as laid out in Art 382 (4) (b) of CRR would also have a material impact from capital perspective. As highlighted above, this is directly linked to the exemption provided in Art 3 of EMIR, while the conditions for this exemption are, in our view, consistent with those provided in Art 113 (6) of CRR which allows for an exemption from the RWA calculation for certain intragroup exposures. For those institutions that have been granted the exemption under Article 113 CRR, maintaining the current exemption from CVA under Article 382 (4) (b) should therefore be permitted for derivative exposures with the exempted intragroup counterparties.

IV. Proposal

Retain the current CVA exemption as laid out in Art 382 (4) (a) & (b) of CRR. Any removal would make EU corporations less competitive on the global stage, particularly vis-a-vis US peers, due to the capital implications.

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