ENJEUX DE LA TRANSPOSITION DE BÂLE III

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BNP PARIBAS

The bank for a changing world

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Basel III – What you hear & what you must know

1. **“Last EBA impact study show a small and decreasing capital shortfall”**
   - But the methodology highly underestimates the real impact
2. **“Basel III was necessary to limit the unwarranted variability of RWA”**
   - EBA stated that this variability is largely justified and ECB announced that TRIM reduces it further… What else?
3. **“Long transitional period will allow banks to adapt capital level without deleveraging”**
   - Market experience shows that banks have to communicate on fully-loaded impact as soon as the legislative proposal is out
4. **“Large banks in IRB are advantaged compared to smaller banks in SA”**
   - Actually, proportionality imposes higher requirements to large banks
5. **“EU banks are not disadvantaged compared to US banks”**
   - Market data points not to lack of capital, but rather lack of profitability
6. **“Capital Market issues are only relevant for a few outliers”**
   - Basel III may jeopardize EU strategic autonomy if not aligned with other jurisdictions

1. Impacts and Capital shortfalls reduced but largely underestimated

- Average T1 MRC increase : +13,1% in the EBA "EU specific" scenario
  - **But + 19,4% for G-SIIs with full FRTB impact***
- CET1 capital shortfall would be only 17,4 bn€ in the EU scenario, according to EBA
  - **This method implicitly suggests that distance to MDA could be reduced to ZERO :**
    - EBA excludes Pillar 2G and the management buffer
    - Not a viable option as it would have severe impact on ratings, funding costs, and financial stability
- Actually, CET1 ratios are expected by EBA to reduce by 170 bps (-180bps for G-SIIs)
  - Unlikely to be accepted by markets… nor supervisors, even with some reduction of P2
- The **capital shortfall to maintain the current CET1 ratio would reach ~210bn€** in the EU specific scenario (+ 13,1%)
  - It corresponds to a RWA increase of ~1 400bn€ and a loss in **lending capacity loss up to ~3 500bn€ * : Almost 5 times the 750bn€ EU recovery plan…**
- **Need to bridge this gap in order to make well informed policy decisions !**

- FRTB impacts have been set to ZERO for 3 G-SIIs (because of questionable CIU treatment)
- BNPP estimates based on EU banks total CET1 as of June 2020: 1600bn€, average CET1 ratio of 14,6%, average RW density of 40%
- Source : EBA transparency Exercise - https://tools.eba.europa.eu/interactive-tools/2020/powerbi/tr20_2_visualisation_page.html

2. Unwarranted variability of RWA has almost disappeared in the EU, as documented by regulators

- **RW variability "*can mostly be explained*** *by the different* ***share of defaulted and non-defaulted exposures*** *and by the* ***portfolio mix*** *of the individual institutions*" *

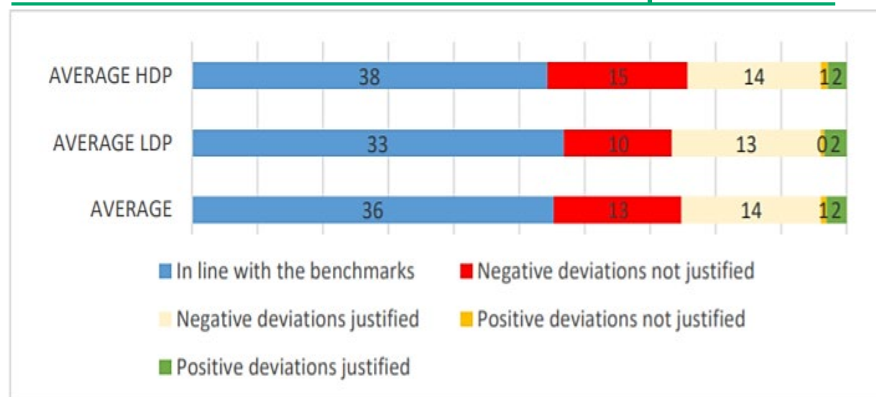
- RW **variability under the SA is 17 % and 13.6% under the IRB: "***The* ***IRB approach does not lead per se to greater variability*** *in capital requirements…*" **

- **Supervisors generally deem the institutions' level of RWAs adequate** with only 11% unjustified negative deviations (i.e. underestimation of own funds requirements) in 2020

  - EBA 2019 report : 13% see graph :

  - Further reduction of unjustified deviations in 2020, thanks to TRIM and IRB Repair, addressing case by case undue variability

CAs' assessment of banks' own funds requirement ***

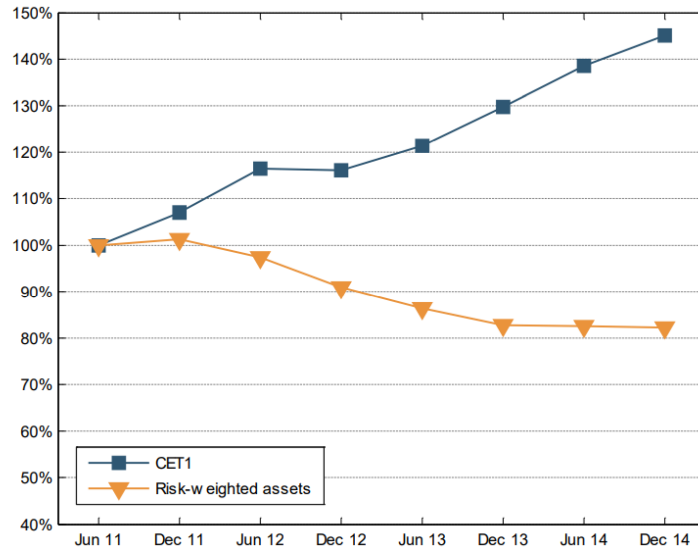


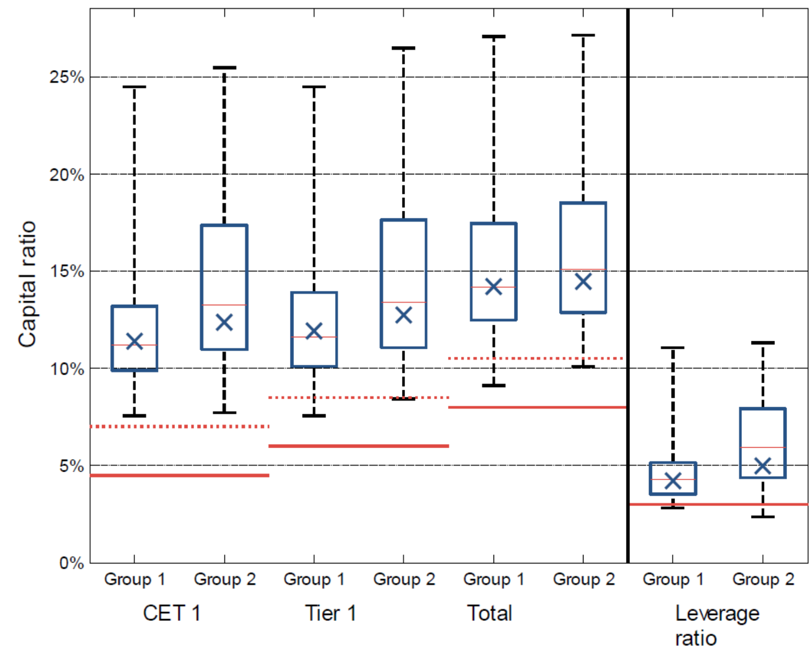
- ***"Thanks to the detailed supervisory follow-up of TRIM, existing internal models can be considered suitable for the calculation of Pillar 1 own funds requirements"*** *(April 2021 ECB TRIM report)*

(*) 2020 EBA Credit Risk Benchmarking Report ; (**) EBA staff paper n°10, Sept.2020 : (***) 2019, EU sample (100 institutions), EBA report

3. Long transitional period will NOT allow banks to adapt without deleveraging

- Deleveraging happened immediately following EU announcement in 2010 to implement Basel III, although entry into force was in 2014, with phase-in of buffers until 2019
  - RWA decreased by almost 20%* following the announcement
  - Most banks fulfilled by 2014 the ratio they were expected to be compliant with by 2019*





Last but not least, the transitional period is limited to the Output floor, while 2/3 of the RWA increase happens BEFORE floor….

*EBA – 2015 Basel III monitoring report based on dec 2014 data

4. Large banks are NOT advantaged compared to smaller ones in SA

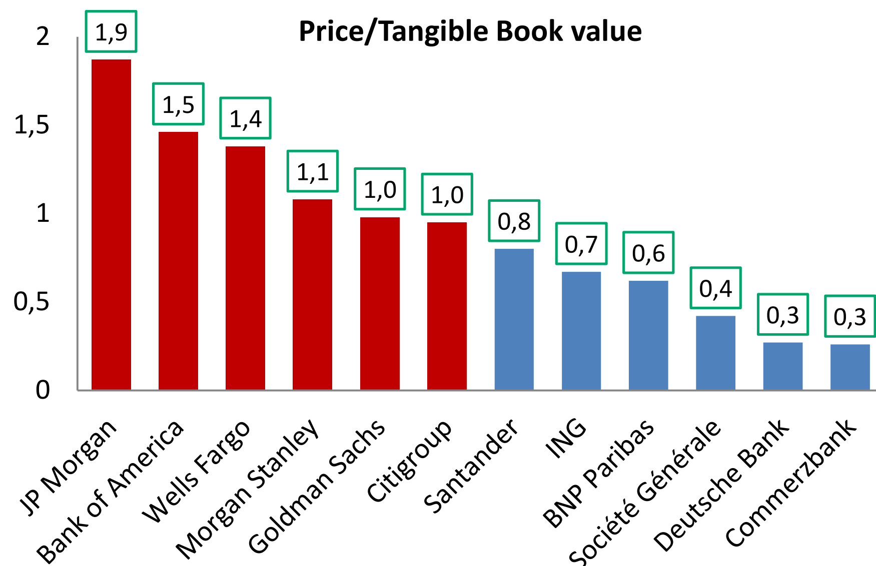
Supervision	Significant institutions (SSM supervision scope) - 119 institutions				LSI - High priority	LSI - Medium priority	LSI - Low priority
Disclosure / NSFR	Large institutions				"Other institutions"		Small & non-complex
P1 requirements	G-SIIs 10 institutions	O-SIIs (non-G-SII) - 113 institutions		Other institutions (non-GSIIs and non-OSIIs) - ~3200 institutions			
Stress testing	EBA stress testing scope - 40 institutions						
TLAC / MREL	G-SIIs 10 institutions	"Top-tier" ~20 / Other banks			o/w "Small banks" *(RCA exemption under BRRD)*		
Eurozone	TLAC Contributions to SRB MREL enhanced requirements (incl. subordination) Full recov. planning requirements Full disclosure requirements LCR Fully-fledged NSFR EBA stress-testing SSM supervision SREP methodology G-SII buffer O-SII buffer Risk-based capital ratios (advanced or standard approaches) G-SII LR surcharge Leverage ratio	Contributions to SRB Enhanced MREL req. Contr. to SRB MREL Full recovery planning requirements Full disclosure requirements LCR Fully-fledged NSFR EBA stress-testing SSM supervision SREP methodology O-SII buffer Risk-based capital ratios (advanced or standard approaches) Leverage ratio	Contributions to SRB MREL Full recovery planning requirements Full disclosure requirements LCR Fully-fledged NSFR SSM supervision SREP methodology O-SII buffer Risk-based capital ratios (advanced or standard approaches) Leverage ratio	Contributions to SRB MREL Full recovery planning requirements Full disclosure requirements LCR Fully-fledged NSFR SSM supervision SREP methodology Risk-based capital ratios (advanced or standard approaches) Leverage ratio	Contributions to SRB Full recovery planning requirements Intermediate disclosure requirements LCR Fully-fledged NSFR Heightened ECB oversight on NCA Tailored SREP methodology Risk-based capital ratios (advanced or standard approaches) Leverage ratio	Contributions to SRB Simplified recov. planning req. Intermediate disclosure requirements LCR Fully-fledged NSFR Medium ECB oversight on NCA Tailored SREP methodology Risk-based capital ratios (advanced or standard approaches) Leverage ratio	Contributions to SRB Simplified recov. planning req. Simplified disclosure req. LCR Simplified NSFR Lighter ECB oversight on NCA Simplified SREP Risk-based capital ratios (advanced or standard approaches) Leverage ratio

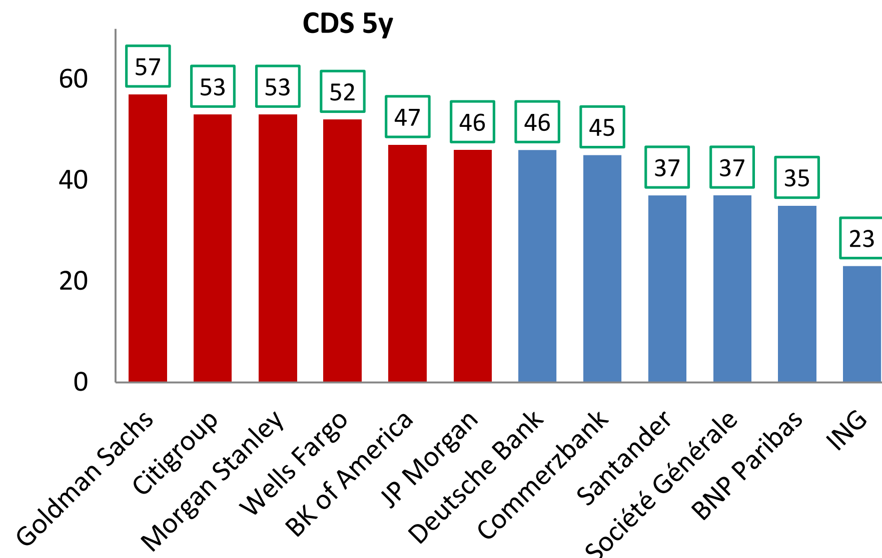
Large banks could face additional constraints like :

- G-SII & O-SII buffers, G-SII LR surcharge, TLAC, MREL enhanced
- Full recovery planning, Full disclosure requirements
- Full NSFR, EBA stress-testing, full SREP, etc.

5. UE banks safer and safer… but structurally more vulnerable vs US

- Higher Price-to-Tangible book values for US banks and cheaper access to markets
- CDS market: a better measure of safety and soundness of a bank





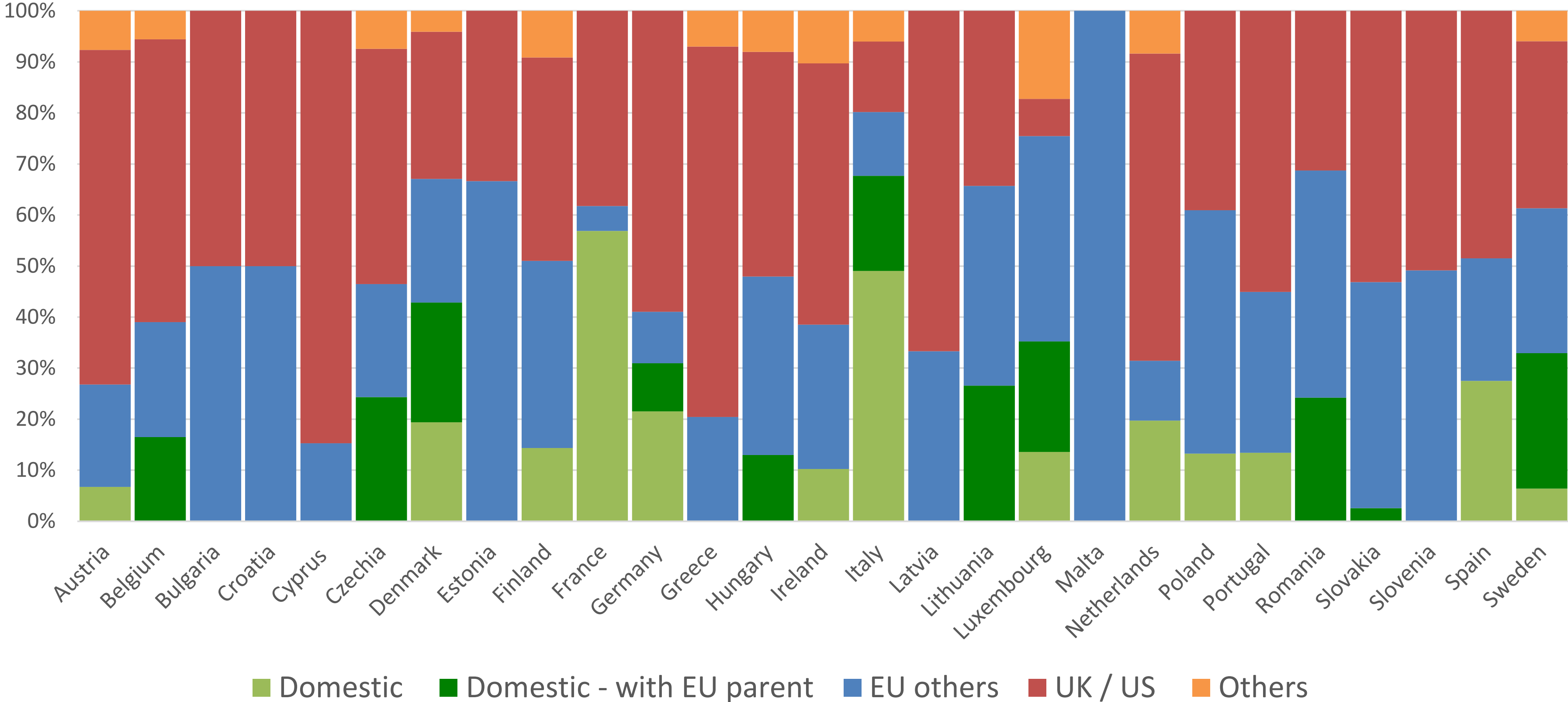
- EU banks ROE's mechanically cut by a factor of 2 given doubling of regulatory capital
- No perspective of progressive normalization of monetary policy penalizes EU banks profitability
- No capacity to off-load assets from EU banks' balance-sheets as in the US
- EU fragmented market
- Goldplating, including application of rules at entity level

Sources: Closing Bell of 28 May, 2021 – BNP Paribas, FG, RIIF (data: Thomson Reuters)

Blomberg 31/05/2021

Classification : Internal

5. EU needs strong CIB banks
to maintain its sovereignty on government and corporate financing



Several banks (such as BNPP, Erste Group, Nordea, Raiffeisen Bank, SEB, Société Générale and Unicredit) have been considered as "quasi domestic" banks in their other main domestic markets, they are categorized as "Domestic - with EU parent" in the graph above.
Source : Dealogic 2020 FY, above EUR 250m, all currencies, Sovs, Agencies and Corpo

Classification : Internal

5. EU needs strong CIB banks
Preserve viability of EU CIB models while improving risk sensitivity

Although capital market activities represent a small percentage of current RWAs, they concentrate almost half of the Basel III RWA inflation, whereas their capital charge requirements had already been massively increased with Basel 2.5

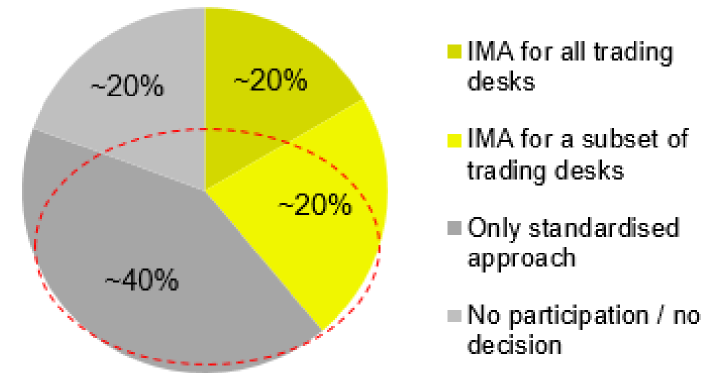
Proposals for Market Risk

Ensure the alignment of the timetable and standard itself with other major jurisdictions, in particular the US

- Convert the reporting into a capital requirement and adapt the standard itself in line with international implementation developments

Better align capital and risk management for internal models

- Beware of the likely consequence of the choice by 60% of banks abandon or reduce the scope of internal models
- Introduce flexibility to avoid desks and risk factors to be excluded from Internal Models due to excessively restrictive criteria
- Take into account specificities of the EU capital markets (smaller and less
  liquid than the US market) and avoid pro-cyclicality



Source: ***ECB 2nd FRTB Questionnaire***

https://www.bankingsupervision.europa.eu/press/publications/newsletter/2020/html/ssm.nl200212_2.en.html

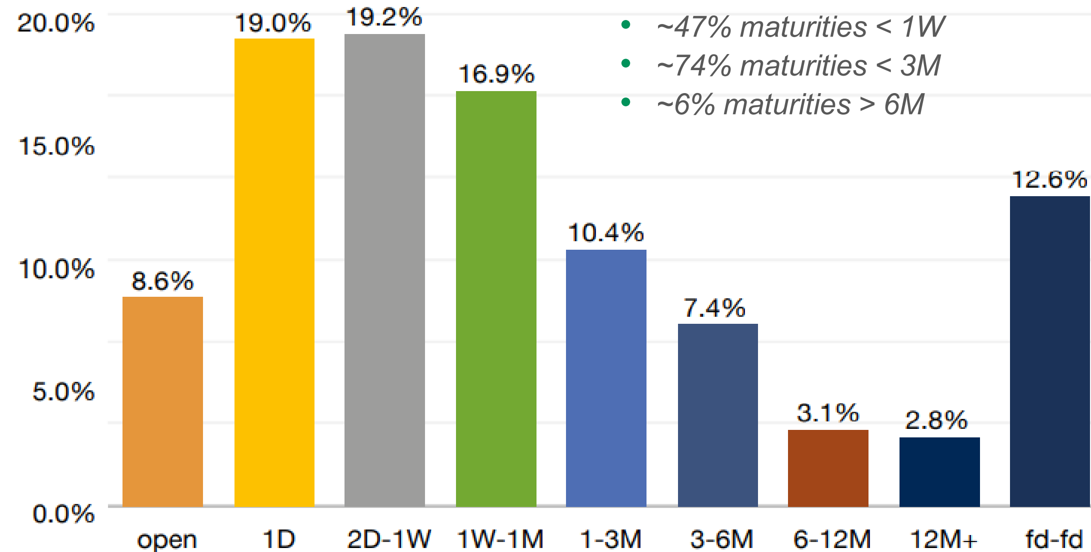
Implement targeted amendments not to penalize end-users

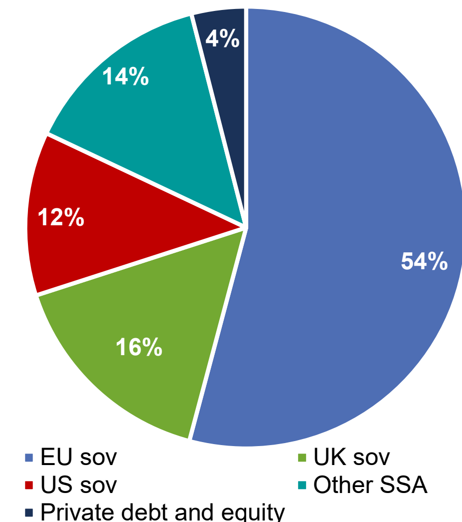
- Remove default probability floor to EU sovereigns and central banks
- Allow a larger use of own modelling of funds (CIUs) under the IMA
- Ensure the SA for residual risks (RRAO) and funds is more flexible and risk-sensitive to remain a credible fallback to internal models

5. EU needs strong CIB banks

Make Securities Financing Transactions (SFTs) treatment more risk-sensitive

- **The Basel IV estimate shows a very large impact of Standardised Risk Weights on SFTs**
  - This impact is explained by the fact that SFTs are by nature very short-term activities
- **Risk Weights should reflect the lower risk entailed by short-term exposures :**
  - In the F-IRB approach, the use of actual maturities should be allowed for more risk sensitive weights. When supervisory maturities are used, a 0.25 years maturity floor (instead of 0.5 years) should apply
  - In the SA, risk weights for SFT exposure should be drastically reduced to reflect the low maturity risk (in line with EU trade finance RW adjustments)



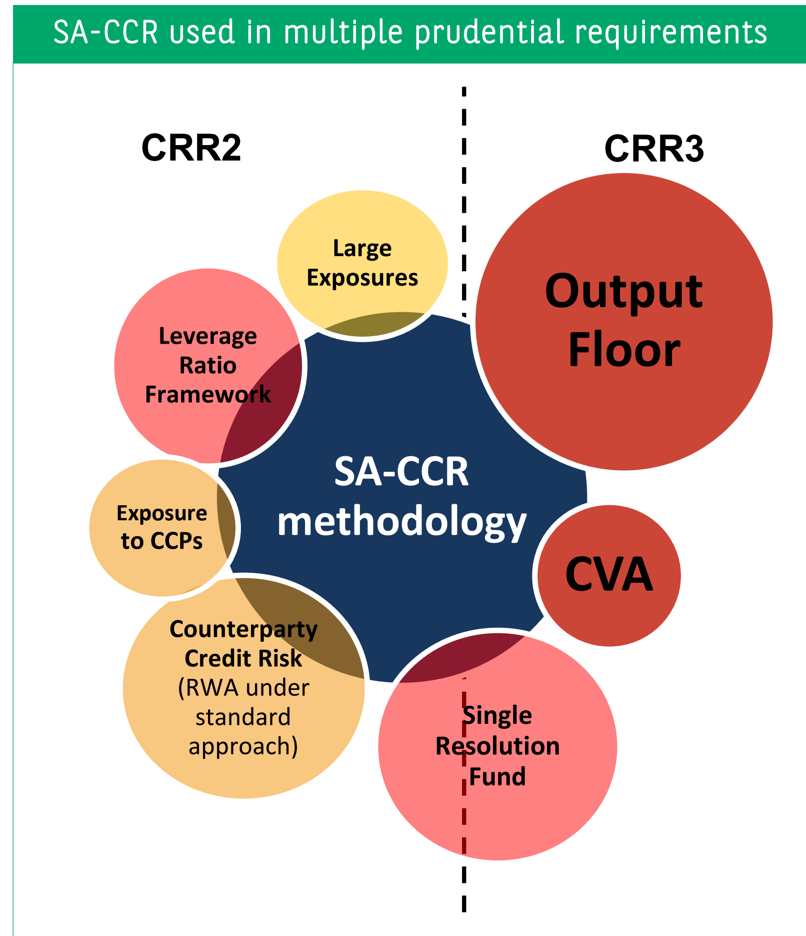


Source: ICMA, European Repo Market Survey, November 2020

*Total value of the repo contracts outstanding on the books of the 61 institutions who participated in the latest survey was EUR 7,885 billion on June 10th, 2020

5. EU needs strong CIB banks
SA-CCR will already bite from June 2021

- **The Standardized Approach for Counterparty Credit Risk (SA-CCR)** replaces both the Current Exposure Method (CEM) and the Standardized Method (SM)
  - Implemented in EU in CRR2: entry into force in June 2021
  - Already in force in the US, with alpha factor set to 1 for commercial end users
- **Why the CCR is particularly sensitive in Europe?**
  - FX use by EU corporates due to imports / exports in USD
  - Strong impact for banks using IMM of Basel IV Output Floor
    - Exposure at default (EAD) from IMM to SA-CCR **~ x 2**
    - amplified by the BIV credit risk RWs from IRBA to SA for corporates and financial institutions **additional ~x 2**
    - Full SA RWA **x 4** IMM RWA and **x 3 post 72,5% floor**
- **What should be done?**
  - 1,4 alpha factor deletion (either for commercial end users or for replacement costs)
  - Accelerate adaptation, possibly through a fast track, to avoid uncompetitive pricing by EU banks compared to their US counterparts, due to higher leverage, large exposure and SA RWA charges



Conclusion

While a faithful implementation of the Basel Accord is important, Europe should :

- **Avoid any goldplating and make proper use of embedded discretions**
  - Implement the output floor as a true backstop
  - Recalibrate existing goldplating (such as Pillar 2 and MREL)
  - Use discretion to set ILM =1
  - Allow supervisory discretion when allowed by Basel (eg Market Risk benchmarking breaches)
- **Improve the relevance and risk sensitivity of the framework by recognizing:**
  - The successful effort by regulators, supervisors and banks to improve the reliability of internal models
  - The need to taylor some risk parameters to European specificities
- **Favor financial sovereignty by**
  - Avoiding to excessively penalize CIB activities
  - Ensuring alignment of Capital Market rules with other key jurisdictions, in timing and substance
- **Comply with the « no significant capital increase mandate »**
  - To avoid a deleveraging wave that would jeopardize the post Covid recovery
- **Ensure viability of the securitization framework to allow banks to finance the recovery and the green transition, while transferring risk to the market**