Conclusion of the global post-crisis regulatory response in Basel and EU implementation

Adam Farkas – Executive Director of the EBA

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Plan of the talk

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- **Post-crisis reform of the standards: the main building blocks**
- **The EBA work on the international standards**
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  - Forerunning and shaping international standards (the case of securitisation)
- **Focus on the finalisation of the Basel 3 review (Basel 3.5?)**
  - The Basel 3.5 reform in 1 slide
  - Reduced scope of IRB modelling
  - Operational risk: new Standardised Measurement Approach
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Overarching EBA stance on international standards

- Internationally active banks have historically served the fundamental purpose of allocating financial resources from regions with excess savings to regions with excess investments;
- With the global financial turmoil:
  - Interconnections across global banks proved to be one of the channels of contagion and international banking experienced significant disruptions;
  - Global institutions have withdrawn from host markets and national authorities have responded with ring-fencing strategies;

International standards are an essential common yardstick to support safe and sound cross-border banking on a global scale, while avoiding the fragmentation of financial markets across regional lines;

It is of paramount importance that the adoption of international standards is mindful of EU specificities and responds to the principle of proportionality of regulation;

Post-crisis reform of the standards: the main building blocks

Quality of capital	Definition of capital: focus on common equity	*Better loss-absorbency capacity for any given amount of regulatory capital*
Quantity of capital	• Min CET1 raised to 4.5% • Capital conservation buffer • Countercyclical capital buffer • G-SIB surcharge	*Higher loss-absorbency, also reflecting the systemic risk build-up and institutions' contribution to systemic risk*
Risk coverage	• New securitisation framework • Fundamental Review of the Trading Book • Review of the Counterparty Credit Risk framework • Bank exposures to central counterparties	*The calculation of risk-weighted assets becomes more risk-sensitive*
Liquidity	• Liquidity Coverage Ratio • Nest Stable Funding Ratio	*Institutions ready to withstand liquidity stress in the short-term and working under a stable funding model in the medium-term*
Leverage	• Leverage Ratio	*Minimum loss-absorbency irrespective of risk-weighting. Backstop metric against leverage build-up*
Accounting & disclosure	• Pillar 3 disclosure • IFRS reform	*Increased market discipline* *Timely and forward-looking provisioning against losses*
Remuneration	• Remuneration policy	*Remuneration to shape correct incentives to risk management*
Resolution	• Bank recovery and resolution framework • Minimum Own Funds and Eligible Liabilities (MREL)	*Orderly resolution and mitigation of externalities on taxpayers*

The EBA work on the international standards

At least 4 different levels:

1) Design of the related Level 2 measures: the EU Single Rulebook

The reform process has provided a unique opportunity to move to a true Single Rulebook for the European banking sector. The EBA has delivered (as per 2016 EBA Annual Report):

- ***146 Technical Standards***
- ***64 Guidelines***

2) Calls for advice and own initiative reports on the implementation of the standards into Level 1

- ***The recent example of the EU Banking Package (CRD V, CRR2, BRRD2)***

  → *next slides*

3) Technical work to forerun and shape international standards themselves

- ***The case of the Basel Simple Transparent and Comparable securitisation reform (STS in the EU)***

  → *next slides*

4) Coordination of EU participation to the Basel negotiation table

- ***The case of the Basel 3.5 ongoing negotiation***

  → *next slides*

Advice on the implementation into EU Level 1 legislation

The recent example of the November 2016 Banking package: CRD V, CRR 2, BRRD 2

CfAs and own initiative reports to assess the impact of international standards, advice co-legislators on their best implementation, embed the principle of proportionality into the EU adoption of the standards.

- *Thorough analyses of the effects of the implementation on European banking markets;*
- *Assessing the impact on banks of different size and business model;*
- *Assessing the impact on lending to small and medium enterprises and to the European economy as a whole; .*

Proportionality is not a call for less rules or national rules, it is about the proportionate application of common rules, taking into account different levels of complexity of the banking business

EBA work - including but not limited to:
EBA report on the Net Stable Funding Ratio (Dec 2015)
EBA report on the Leverage Ratio (Aug 2016)
Response to the CfA on SA-CCR and the FRTB (Nov 2016)
EBA Final report on MREL (Dec 2016)
EBA report on the impact assessment of the IFRS (Nov 2016, July 2017)
EBA opinion on the application of proportionality to remuneration provisions (Nov 2016)

Forerunning and shaping international standards

EU STS securitisation foreruns Basel STC securitisation

European Union

October 2014: EBA discussion paper on Simple Transparent and Standardised (SST) securitisation: a high quality securitisation product is defined by criteria drafted by the EBA.

January 2014: EBA report on qualifying securitisation (term and ABCP): high quality term and ABCP securitisation is defined and preferential risk weights are calibrated

September 2015: Commissions' proposal on STS securitisation and amended risk weights in the CRR

June 2017: The trilogue reaches an agreement. Entry into force Jan 2018

Basel Committee

July 2015: BCBS/IOSCO consultation paper on simple transparent and comparable (STC) term securitisation

November 2015: BCBS consultation on calibration of STC risk weights for term securitisation;

July 2016: term STC framework is finalised

July 2017: Consultation is launched on STC ABCP securitisation (ongoing)

Focus on the finalisation of the Basel 3 review (Basel 3.5?)

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The ongoing review aims at enhancing simplicity, comparability and risk-sensitivity of international standards.

Negotiation process:

(green)	Stable agreement
(red)	Under discussion

- **Substantial revisions to the SA for credit risk, among which:**
  - New **specialised lending** exposure classes (project/object/commodity);
  - Differentiated treatment of **general vs. income producing real estate** exposures;
  - Introduction of the **EU loan-splitting approach** for residential real estate exposures;
  - **Abolition of sovereign rating-based treatment** of financial exposures, more granular treatment proposed for **unrated banks**;
  - Preferential treatment on EU specificities: **SME exposures** (pref. 85% RW) and **covered bonds**;
  - Revised treatment of **off-balance sheet exposures** (new credit conversion factors);

→ *Enhanced risk-sensitivity and reduced reliance on external ratings*

- **The use of internal models is constrained on several fronts:**
  - **Restrictions in scope** and parameter estimation on the **IRB** approach for credit risk
  - Elimination of internal modelling (AMA) for Operational Risk → **new SMA**
  - Elimination of internal modelling for CVA → **no IMA-CVA**

→ *Excessive RWA variance will be reduced*

- **Leverage Ratio: new exposure measure and new G-SIB surcharge = 50% of own-funds surcharge**
- **Aggregate [70%-75%] output floor?**

Reduced scope of IRB modelling

March 2016 consultation:

Evolution of the proposal:

Currently eligible to A-IRB:

Modelling concern focuses on LGD estimation

▪ Banks and other FIs	→ Standardised Approach	→ F-IRB
▪ Large corporates (>EUR 50 billion group assets)	→ Standardised Approach	→ F-IRB
▪ Specialised lending	→ Standardised Approach; → Slotting approach	→ A-IRB
▪ Equities	→ Standardised Approach	
▪ Corporates with group revenues > EUR 200m	→ F-IRB	

Restrictions on remaining scope of modelling:

- New and increased PD and LGD floors – i.e. input floors;
- Tightened requirements on PD estimation (granularity, stability and downturn coverage of the time series);
- Increased haircuts on financial collateral combined with increased use of supervisory conversion factors parameters for off-balance sheet exposures;

Operational risk: new Standardised Measurement Approach

New SMA = [BIC] x [ILM]

Business Indicator Component [BIC]: A measure of bank's income. It assumes that operational risk in a bank increases with the bank's income. Three different income buckets are charged by different coefficients;

Internal Loss Multiplier [ILM]: A measure of banks' historical losses. Banks which have experienced greater operational risk losses historically are assumed to be more likely to experience operational risk losses in the future;

The new SMA replaces all existing approaches. AMA is abandoned as overly complex and opaque

The evolution of the proposal resulted in the following:

- **The ILM may be set to 1 at national discretion:** the loss component of the requirement can be 'switched off';
- **The coefficients of the income buckets in the BIC will be applied in accordance with a phase-in:** the impact of the income component is mitigated during the first years of the reform;

Overarching EBA stance on RWA variability and IRB 1/2

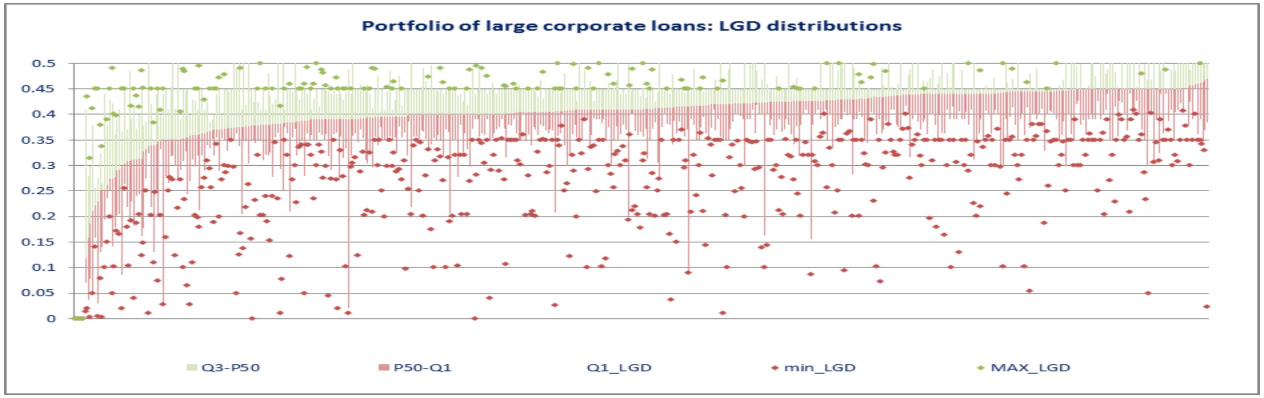
- Credit risk accounts for the bulk of the observed RWAs variance;
- RWA variance can be decomposed:
  - **Risk-based variability:** explained by risk composition of banks' assets and risk appetite. A high degree of consistency is found in banks' assessment of the relative riskiness of obligors;

    → **Desirable variability: risk-sensitive arm of regulatory capital framework. Internal models should remain the first driver of capital requirements!**

  - **Practice based variability:** explained by both bank and supervisory/implementation practices (partial use, definition of default, treatment of defaulted assets, rating scales, data coverage, cyclical adjustments, supervisory floors and add-ons etc.) and, potentially, aggressive modelling;

    → **Should be reduced to improve RWAs comparability and level playing field**

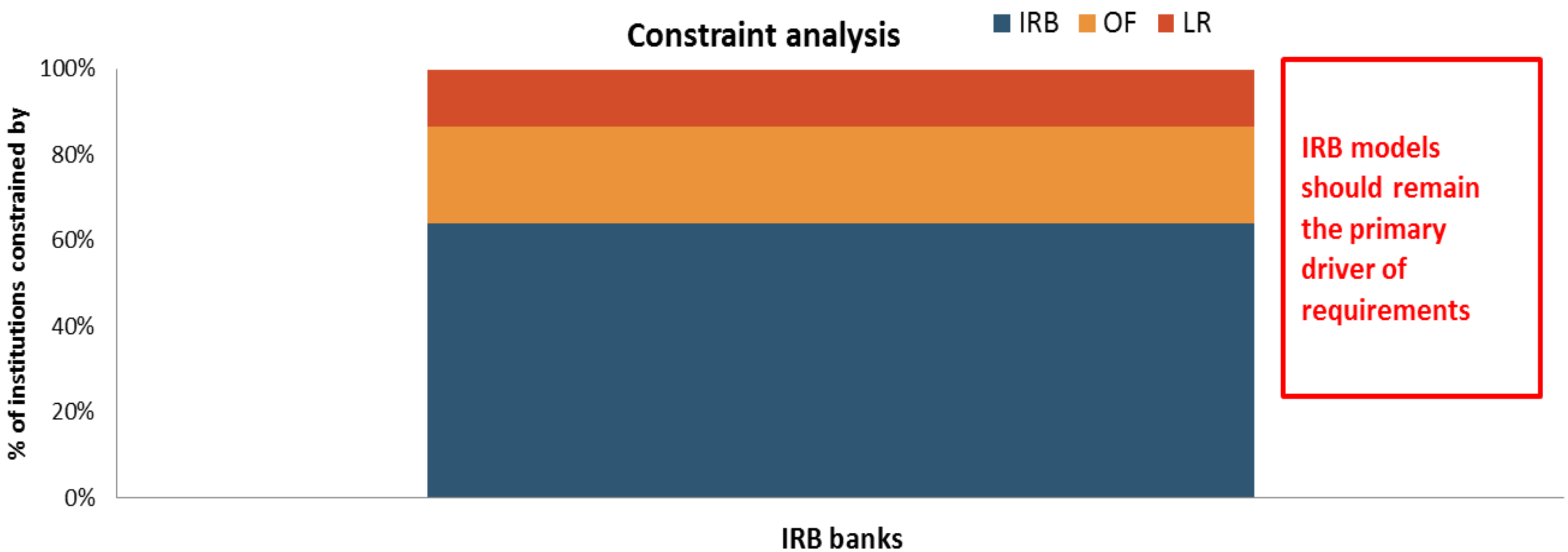
Mostly an LGD (rather than PD) estimation problem in low-default portfolios



When given a common portfolio of loans to large corporates different IRB banks produced quite scattered LGD estimates. **The same risk exposure is measured differently by different IRB banks**

Overarching EBA stance on RWA variability and IRB 2/2

- Moderately calibrated input floors can address modelling risk – **particularly for low-default portfolios**;
- Restrictions on LGD modelling **address variability without giving in on risk-sensitivity**;
- The **output floor is a top-down adjustment** that would come on top and beyond the proposed restrictions to internal modelling and, most importantly, the backstop function already exercised by the leverage ratio. **Would risk-sensitivity be overly constrained? Can we afford a framework where internal models are not the main drivers of regulatory capital?**
- A crucial element of the EBA toolbox to assess the reform is the **IRB constraint analysis** – see example below:



IRB models should remain the primary driver of requirements

Questions?

Thank you

EUROPEAN BANKING AUTHORITY

Floor 46, One Canada Square, London E14 5AA

Tel: +44 207 382 1776
Fax: +44 207 382 1771

E-mail: info@eba.europa.eu
http://www.eba.europa.eu