

Thomas B. Jorgensen

Head of the Supervisory Policies Division

Directorate General Micro-Prudential Supervision IV

European Central Bank

Finalising Basel III Reforms

Club de Gestión de Riesgos de España (CGRE)

Madrid, 10 November 2016

Disclaimer: The views expressed here are solely those of the presenter and do not necessarily represent the views of the ECB or the SSM.

1. Overview
2. Addressing Risk-Weighted Assets (RWA) Variability in Internal Models
3. Finalisation of the outstanding Basel III reforms

Main messages

- **The Basel Committee on Banking Supervision has a formidable task**

- The outstanding Basel III reforms are nearing completion – a global agreement may be reached in January 2017 for the revision of credit risk, CVA, operational risk and a supplementary LR for G-SIBs;

- The BCBS is resolved to not increase significantly overall capital requirements for banks (however some banks which are genuinely outliers may do face a significant increase);

- **The impact of reforms will be somewhat diverse, unavoidably**

- Banks differ in multiple dimensions: size, business model, geographical presence ...

- There is no such thing as a one-size-fits-all regulation.

- **Reform implementation will be key - at all levels:**

- (i) regulatory adoption by legislators – How will BCBS reforms be implemented in the EU?

- (ii) compliance by banks – Impact on RWAs and internal risk management practices;

- (iii) examination by the supervisors;

- (iv) scrutiny by market stakeholders.

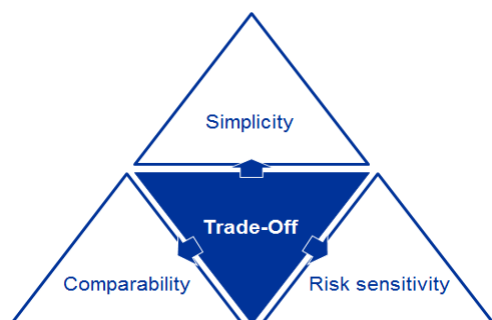
- **Need for regulatory stability**

B	5	3	2		7			8
6	A	1	5					2
2		S	9	1	3			5
7	1	4	6	9	2			
	2			E				6
			4	5	1	2	9	7
	6		3	2	5	L		9
1					6	3	III	4
8			1		9	6	7	?

- In January 2016, the **Basel Committee's oversight body, the Group of Governors and Heads of Supervision (GHS)**, agreed on completing the work to address the problem of excessive variability in risk-weighted assets (RWA) by the **end of 2016**.
- In achieving this, it would consult on proposals to:
 - Remove internal model approaches for certain risks, and
 - Set additional constraints on the use of advanced approaches for credit risk, in particular through the use of floors.
- In parallel, the BCBS would conduct a QIS of the reforms and focus on **not significantly increasing overall capital requirements** – a commitment publicly reaffirmed by the GHS at its latest meeting on 11 September 2016.
- The finalization of these outstanding reforms will bring Basel III -started in 2009- to a close. Basel III has been devised as a multi-constraint framework:
 - More capital and of higher absorbing capacity (CET1)
 - Liquidity standards (LCR, NSFR)
 - Non-risk-based backstop measure: the leverage ratio (LR)
 - Macroprudential overlay to address systemic risks (SIB buffers, CCyB).

The BCBS is placing emphasis on achieving simplicity, comparability and risk sensitivity

- Objectives:**
- (i) Improve the ability of individual banks, and the banking sector, to absorb shocks and appropriately manage system-wide risks by, for example, constraining excessive leverage and credit growth;
 - (ii) Align capital requirements with the actual risks taken by banks (including model risks) and reduce incentives for regulatory arbitrage and gaming;
 - (iii) Promote the premise that bank boards and management take primary responsibility for managing risk and capital, and encourage improved risk management within banks;
 - (iv) Ensure that the framework has broad applicability to a wide range of banks, can be implemented consistently and provides a level playing field;
 - (v) Deliver a well-understood measure of capital adequacy that facilitates comparisons across banks and over time.

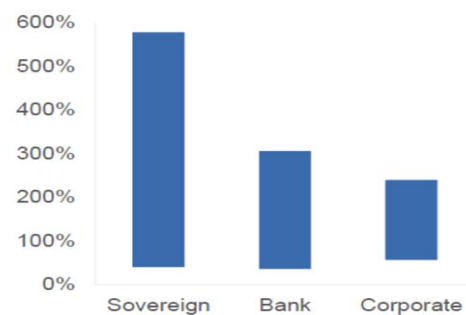


The aim is to strike the right balance

2. Addressing RWA variability in internal models

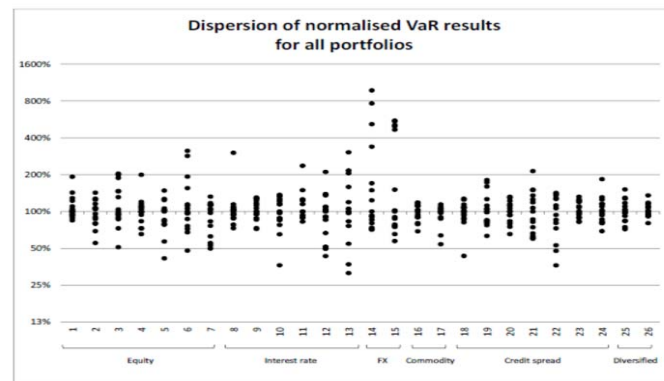
- The 1988 Basel I framework had limited risk-sensitivity.
- Basel II allowed considerable use of internal models to determine capital requirements. While permitting a more accurate risk measurement, it gives banks incentives to underestimate risk. Several studies have found substantial variation in RWAs across banks.
- Complexity in internal models, banks' choices in modelling risk parameters and national discretions in the Basel framework are the main factors explaining this variation:
- More than half of the variation in RWs for credit risk is attributable to the relative shares of different asset classes held by banks (i.e. overall banking book risk weights depend on the composition or mix of portfolio exposures).

Risk weight variability in the banking book ^(a)



Source: Basel Committee and Secretariat calculations.
 (a) The chart shows the normalised distribution of risk weights (with 100% representing the cross-bank median risk weight as the benchmark) reported by banks under the Committee's banking book HPE study.

Variability of value-at-risk results ^(a)



Source: Basel Committee and Secretariat calculations.
 (a) The chart shows the dispersion of normalised VaR results for all portfolios used as part of the Committee's market risk HPE. For portfolios 25 and 26, the diversification benefit is plotted rather than individual model results.

Source: BIS. Speech by William Coen, BCBS Secretary General, at the Australian Financial Review's Banking and Wealth Summit, Sydney, 5 April 2016.

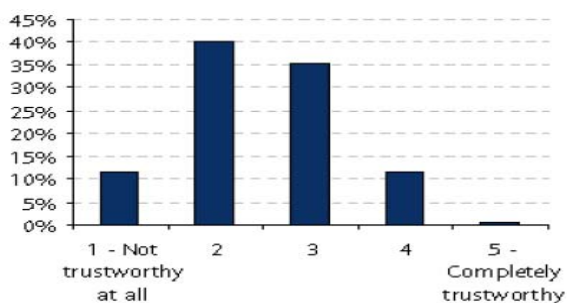
2. Addressing RWA variability in internal models

ECB-PUBLIC

Limited comparability limits investors trust in models

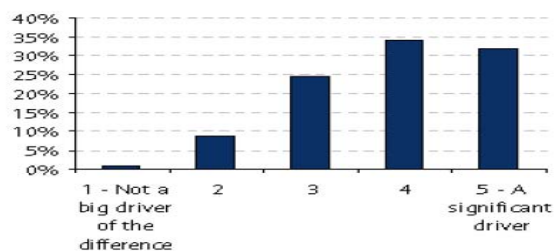
HOW MUCH DO YOU TRUST RISK WEIGHTINGS?

All Investors



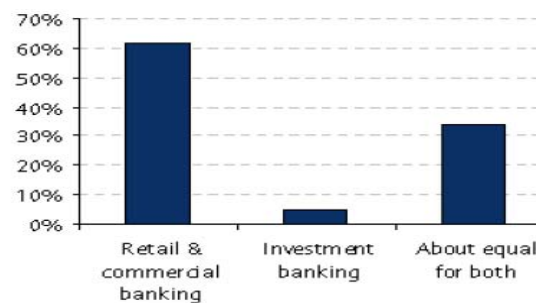
MAJOR DIFFERENCES REFLECT THE WAY NATIONAL REGULATORS APPLY THEIR RULES?

All Investors



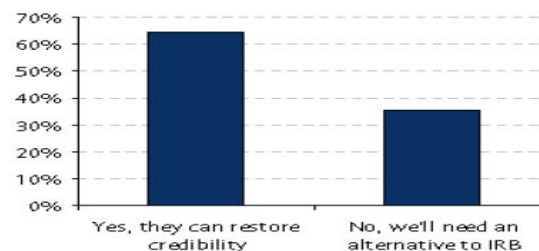
DO YOU VIEW RWs MORE TRUSTWORTHY FOR... ?

All Investors



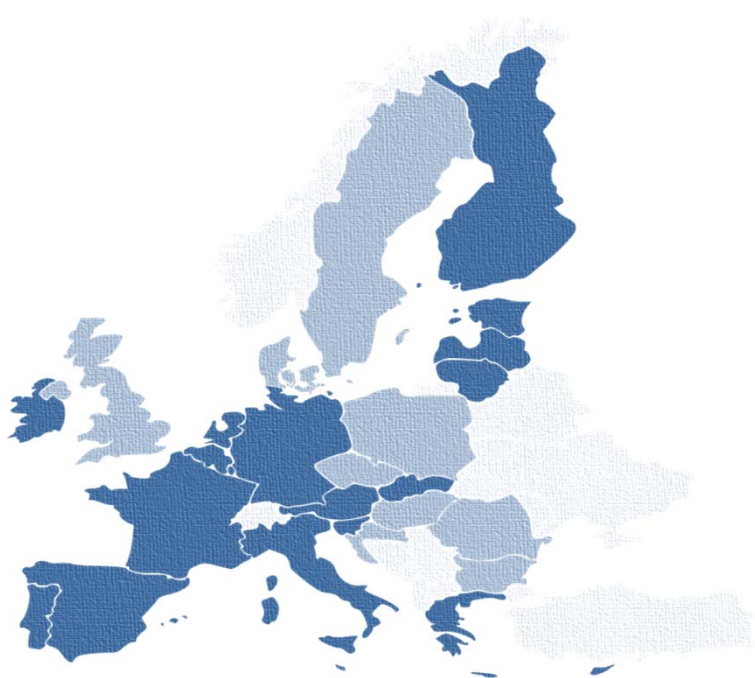
CAN REGULATORS RESTORE CREDIBILITY IN IRB?

All Investors



Source: Barclays Research (2012).

The TARGETED REVIEW OF INTERNAL MODELS (TRIM) is an SSM initiative that seeks to restore credibility, adequacy and appropriateness of approved Pillar 1 internal models used by significant institutions



STARTING POINT

- Approx. 2400 models categories
- 69 SIs with Credit risk models
- 36 SIs with Market risk models
- 8 SIs with Counterparty credit risk models
- 17 NCAs
- Operational risk excluded

Overview of BCBS regulatory work streams



3. Finalisation of outstanding Basel III reforms

ECB-PUBLIC

Credit risk IRB

IRB Framework

Parameter floors

The new proposal **removes the option to use the IRB approaches for certain exposures**, where it is judged that the model parameters cannot be estimated sufficiently reliably for regulatory capital purposes:

Exposures	Current Basel standards			BCBS proposal		
	AIRB	FIRB	STD	AIRB	FIRB	STD
Banks	✓	✓	✓	✗	✗	✓
Large corporates ¹	✓	✓	✓	✗	✗	✓
Other corporates	✓	✓	✓	✗ ²	✓	✓
Specialised lending	✓	✓	✓	✗	✗	✓
Equity exposures	✓	✓	✓	✗	✗	✓
Retail exposures	✓	✓	✓	✓	✓	✓
Eligible purchased receivable	✓	✓	✓	✓	✓	✓
Sovereigns	✓	✓	✓	Under revision		✓

Additionally, it **introduces a floor to the internal model method for counterparty credit risk (IMM-CCR)** based on a percentage of the applicable standardised approach.

(1) Corporate exposures of consolidated groups with total assets exceeding EUR50bn

(2) Corporate exposures that are part of consolidated groups that have annual revenues greater than EUR200m

3. Finalisation of outstanding Basel III reforms

Credit risk IRB

IRB Framework

Parameter floors

Additionally, **the new proposal adopts model-parameter floors** to ensure a minimum level of conservatism for portfolios where the IRB approaches remain available:

Exposures	PD		Current	LGD		EAD/CCF	
	Current	Proposed		Unsecured	Secured	Current	Proposed
Corporates	3bp	5bp	N/A	25%	0% financial 15% receivables 15% commercial or residential real estate 20% other physical	N/A	sum of (i) the on balance sheet exposures; and (ii) 50% of the off balance sheet exposure using the applicable CCF in the SA
Mortgages		5bp	10%	N/A	10%		
QRRE transactors ¹		5bp		50%	N/A		
QRRE revolvers	N/A	10bp		50%	N/A		
Other retail		5bp	N/A	30%	0% financial 15% receivables 15% commercial or residential real estate 20% other physical		

(1) Facilities such as credit cards and charge cards where the balance has always been repaid at each scheduled repayment date and that at least 6 months have passed since the facility was first used as a means of payment.

Output floor

Parallel approach

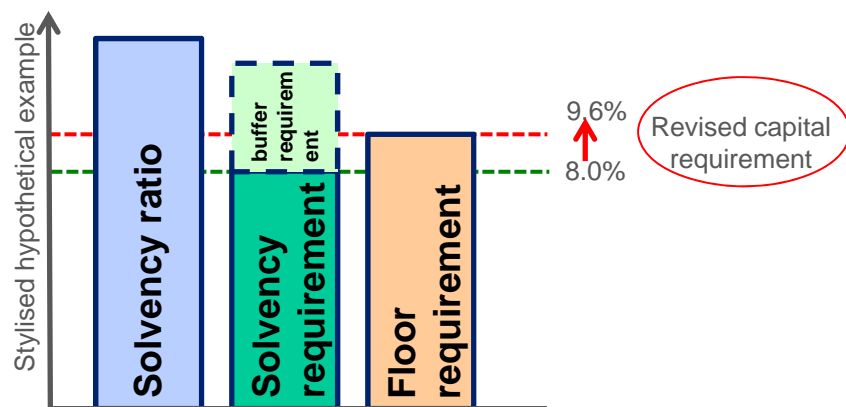
(current EU practice for **Basel I floor**)

RWA_{actual}: 100 (solvency ratio 12%)

- minimum requirement of 8% met and bank has 4% buffer

RWA_{floor basis}: 150

- **floor requirement**: $[(150 * 80% * 8\%)/100] = \underline{9.6\%}$



(the floor operates in parallel to the solvency requirement and has no direct implications on solvency ratio. As buffer requirements do not exist for the floor, the floor is rarely binding)

RWA adjustment approach

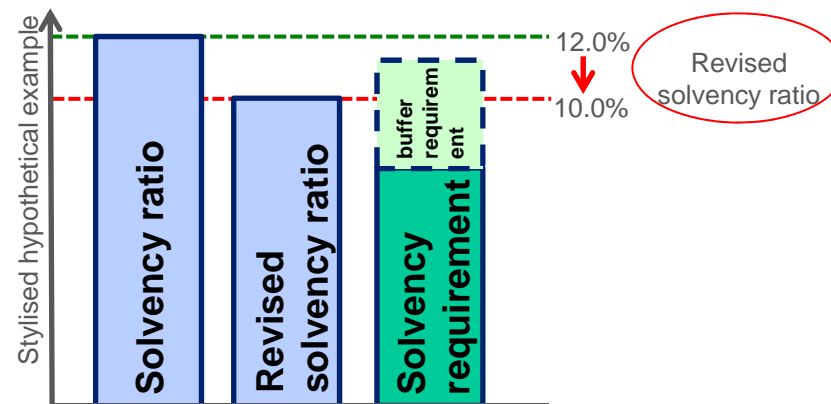
(envisaged for new **SA-based floor**)

RWA_{actual}: 100 (solvency ratio 12%)

- minimum requirement of 8% is met and bank has 4% buffer

RWA_{floor basis}: 150

- **floor RWA adjustment**: $[100 + \text{MAX}[0; ((150 * 80\%) - 100)]] = 120$
- **revised solvency ratio** (after floor adjustment): $12/120 = \underline{10.0\%}$



(the floor adjusts the solvency ratio downward. A lower solvency ratio can have the effect that buffer requirements are no longer met – even if minimum requirements continue to be met)

- **Impact of CR-SA and CR-IRB reforms on banks' internal risk management practices**
 - Lesser room for “RWA optimization” giving possibly better and more conservative overview for bank management as well;
 - However possible increased misalignment between, for example, economic capital models and regulatory models;
 - Increasing importance of risk management function with many dimensions (EC, rating, regulatory, IFRS 9, multiple constraints LR, LCR, NSFR etc);
 - Possible increased risk taking to be seen and if so supervised well.

Thank you for your attention

