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Basel III reforms less stringent than expected despite the output floor

But the rules still have to be implemented in the local legislation and the possible differences will be crucial in assessing the final impact

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The Basel Committee reached an agreement on the Basel III overhaul yesterday. Our first impression is that the package is somewhat less penalising for the banks than initially feared.

A significant part of the package is the introduction of a so-called output floor at 72.5% limiting the use of internal risk models. The Committee also introduces revisions to standardised approach for credit risk, IRB framework, CVA framework and operational risk framework. Additionally, the package comes with a G-SIB leverage buffer as of 2022 with a revised exposure definition.

The banks will have time to adjust to the upcoming changes. The output floor is phased in starting on 1 January 2022 at 50% reaching 72.5% on 1 January 2027. The output floor level and the transitional period correspond to the market expectations in our view. The increase in RWA due to the regulatory change may be capped at 25% by the national supervisor during the transitional phase.

While the majority of large banks use the internal risk models, the standardised model is relevant due to the introduction of an output floor linking the two. For assessing the credit risk for residential real estate exposures the standardised model risk weight table is altered such that on average the risk weights for mortgages will be lowered.

Additionally, the Committee introduces an alternative splitting approach for assessing standardised mortgage credit risk that could result in high LTV mortgages obtaining lower risk weights than with the standard risk weight table for the standardised approach. Most likely you can use the alternative approach for the whole book only, and not pick and choose between the two approaches in our view.

According to the impact assessment published by the EBA, the weighted average CET1 ratio of EU banks will decrease moderately, i.e. by 0.6ppt as compared with the current framework to 11.6%. For the G-SIIs the CET1 ratio effect would be somewhat larger than for the whole sample at -0.8ppt. The CET1 capital deduction would amount to €17.5bn for the whole sample, while the total capital impact would amount to €39.7bn. The major driver for the changes is the introduction of an output floor.

The smaller Group 2 banks instead would see their CET1 ratios on average increase by 0.20ppt. The smaller banks are likely to utilise less internal models, a likely explanation for the difference.

> The rules will still have to be implemented in the local legislation, and the possible local differences will be crucial in assessing any final impact.
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> In general, an introduction of an output floor is likely to have a larger effect on the banks that have lower risk density such as the Nordic and Benelux names in our view.
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> In addition, the banks that have already higher risk density such as the Southern European banks should be less affected. That said, the alternative approach introduced for the mortgage exposures may lessen the impact on the Dutch names.

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