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Financial Risk&Regulation

Changes in supervisory expectations in the financial sector

Newsletter – January 2021

The European Commission and the European Banking Authority continues the implementation of the Basel III package in the EU. Although the package is delayed, one of the main reasons was the development of the COVID-19 package, and the avoidance of a disproportionate increase in the banks' burdens, the EU bodies are determined to implement it. In this newsletter, we summarize the impact assessment prepared by the EBA and address changes in reporting and disclosure rules and technical conditions aiming at increasing coherence between different instruments and reducing institutional operational burdens.

Basel III impact assessment

Background

As a result of regulatory efforts in the wake of the global financial crisis, the Basel Committee issued in December 2017 and updated in January 2019 the final elements of the Basel III framework and the final market risk framework (including the FRTB framework for trading book reviews). The revised regulatory proposals aimed to address the shortcomings of the pre-crisis regulatory framework and to strengthen the resilience of the banking system to cyclical economic crises.

The most recent change in the capital regulatory framework was the release of CRR2 and CRD5, which we also wrote about in the newsletter of August 2019, with the general first date of application of this package being 27 June 2020. The regulation changed as a result of the COVID-19 crisis, which we wrote about in our newsletter of July 2020.

The European Banking Authority (EBA) commented on the implementation of the Basel III reforms in two steps, in August and December 2019, following a call from the European Commission in May 2018 (Call for Advice - CfA). These reports from the EBA include a quantitative impact assessment on the implementation of the reforms, grouped by bank size, based on data reported by the participating banking groups at the EU consolidated level, recommendations for implementation and a macroeconomic impact assessment (carried out by the EBA in conjunction with the ECB). In March 2020, in addition to the above, the EBA conducted a quantitative impact study for individual entities.

In these reports, the EBA clarified that it supported the implementation of Basel III reforms. According to the supervisory authority, Basel III reforms can strengthen confidence in the European banking system and enhance its resilience. According to the EBA, these benefits far outweigh the potential difficulties of the implementation of regulatory capital requirements. However, due to the crisis caused by Covid-19, the implementation of the Basel III reforms was postponed by the Basel Committee on Banking Supervision by 1 year, so their entry into force is planned for 1st January 2023 (the transitional provisions are also shifted away one year later, 1 January 2028). The current expected timing of the implementation is shown in Table 1.

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Expected time horizon of application of extraordinary policy and legislative measures

Time horizon	Short term (1-2 years)	Medium term (2-5 years)	Long term (<5 years)
Revised Basel III framework		**Start of phase-in period**	**Fully loaded implementation**
Moratoria on loan repayments	Measure in place	Measure not in place	Measure not in place
Public sector guarantee schemes	Measure in place	Uncertainty	Measure not in place
Release of capital buffers	Measure in place	Uncertainty	Measure not in place
Changes in P2R Composition	Measure in place	Measure in place	Measure in place
Frontloading some of the non-deduction of prudently valued software assets	Measure in place	Measure in place	Measure in place
Frontloading the CRR II SME SF	Measure in place	Measure in place	Measure in place
Extension of transnational arrangements for IFRS 9 provisions (*)	Measure in place	Measure in place	Measure not in place
Frontload of the preferential treatment of loans to pensioners or employees	Measure in place	Measure in place	Measure in place
Preferential treatment to public sector guaranteed loans under the NPL backstop	Measure in place	Measure not in place	Measure not in place
Temporal exclusion of central banks reserves from the LR calculation	Measure in place	Measure not in place	Measure not in place
Delay G-SII buffer for LR	Measure not in place	Measure not in place	Measure not in place

Measure not in place ■ Measure in place ■ Uncertainty ■

(*) The extension of the transitional arrangements for IFRS9 provisions represents a stronger mitigation effect in the short term, as the add-back factors are higher at the beginning of the phase-in period and decrease progressively in the following years.

New EBA report on BASEL III reforms

On 10 December 2020, the EBA published a recent report on the impact of Basel III reforms on the capital position of European banks. The report examines 99 European banks, covering 75% of the total assets of the EU banking system. The report also includes an assessment of the Covid-19 impact (in a qualitative way other than credit risk). **There has been no change in the proposals compared to the 2019 report, the EBA estimates that the positive effects of the reforms remain unchanged, while the capital impact has even moderated.**

The impact assessment of the implementation of Basel III reforms was carried out by the European Banking Authority according to two scenarios. The first scenario (a./ "Basel III") was prepared in accordance with previous EBA recommendations, similar to the 2019 reports. The goal of this scenario was to update the 2019 results. The second scenario (b./ "EU specific") considers the additional features requested by the European Commission: the SME multiplier, the EU CVA (Credit Valuation Adjustment) exceptions, and uses the supervisory option to exclude the bank-specific historical loss component from the calculation of the capital for operational risk. This EU-specific scenario thus differs in some respects from the 2019 EBA proposals. Two additional measures were taken into account in the calculations: the change in the prudential treatment of software assets and the change in Pillar 2 composition rules in the impact assessment.

a./ Basel III scenario

Under Basel III, the implementation of the reforms planned until January 2028 (taking into account Pillar 2 requirements and EU-specific buffers) will increase the Tier 1 (T1) minimum required capital (MRC) amount by 18.5% compared to the 2019 baseline. Bank-specific effects are heterogeneous in the sample, with a median increase of 11.7%, below the weighted average. This is explained by the increase in the capital requirement of large banks. The average total capital ratio of the sampled banks in the sample from 18.2% to 15.3% and result in a shortfall in total capital of EUR 52.2 billion (across 13 out of 99 banks), of which EUR 30.2 billion of common equity Tier 1 (CET1).

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The MRC effect lags behind the 24.1% reported in the December 2019 report. The decrease in the MRC effect is mainly due to the lower CVA effect (2.1% instead of the latest estimate of 4.3%) after the introduction of the new CVA framework in July 2020 and the decrease in the output floor effect (6.7% compared to 9.5%). The lower capital shortfall is due to the improving capital position of banks (remember, the analysis is based on 2019 data) and the lower MRC.

Percentage change in T1 MRC (relative to current T1 MRC) by bank size, Basel III scenario, December 2019 data

Bank size	Δ SA	Δ IRB	Δ CCP	Δ SEC	Δ MKT	Δ OP	Δ CVA	Δ LR	Δ OF	Δ Total
All banks	**2,4**	**2,6**	**0**	**0,4**	**0,8**	**3,8**	**2,1**	**-0,2**	**6,7**	**18,5**
Large	2,3	2,6	0	0,4	8	4	2,1	-0,2	6,9	19
of which GSII	2,2	3,9	0	0,6	0,5	6,3	2,3	0	6,7	22,4
of which OSII	2,6	0,6	0,1	0,3	1,3	2	2,1	-0,1	7,9	16,5
Medium	3,2	0,1	0	-1,1	-0,9	-0,8	0,3	0,2	0,8	1,9
Small	6,9	0	0	0	0	-19,8	0	0	0	-12,9

Sources: EBA 2019-Q4 QIS data and EBA calculations

Notes: Based on a sample of 99 banks: Large (73), of which G-SII (8), of which O-SII (46); Medium (22); Small (4). SA, standardized approach to credit risk; IRB, internal ratings-based approach to credit risk; CCP, central counterparty; SEC, securitization; MKT, market risk; OP, operational risk; CVA, credit valuation adjustment; LR, leverage ratio; OF, output floor. Δ MKT based on "reduced bias estimation". Δ CVA based on July 2020 CVA framework. Δ OF impact is based on the main approach to implement the output floor.

b./ EU specific scenario

For the EU-specific scenario, Basel III reforms could increase Tier 1 MRC values by 13.1% compared to the 2019 baseline. The lower impact compared to the first scenario is due to the additional elements requested by the European Commission and included in the scenario by the EBA, which reduce the MRC impact on the related specific risk types. However, MRC growth is strengthened by the growing impact of the output floor. As a result of the lower MRC effect, the average total capital ratio would decrease from 18.2% to 16.1% and the capital shortfall would be € 33.0 billion, of which EUR 17.4 billion CET1.

As in the previous CfA report, the current impact assessment shows that the output floor and credit and operational risk have the greatest impact. CVA risk contributes less to the overall effect compared to previous calculations, but it is important to note that the calculations have already been made here under the new CVA regulatory framework.

Percentage change in T1 MRC (relative to current T1 MRC) by bank size, EU-specific scenario, December 2019 data

Bank size	Δ SA	Δ IRB	Δ CCP	Δ SEC	Δ MKT	Δ OP	Δ CVA	Δ LR	Δ OF	Δ Total
All banks	**1,7**	**1,3**	**0**	**0,4**	**0,8**	**1,7**	**0,5**	**-0,1**	**6,9**	**13,1**
Large	1,7	1,4	0	0,4	0,8	1,7	0,5	-0,1	7,1	13,4
of which GSII	1,4	3,1	0	0,6	0,5	2,1	0,6	0	7,6	15,9
of which OSII	2	-1,2	0,1	0,3	1,3	1,4	0,4	0,2	7,3	11,6
Medium	2	0,1	0	-1,1	-0,9	0,2	-0,2	0,1	0,8	1
Small	4,9	0	0	0	0	-19,8	0	0	0	-14,9

Sources: EBA 2019-Q4 QIS data and EBA calculations

Notes: Based on a sample of 99 banks: Large (73), of which G-SII (8), of which O-SII (46); Medium (22); Small (4). SA, standardized approach to credit risk; IRB, internal ratings-based approach to credit risk; CCP, central counterparty; SEC, securitization; MKT, market risk; OP, operational risk; CVA, credit valuation adjustment; LR, leverage ratio; OF, output floor. Δ MKT based on "reduced bias estimation". Δ CVA based on July 2020 CVA framework. Δ OF impact is based on the main approach to implement the output floor.

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Diverging Basel III effects by bank size

Basel III reforms have a significantly greater impact on large and systemically important financial institutions than on medium and small banks. For the latter, it can be observed that the application of the standard methodology for credit risk has a significant effect on the growth of the capital requirement, the effect of the output floor is low and the effect of the reforms on operational risk is negative. However, small and medium-sized banks were present in smaller numbers in the sample, so the results for them should be interpreted with caution.

The impact of the reform is heterogeneous across countries and business models. The increase in capital requirements cannot be considered a clear direction: the capital requirements of many banks, especially small and medium-sized banks, may also decrease from the current level due to changes in the standardized approach and the calculation of operational risk. As in the previous report, the capital shortfall comes almost exclusively from large banks, mainly global systemically important institutions (G-SIIs).

MREL impact

The European Banking Authority has updated and published in its report its calculations on the MREL effects of the Basel III reforms, using data from December 2019. The EBA took into account that BRRD2 will be applicable sooner than the revised Basel III rules, so the effects have been assessed separately for the financial institutions that are expected to be covered by the rules (G-SIIs, large banks) and for other financial institutions. In the Basel III scenario, the total MREL deficit due to Basel III ranged from € 7.0 billion to € 8.6 billion. In the EU-specific scenario, the MREL deficit amounted to around € 2 billion.

Update of the European reporting framework

On 22 December, the EBA published the 3.0 update of the European Union banking reporting framework and the Implementing Technical Standards (ITS) for the Pillar 3 disclosures by financial institutions.

The update of the reporting framework was made possible by the European Commission's adoption of the Supervisory Reporting Implementing Act and its annexes, which incorporate the changes provided by CRR2 and the Prudential Backstop Regulation.

The ITS adopted by the European Commission aims to improve the consistency of disclosures by financial institutions in their disclosure obligations. The EBA has updated its review of quantitative data disclosure and supervisory reporting. The purpose is to support the supervisory compliance process, improve consistency, and improve the quality of published data. The EBA has also published a summary guide showing how regularly each type of institution needs to publish each template and data table in order to comply with CRR2.

The EBA has also published the first phase of the technical package for the reporting framework (v3.0). This package sets out the standard specifications for implementing EBA reporting obligations. The package includes validation rules, the Data Point Model (DPM) data dictionary and the new XBRL taxonomy, and the EBA has also updated the DPM query tool. The technical package published by the EBA also includes reporting requirements for FINRP, COREP, equity (including FRTB), liquidity COREP table, encumbered assets, large exposures, leverage ratio and G-SII data.

Contacts:

Ágnes Rakó
Partner
M: +36 70 370 1792
E: agnes.rako@kpmg.hu

Péter Szalai
Director
M: +36 70 370 1739
E: peter.szalai@kpmg.hu

Gergő Wieder
Senior Manager
M: +36 70 333 1471
E: gergo.wieder@kpmg.hu

József Soltész
Manager
M: +36 70 370 1766
E: jozsef.soltesz@kpmg.hu

KPMG.hu

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