

Financial Risk & Regulation

Implementation of the final Basel 3 package continues

Newsletter – September 2020

On 27 March, the Basel Committee on Banking Supervision (BCBS) announced the deferral of the implementation of the final Basel 3 package (also referred to as Basel 4) by one year to 2023 in response to COVID-19. How this affects the remaining Basel reforms? Is a one-year deferral enough and, in the new reality, do they still make sense? In this newsletter we consider the most likely post-COVID scenarios for implementation of the remaining Basel reforms and what these might mean for financial institutions.

Regulatory response to the pandemic

Throughout the pandemic, banks have been called upon consistently to support government and regulatory efforts to keep the economic functioning smoothly and to avoid a more severe depression. They were also encouraged to take full advantage of the flexibility afforded by the regulatory framework.

In immediate response to the COVID-19 crisis, prudential financial regulators took “swift and forceful”¹ action to promote financial stability and enable banks to continue to support lending² to retail and corporate customers.

It can be said both in Hungary and internationally that among a raft of other measures capital buffer requirements were reduced, concessions were granted to operate temporarily below Pillar 2

Guidance (P2G)³, mitigations were made to reduce operational burdens⁴, CRR rebates were introduced or brought forward⁵ and new guidelines were issued on how to use the flexibility of IFRS 9⁶ to recognize increase in credit risk taking the moratorium and the state of emergency into account. Banks were asked to reconsider their 2020 dividend and remuneration plans and, in some jurisdictions, more stringent capital preservation measures were introduced for systemically important banks.

In perhaps the most significant concession for banks, the Basel Committee’s oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), announced deferral of the implementation deadlines for final Basel 3, in order to provide additional operational capacity for banks and supervisors.

¹ Central banks’ response to Covid-19 in advanced economies <https://www.bis.org/publ/bisbull21.pdf>

² https://ec.europa.eu/info/publications/200428-banking-package-communication_en

³ <https://blog.kpmg.hu/2020/03/az-mnb-szamos-intezkedest-tett-kozze-a-bankok-mukodesenek-tamogatasara/>
<https://blog.kpmg.hu/2020/04/az-mnb-fontos-vezetoi-korleveleket-adott-ki-penzintezetek-es-biztositok-szamara/>

⁴ <https://blog.kpmg.hu/2020/04/eba-nyilatkozat-a-covid-19-bankszakmai-hatasainak-felugyeleti-kezeleserol/>

⁵ <https://home.kpmg/hu/hu/home/tanulmanyok/2020/07/frm-2020-07.html>

⁶ <https://home.kpmg/hu/hu/home/tanulmanyok/2020/08/frr-2020-08.html>

Timeline of final Basel 3 implementation

New operational risk standardized approach	Modified credit risk standardized and IRB approach CVA risk	Output floor introduction
Securities financing transactions		New market risk framework (capital requirement, operation, boundary between books)
Reporting and disclosure recommendations		

The road to recovery

Even with concessions such as those made by the Basel Committee, profitability was already a concern for many banks before the COVID-19 – this will now be exacerbated by the prospect of persistently low interest rates, expected increases in non-performing loans, reduction in asset quality, significant deterioration in funding conditions and the need to rebuild depleted capital and liquidity reserves. Initial assessments from the EBA⁷, the BIS⁸ and the ECB⁹ all conclude that the future for banks will be extremely challenging.

Supervisors support a timely implementation of final Basel 3 – “Postponed is not cancelled”

Despite the change in timelines, regulators currently remain committed to implementing the final Basel 3 reforms. However, they acknowledge that there will be challenges.

It is clear that profitability will be a critical factor in rebuilding banks' future capital positions and regaining pre-crisis levels, and EU and UK regulators have made it clear that banks will be given adequate time to replenish their buffers.

The situation in Hungary is similar, according to the current decisions of the MNB:

- the level of capital buffers for systemically important credit institutions is expected to return to pre-COVID in three years from the beginning of 2022,
- the rules of the systemic risk capital buffer are expected to be complied with again from the beginning of 2021,
- in the current crisis, credit institutions may breach the capital buffer limit, which they will have to replenish by the end of the post-crisis transition period (there is no specific date currently).

Based on preliminary assessment¹⁰ of the impact of COVID-19 on the EU banking sector, the EBA concluded that overall the EU banking sector is resilient, though it admitted that there are weaker banks whose capital ratios might not be sufficient to weather the upcoming challenges from the COVID-19 crisis. The crisis will affect asset quality and, therefore, profitability going forward.

Both the ECB and the EBA will decide early in Q4 2020 whether COVID-19 capital and operational relief measures should be prolonged or whether the time is right for a return to normal levels of supervision. The ECB is expected to submit a risk assessment in end of 2020, based on the observations of national competent authorities, which may affect the EU's CRR3/CRD6 proposals.

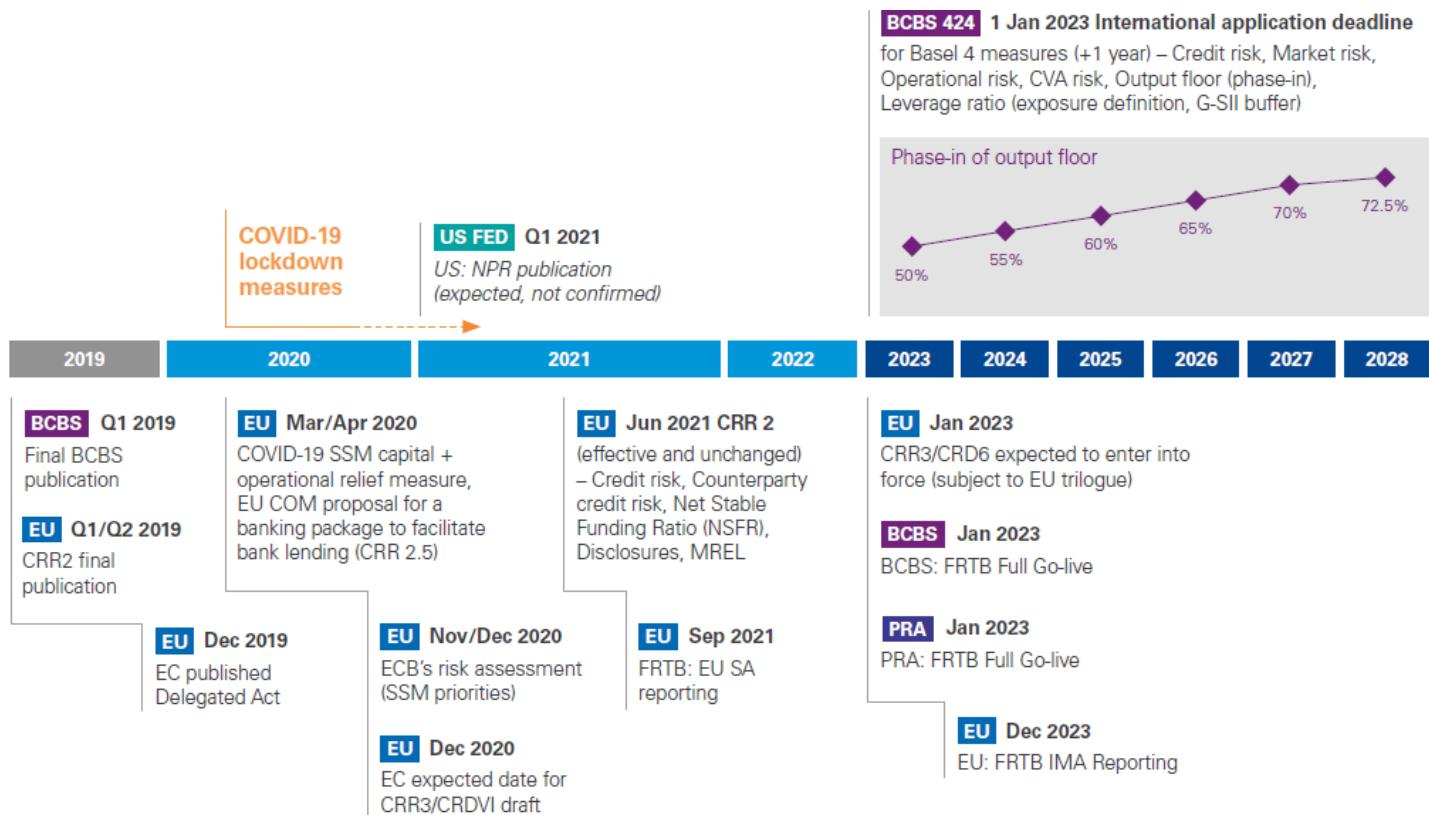
⁷ COVID-19 is placing unprecedented challenges on EU banks: <https://eba.europa.eu/covid-19-placing-unprecedented-challenges-eu-banks>

⁸ Effects of Covid-19 on the banking sector: the market's assessment: <https://www.bis.org/publ/bisbull12.htm>

⁹ The coronavirus crisis and ECB Banking Supervision: taking stock and looking ahead: <https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200728~0bcabfb8bc.en.html>

¹⁰ <https://eba.europa.eu/covid-19-placing-unprecedented-challenges-eu-banks>

Timeline of final Basel 3 implementation



The following scenarios may arise with regard to the timing of the introduction of these Basel reforms:

Scenario 1: Full implementation of BCBS revised timeline

- Full implementation of measures for credit risk, market risk, operational risk, CVA and leverage ratio by 1 January 2023. Output floor phased-in from 1 January 2023 to 1 January 2028.
- Considering that the CRR3/CRD6 bill is expected in Q4 2020 at the earliest, EU implementation is unlikely to happen by January 2023.
- The EU has already delayed implementation of FRTB IMA reporting by six months to September 2021. This could be delayed further.
- US legal process not yet started – legislative proposal publication expected in Q1 2021.

This scenario would be very challenging for banks, many of whom have not yet begun their Basel programmes in earnest, and whose resources may have been diverted onto COVID-related work.

Scenario 2: Partial implementation of BCBS revised timeline

- Implementation by 1 January 2023 of measures for credit risk, market risk, operational risk, CVA and leverage ratio. Further extension of the phase-in for the output floor requirements.
- The bulk of the measures would be implemented in accordance with the Basel Committee's revised timeline, but the specific measures associated with the output floor could be delayed for a further period, giving firms longer to comply in full with the requirements.

This approach would help firms with capital requirements and ratios, but overall implementation effort would still be in the same timescale. The scenario also still relies on legislative proposals being in place by 1 January 2023.

Scenario 3: Further one-year delay of entire Basel package

- A further delay to 1 January 2024, to both the operational and capital dimensions of the final Basel 3 requirements in key jurisdictions.

- Deferral of the original 1 January 2022 timeline has given firms breathing space to address other more pressing issues, but implementation challenges remain, not least the legislative proposals yet to be published.

A more comprehensive delay would benefit firms and offer regulators a much more realistic chance of achieving an implementation that has not been “watered down”.

Looking ahead

Banks should consider the most likely scenarios, but given the current uncertainty, there are other possibilities. Further waves of the virus, whether localized or more widespread, could place additional operational and financial pressures on firms. If the economic recovery does not play out as hoped, causing a prolonged downturn and an extended period of depressed returns for banks, we can envisage a further scenario in which the final Basel reforms are put on hold indefinitely or do not happen at all, if policymakers conclude that the effort involved in implementation outweighs the benefits.

Banks are currently focusing a significant part of their resources on the COVID crisis, but once normalized, preparations for Basel reforms will return to the fore, but it is not yet clear whether the experience of the crisis will be incorporated into regulation now or only at a later stage. This could be an opportune moment for the Basel Committee to take a step back and consider emerging issues, such as climate risk and other elements of ESG (Environmental, Social, Governance), and whether these should or could now be baked into the reforms.

Regardless of the timing of regulatory change, financial institutions will certainly need to strengthen their future ability to raise capital, increase profitability, improve operational flexibility and develop a data management culture.

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

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

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

KPMG.hu



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