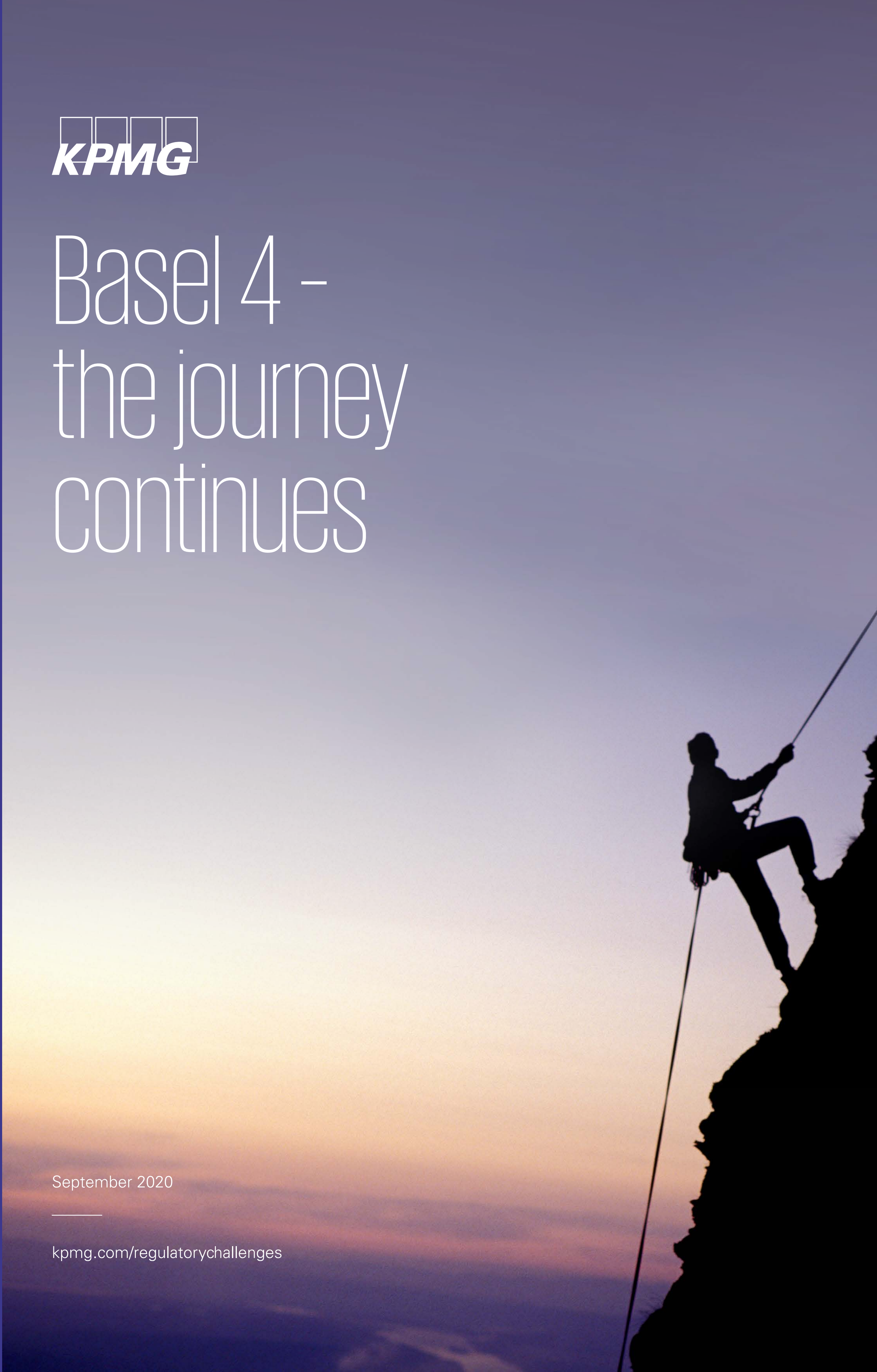

Basel 4 - the journey continues

September 2020

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Basel 4 - the journey continues

On 27 March, the Basel Committee on Banking Supervision (BCBS) announced its deferral of the implementation of the final Basel 3 package (Basel 4) by one year to 2023 in response to COVID-19.

Regulatory response to the pandemic

Throughout the pandemic, banks have been called upon consistently to support government and regulatory efforts to keep the financial system functioning smoothly.

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 lending to retail and corporate customers. Banks were encouraged to take full advantage of the flexibility afforded by the regulatory framework.

Among a raft of other measures, capital buffer requirements were reduced, concessions granted to operate temporarily below Pillar 2 Guidance (P2G) and new guidelines issued on how to use the flexibility of IFRS 9 to recognise increases in credit risk. 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 Basel 4, in order to provide additional operational capacity for banks and supervisors.

The road to recovery

Even with concessions such as those made by the Basel Committee, banks face an uphill struggle to recover from the impacts of the pandemic. Profitability was already a concern for many banks pre-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 EBA,[2] the BIS[3] and the ECB[4] all conclude that the future for banks will be extremely challenging.

So, where does this leave the remaining Basel reforms? Is a one-year deferral enough and, in the new reality, do they still make sense?

In this paper we consider the most likely post-COVID scenarios for implementation of the remaining Basel reforms and what these might mean for firms:

Scenario 1: No change to BCBS revised timeline – full implementation from 1 January 2023

Scenario 2: Partial implementation of BCBS revised timeline – with further extension for output floor

Scenario 3: Further one-year delay of entire Basel 4 package – implementation from 1 January 2024

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

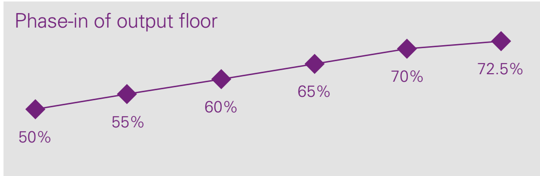
2 COVID-19 is placing unprecedented challenges on EU banks: https://eba.europa.eu/covid-19-placing-unprecedented-challenges-eu-banks

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

4 The coronavirus crisis and ECB Banking Supervision: taking stock and looking ahead: https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200728~0bcbafb8bc.en.html

Basel 4 implementation timeline

BCBS 424 **1 Jan 2023 International application deadline** for Basel 4 measures (+1 year) – Credit risk, Market risk, Operational risk, CVA risk, Output floor (phase-in), Leverage ratio (exposure definition, G-SII buffer)



COVID-19 lockdown measures

US FED **Q1 2021**
US: NPR publication (expected, not confirmed)

2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028

BCBS **Q1 2019**
Final BCBS publication

EU **Q1/Q2 2019**
CRR2 final publication

EU **Dec 2019**
EC published Delegated Act

EU **Mar/Apr 2020**
COVID-19 SSM capital + operational relief measure, EU COM proposal for a banking package to facilitate bank lending (CRR 2.5)

EU **Nov/Dec 2020**
ECB's risk assessment (SSM priorities)

EU **Dec 2020**
EC expected date for CRR3/CRDVI draft

EU **Jun 2021 CRR 2**
(effective and unchanged) – Credit risk, Counterparty credit risk, Net Stable Funding Ratio (NSFR), Disclosures, MREL

EU **Sep 2021**
FRTB: EU SA reporting

EU **Jan 2023**
CRR3/CRD6 expected to enter into force (subject to EU trilogue)

BCBS **Jan 2023**
BCBS: FRTB Full Go-live

PRA **Jan 2023**
PRA: FRTB Full Go-live

EU **Dec 2023**
EU: FRTB IMA Reporting

Supervisors support a timely implementation of Basel 4 – "Postponed is not cancelled"

Despite the change in timelines, regulators currently remain committed to implementing the final Basel 4 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.

In its banking package announcement[5] on 28 April 2020, the European Commission noted that it would use the additional time arising from the implementation delay to inform its forthcoming proposal on Basel 4. The impact of COVID-19 on EU banks' financial situation will be reflected in an impact assessment that will accompany the CRR3/CRD6 legislative proposals expected by the end of 2020.

Based on preliminary assessment[6] 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 oversight. The ECB is expected to submit a risk assessment in November/December 2020, based on the observations of national competent authorities, which may affect the EU's CRR3/CRD6 proposals.

However, these reviews notwithstanding, the prevailing sense from regulators is that the remaining implementation should not be modified further if a meaningful implementation is to be achieved.

5 https://ec.europa.eu/info/publications/200428-banking-package-communication_en
6 https://eba.europa.eu/covid-19-placing-unprecedented-challenges-eu-banks

> "The crisis has proven the value of our reformed regulatory framework. […] The important thing is that we don't compromise on the substance, and that the proposal is not diluted in the face of the corona crisis. A too mild implementation of Basel III[7] in the EU would damage the consensus-based mechanism of internationally harmonised banking regulation – a mechanism that should be of utmost importance for us Europeans defending multilateralism.
>
> Such a lenient implementation would give others a reason to diverge from the mutually agreed framework, too. It would not only jeopardise the international level playing field, it would also weaken the long-term resilience of the financial sector. […]."

Professor Dr. Joachim Wuermeling,
Bundesbank Executive Board Member for supervision

In the UK, the May[8] and August[9] Financial Stability Reports confirmed that the **core banking system has so far been resilient** to COVID-19 market stresses. However, major UK banks are still expected to suffer significant credit losses on UK and overseas loans as a result of the pandemic. HM Treasury and the PRA expressed support for the BCBS decision to defer the Basel timeline, noting that they would "work together towards a UK implementation that is consistent with the one-year delay". They also reiterated their commitment to a full, timely and consistent implementation of the Basel standards.

In the US, regulators have been less proactive on Basel 4 and the legislative proposal to enact the final reforms is yet to be published. This is expected in Q1 2021. It remains to be seen whether that will leave enough time for banks to implement all the necessary measures in line with the Basel Committee's proposed timeline.

7 Referring to Basel III final reforms, i.e. Basel 4

8 https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf

9 https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/august-2020.pdf

Basel 4 implementation – possible scenarios

Scenario 1: Full implementation of BCBS revised timeline

- **Full implementation by 1 January 2023** 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.
- EU implementation is contingent upon CRR3/CRD6 entering into force by 1 January 2023. Given that the legislative proposal is not expected until Q4 2020, this would be an uncharacteristically rapid turnaround.
- The EU has already delayed implementation of FRTB-SA reporting by six months,[10] to September 2021. This could be delayed further.
- US legal process not yet started – NPR publication expected Q1 2021.

! This scenario would be very challenging for banks, many of whom have not yet begun their Basel 4 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 4 package

- **A further delay, to 1 January 2024**, to both the operational and capital dimensions of the Basel 4 requirements is, in our view, the pragmatic position for the regulators to adopt in key jurisdictions and would be a welcome development for banks.
- 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.
- Work for 2020 is largely on hold or has been mothballed completely. **We expect 2021 and 2022 to be years of significant build for firms** as they work to establish or re-group Basel 4 implementation teams and to get to grips with the requirements. We would then expect to see parallel run work taking place in 2023, in preparation for a full implementation as of 1 January 2024.

! 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".

10 https://eba.europa.eu/eba-provides-further-guidance-use-flexibility-relation-covid-19-and-calls-heightened-attention-risks

Looking ahead

Banks should consider the most likely scenarios as set out in the graphic. However, given the current uncertainty, there are other possibilities.

Further waves of the virus, whether localised or more widespread, could place additional operational and financial pressures on firms. Such conditions would not support focused engagement on large-scale implementations such as Basel 4. The Basel Committee and local regulators will need to take a pragmatic view.

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:

— While Basel 4 is part of the programme to make banks more financially resilient than ever, it could be argued that a significant proportion of the work has already been done and that COVID-19 has demonstrated just how far the sector has already come in reducing risk.

— There may be limited appetite to press on with further reforms at a time when the focus is, and should be, on repairing and reversing lockdown damage to the economy, supporting customers through lending, and starting to rebuild reserves.

— Banks have done much to rehabilitate themselves since the 2008 crisis and will not relish the prospect of appearing in any way to compromise the recovery this time around.

— Policymakers may conclude that the effort involved in implementation outweighs the benefits or is simply misplaced effort at this time, when other activity needs to be prioritised.

The Basel Committee has a tricky route to navigate over the coming months. On the one hand, it will be keen to get the job done. But, on the other it must weigh up the risk of appearing to put **rules ahead of recovery**.

We would hope to see a further period of review and reassessment, resulting in a practical decision to defer full implementation by a further year to 1 January 2024. This will require some adjustment from regulators and firms.

Sustainable regulation – lessons from COVID-19

Whether Basel 4 is implemented in January 2023 or with a one-year delay, we are seeing a shift in regulatory priorities, post-pandemic. 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, and whether these should or could now be baked into the reforms.

A pause for thought now might prevent implementation of a set of risk measures which rapidly become out-dated and require further refinement (Basel 5, 6 etc.) in the next few years. **Perhaps this is the moment to focus on sustainable regulation.**

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