Basel III and the conundrum of IRB models

EBI Annual Conference

15 February 2024, Frankfurt

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[1] *As agreed in December 2023*

BASEL III AND THE CONUNDRUM OF IRB MODELS

The IRB journey: development

1 IRB MODELS CONCEIVED IN BASEL II

International Convergence of Capital Measurement and Capital Standards

A Revised Framework

Updated November 2005

…must incorporate all relevant, material and available data, information and methods

2 FOUNDATIONS OF BASEL II (AND III AND IV)

Madrid compromise

- Expected losses to be covered with provisions
- Unexpected losses to be covered with capital

The Second Pillar

Capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes

3 BASEL III GLOBAL PACKAGE AGREED IN 2010

Basel Committee
on Banking Supervision

December 2010

Basel III: A global regulatory framework for more resilient banks and banking systems

4 BASEL III ACCOMPLISHED IN 2016

Basel Committee
on Banking Supervision

Basel III
Monitoring Report

March 2016

All large internationally active banks meet Basel III minimum and CET1 target capital requirements

BASEL III AND THE CONUNDRUM OF IRB MODELS

The IRB journey: adjustment

5 EBA IRB REPAIR PROGRAM 2015-onwards

2015 *Thorough examination of undue risk weights variability and deep changes in bank models*

2020 *Significant **reduction or elimination of variability** that could not be explained by risk profile*

6 ECB TRIM EXERCISE 2016-2021

TARGETED REVIEW OF INTERNAL MODELS

- ✓ *Checked **compliance** with regulation*
- ✓ *Ensured results **reliable** and **comparable***
- ✓ ***Harmonised** supervisory practices*

RESULTS

- *200 on-site model investigations*
- *5,800 findings*
- *RWA increased by 12%*
- *Impact of 71 bps on CET1 ratio*

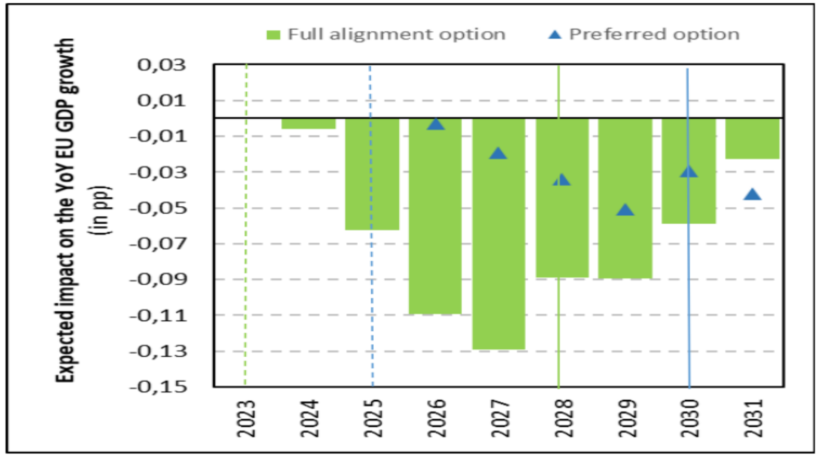
7 "FINALISATION OF BASEL III" December 2017

Reduced scope of IRB models

IRB output floor at 72.5% of SA

Impact of +24% on EU banks' min. CET1 requirement

8 BANKING PACKAGE: STABILITY & GROWTH



Banking Package[1]

- Capital floor objectives
  - ✓ To reduce the excessive variability of banks' capital requirements calculated with internal models
  - ✓ To enhance the confidence in risk-based capital requirements
  - ✓ To make capital requirements more comparable across banks
- Capital floor level
  - ✓ Both at consolidated level and at individual level of subsidiaries
  - ✓ Option for Member States to derogate from the individual level
  - ✓ Commission to prepare a holistic report of reforms in the last 15 years

[1] *As agreed in December 2023*

Transitional arrangements[1]

- Unrated corporates
  - ✓ To avoid disruptive impacts on bank lending to unrated corporates
  - ✓ Risk weight of 65% for unrated corporates with PD < 0.5%
  - ✓ Until end of 2031
  - ✓ Future legislative proposal upon report of the ECAs
  - ✓ Potential extension if substantiated, of up to 4 years
- Derivatives
  - ✓ Alpha factor equal 1 for exposures of interest rate and foreign exchange derivatives
  - ✓ Until end of 2029

[1] *As agreed in December 2023*

Transitional arrangements[1]

- Low-risk residential mortgages
  - ✓ To avoid disruptive impacts on bank lending to low-risk mortgage exposures (below 55% LTV) a risk weight of 10% may be assigned to that part
  - ✓ Member State discretion given disparities of immovable property markets
  - ✓ Only applicable to exposures in that Member State
  - ✓ Subject to strict conditions (8-year track record of minimal losses)
  - ✓ Until 2032 with potential extension if substantiated, of up to 4 years
- High-quality object finance
  - ✓ Reduced risk weight to avoid discontinuation of activities
  - ✓ Terms to be assessed by a report prepared by the EBA

[1] *As agreed in December 2023*

Transitional arrangements[1]

- Securitisation positions
  - ✓ To foster active management of bank portfolios in the context of the CMU
  - ✓ Reduced *p* factor for STS (0.25) and non-STS (0.5) transactions
  - ✓ Until end of 2032
  - ✓ EBA report on a more risk-sensitive treatment of securitisation transactions
- Specialised Lending
  - ✓ Reduced LGD input floor due to different characteristics to corporate lending
  - ✓ Until 2029
  - ✓ EBA report on the appropriate calibration of SL risk parameters
  - ✓ Potential extension if substantiated, of up to 4 years

[1] *As agreed in December 2023*

BASEL III AND THE CONUNDRUM OF IRB MODELS

Transitional arrangements[1]

- Credit conversion factor
  - ✓ To avoid hampering working capital credit to companies
  - ✓ Phase in of the factor from 2029 to 2032
  - ✓ EBA report by 2028 to assess the conditions for potential extension
- Equity exposures
  - ✓ Phase in of new risk weights until 2029
  - ✓ Preservation of current risk weights for strategic investments meeting certain conditions

[1] *As agreed in December 2023*

Transitional arrangements[1]

- Securities Financing Transactions (SFT)
  - ✓ To prevent effects on the liquidity of debt and securities markets, including the sovereign debt markets
  - ✓ EBA to report on the impact and appropriateness for short-term SFTs
- Reversal to standardised approach
  - ✓ To allow institutions to revert to less sophisticated approaches under a simplified procedure (applications during 3 years)
  - ✓ Upon supervisory authorisation to avoid regulatory arbitrage

[1] *As agreed in December 2023*

Final thoughts

- Fixing a problem already solved
- Enhanced complexity (implementation and supervision)
- Business integration – regulatory metrics not for business use
- Balance between Pillar 1 and Pillar 2 after the 2023 turmoil

Whatever the transformation of the current banking system, even if it dissappeared in the future, the value of internal risk models will remain so long as lending and financing continue

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