Helaba

Focus on: Credit
18 June 2024



Dr. Susanne Knips
Senior Credit Analyst
T +49 69/91 32-32 11

Major European banks: Well prepared for Basel IV

With the remaining changes arising from the Basel IV standards having recently been approved by the EU Council, the last phase comprising an EU-wide overhaul of key frameworks for banks has now been concluded. The goal is to make the industry even more resilient to potential economic shocks. While the updated standards do not contain any surprises, the institutions now have greater regulatory clarity. As the changes were announced with plenty of advance notice, banks have had sufficient time to prepare effectively for the upcoming reforms.

Outstanding Basel IV package approved by EU Council

On 30 May 2024, the Council of the European Union adopted final implementation of amendments to the Basel framework for banks, which had been outstanding for many years, and in doing so brought the legislative process for the so-called EU Banking Package to a close at European level (see EU Council press release of 30 May 2024). The amended framework is commonly referred to as "Basel IV" and specifically addresses capital requirements for banks that have been tightened and revised a number of times since the global financial crisis of 2008/2009. Its most recent implementation at European level is reflected in adjustments to the Capital Requirements Regulation (CRR III) and the Capital Requirements Directive (CRD VI). The amended frameworks are expected to be published in the EU's Official Journal in August and will then enter into force 20 days later. The new requirements under the regulation will be generally applicable from 1 January 2025. As is customary for directives, the amendments to CRD must be transposed by member states into national legislation within 18 months.

Main feature of reforms: output floor

The main feature of the outstanding banking package is the introduction of a so-called output floor that applies when using internal models to calculate regulatory capital ratios. It ensures that capital requirements that are determined using banks' own (internal) models cannot be reduced significantly compared to applying standardised models. Accordingly, the risk-weighted assets (RWA) used to calculate the regulatory capital ratios on the basis of internal models must not be at least 72.5 % of the value that would result if the standard approach were applied.

There is a transition period before the output floor is fully implemented, during which the minimum level of RWAs steadily increases compared to the standard approach when internal models are used. The minimum ratio of 72.5 % will not apply until the end of 2032.

The new rules also introduce amendments to enhance banks' management of ESG (environmental, social and governance) risks. However, there are no provisions for the inclusion of ESG aspects in capital requirements, the so-called Green Supporting Factor within Pillar 1 requirements[1]. Furthermore, the new rules harmonise minimum requirements applicable to the authorisation of branches of third-country banks and the supervision of their activities in the EU.

[1] Pursuant to Article 501c CRR III, EBA will initially conduct a further assessment on the prudential treatment of ESG risks in Pillar 1.

Reforms meet expectations

The adoption of the final regulation by the EU Council does not come as a surprise, as the European Commission had presented an initial legislative proposal for the implementation of the final Basel reforms as far back as October 2021 (see our publication "**EU Banking Package 2021 Implementation of Basel III imposes uneven burden on banks**" of 5 November 2021). The Council and the European Parliament reached a tentative political agreement on the proposal on 27 June 2023.

Package takes features specific to EU into account

It is vital for European banks that the EU banking package recognises the specific features of the local banking industry. In some points, the EU Commission's legislative proposal of October 2021 already diverged from rules originally proposed by the Basel Committee on Banking Supervision (BCBS) or took advantage of optional provisions within the framework. The EU Council of Ministers endorsed these proposals in a joint position in November 2022 (see our publications "**EU Council agrees its position on Basel III banking package**" of 9 November 2022).

Among other things, these relate to less stringent requirements when calculating the output floor in the case of exposures to non-rated companies (generally SMEs) and mortgage loans (For more information on features specific to the EU see our publication "**EU Banking Package 2021 Implementation of Basel III imposes uneven burden on banks**" of 5 November 2021).

Conclusion of several years of regulatory reform following global financial crisis

The final implementation of the EU regulations was preceded by many years of regulatory reforms. In the BCBS, prudential regulatory authorities from 28 countries worldwide agreed on a new global standard known as Basel III that was designed to strengthen the banking sector. At the end of 2017, the Basel Committee presented a range of amendments to the Basel III framework (Basel IV[2]).

The European Parliament passed a preliminary banking package with amendments to the frameworks for bank recovery and resolution (BRRD II/SRMR II) as well as minimum capital requirements (CRR II/CRD V) as early as 2019 to implement the changes in Europe. CRR II has been directly applicable since the middle of 2019[3], making requirements such as the net stable funding ratio (NSFR) mandatory since the end of June 2021.

Member states were required to transpose the directives amended at the time, CRD V and BRRD II (Bank Recovery and Resolution Directive), within 18 months, i.e. by the end of 2020 at the latest. These made statutory minimum MREL ratios applicable to top-tier banks in Europe with total assets of EUR 100 billion or more[4] from 1 January 2022.

However, final implementation of other aspects of the Basel III amendments, particularly changes to credit risk regulations, was still pending. At its ultimate level of 72.5 %, the output floor was originally due to be phased in between 2022 and 2027, but COVID-19 led to an extended delay: In order to reduce the burden on the banking industry, implementation in Europe of the final Basel III package in March 2020 was initially deferred (see our publication "**Europäische Banken: EZB mit Maßnahmen gegen Corona-Schock**" of 13 March 2020).

[2] In contrast to Basel II, which was primarily aimed at strengthening regulatory capital ratios, Basel IV focuses on the denominator of the capital ratio - the measurement of banks' risk positions, i.e. credit, market, counterparty and operational risks.
[3] With transition periods for certain measures of 2 years, i.e. since 28 June 2021.
[4] In addition, the resolution authority may classify a bank as top tier, even with total assets of less than EUR 100 billion, if it deems a failure of such bank as sufficiently likely to constitute a systemic risk (fishing option).

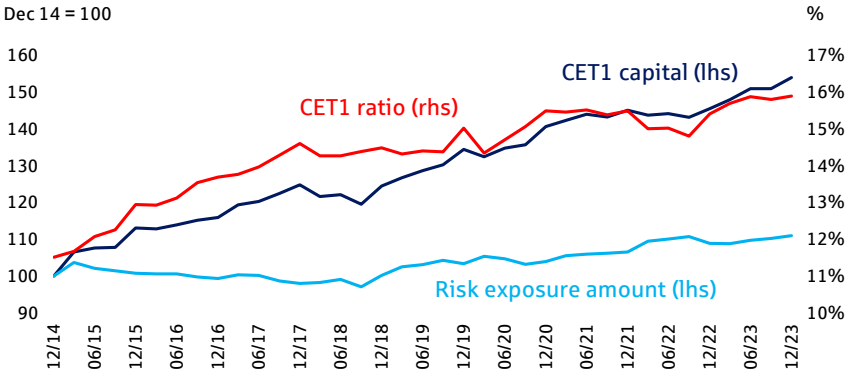
Only limited additional measures necessary for institutions

Many years of discussions, which in some cases led to even more stringent demands, preceded the Basel IV compromise in December 2017. That is why European banks have had a long time to prepare for the tighter requirements now being introduced. The impact of the output floor on Dutch banks, for example, was particularly severe due to their significant exposure to residential mortgage lending that had previously benefited from relatively generous capital requirements. Institutions such as ABN AMRO and Rabobank originally estimated the resulting increase in their regulatory risk-weighted assets at up to 35 % each. In response, both banks took extensive action to mitigate the additional capital charges, chiefly by offloading assets.

In 2021, the EU Commission estimated that the average rise in European banks' capital requirements would be less than 9 % at the end of the transition period if its preferred proposals were implemented (taking EU-specific features into account). Since that time, the institutions have pressed ahead with mitigating action. The Bundesbank recently calculated that minimum capital requirements for German banks would increase by an average of only 3.1 % by the end of the transition period. It is important to note in this regard, though, that there are considerable differences between each individual bank, and that the requirements will rise to a varying degree based on specific business activities and regions.

Moreover, European banks boast strong capital ratios. One reason for this is that capital requirements have been steadily rising since the global financial crisis; another is that restrictions on dividend payouts during COVID-19 resulted in the accumulation of excess capital. In addition, banks once again generated substantial profits thanks to the changed interest rate environment and were therefore able to replenish their capital buffers. This is reflected in high dividend payouts and share buyback programmes (see our publication "**Major European Banks - Heading into 2024 with strong credit risk buffers**" of 16 January 2024).

European banks recently boast high capital ratios



Sources: EBA, Helaba Research & Advisory

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Editor:
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Publisher:
Dr. Gertrud R. Traud
Chief Economist/
Head of Research & Advisory

Neue Mainzer Str. 52-58
60311 Frankfurt am Main
Germany
T +49 69 / 91 32 – 20 24

Internet: www.helaba.com

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