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Basel IV and the Future

Changes, Adaptations, and Unaddressed Challenges

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The Implications of Basel IV: Changes, Adaptations, and Unaddressed Challenges

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Introduction

In December 2017 the Basel Committee finalised and released the 4th iteration of reforms on Banking Supervision. This new set or reforms takes the official name of "Basel III: Finalizing post-crisis reforms", but in the financial industry is also known as "Basel IV".

The Basel IV framework, an extension of the Basel III regulatory framework, aims to enhance the stability and resilience of the global banking system by further strengthening capital adequacy requirements and risk management practices. This article will delve into the key points and differences between Basel III and Basel IV, discuss how banks are adapting to the latest standards, and identify gaps that may need to be addressed by future regulatory reforms.

Basel III: The Foundation

Basel III was introduced in response to the 2007-2009 global financial crisis, focusing on three main areas: capital adequacy, liquidity risk management, and macro-prudential regulations. Key features of Basel III include higher minimum capital requirements, the introduction of the leverage ratio, the liquidity coverage ratio (LCR), and the net stable funding ratio (NSFR). These reforms aimed to ensure banks maintain sufficient capital buffers and liquidity to withstand economic shocks and reduce the risk of systemic failure.

Basel IV: Enhancements and Differences

Basel IV builds on the foundation set by Basel III, introducing refinements to enhance risk sensitivity, reduce model variability, and improve transparency in the regulatory framework. Basel IV includes new standards for credit risk and operational risk and a credit valuation adjustment. It also introduces an output floor, revisions to the definition of the leverage ratio and the application of the leverage ratio to global systemically important banks.

Some of the most notable changes include:

- Output Floor: A minimum output floor is set at 72.5% of the risk-weighted assets (RWAs) calculated using the standardised approach, ensuring a consistent level of capital across banks and mitigating excessive variability in RWAs calculations.

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- Operational Risk: Basel IV replaces the existing approaches for calculating operational risk with a new standardised measurement approach (SMA), simplifying the calculation and promoting consistency across banks.
- Enhanced Disclosure Requirements: Basel IV requires banks to provide more granular and standardised disclosures, improving transparency and comparability.

The new Basel standards are going through a fragmented implementation process region by region. These will likely combine with the inherent differences in capital requirements to create significant inconsistencies in the ways that risks are treated between jurisdictions, resulting in globally different capital requirements and skewed incentives.

In October 2021, the European Commission (EC) published its proposed implementation of the Basel IV standard, with a go-live date of 1 January 2025. The Capital Requirements Regulation (CRR) III and the Capital Requirements Directive (CRD) VI seek to balance two objectives: implementing the proposals of the BCBS to enhance financial stability and supporting EU institutions' ability to continue financing the economy.

In the United Kingdom, the Bank of England has announced that Basel IV will go live on 1 January 2025, a date that aligns with the EU. Many market participants expect the UK to stick broadly to the BCBS standard, but also to follow some EU divergencies and potentially introduce UK-specific ones.

Adapting to Basel IV

The new regulatory requirements provide an opportunity for banks to rethink their portfolio of businesses, as well as individual business models. Few banks have begun to review business activities to spot areas that, even after mitigation efforts, will be capital drags in a Basel IV environment. Banks are proactively adapting to the new regulatory landscape by:

- Adjusting their balance sheets to optimise capital allocation and reduce the impact of increased risk-weighted assets.
- Enhancing risk management practices and internal controls to comply with the new risk-weighting methodologies and disclosure requirements.
- Exploring new business models and revenue streams to mitigate the potential impact of higher capital requirements on profitability.
- Investing in technology and automation to streamline processes, improve risk measurement, and reduce operational costs.

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Credit risk

Key elements of new standards:

- Standardised approach more granular and risk sensitive
- Removing the option to use advanced IRB for institutions and large corporates, and any IRB approach for equity
- Restrictions on model parameters (input floors)

Implementation date[1]: 1/1/2023

Impact on capital requirements:

Higher capital requirements - in particular on higher risk exposures, income producing real estate, and where IRB no longer available

CET1 capital ratio impact[2]:

4.5% reduction (4.7% for EU G-SIBs)

Other impacts:

- Pricing of long term credit exposures
- Systems and data
- Read-across to counterparty credit risk

Potential mitigating actions:

- Asset allocation
- Use of remaining modelling opportunities

More to come?

- CRR3
- Use of national discretions
- Impact of TRIM
- Sovereign exposures

Market risk

Key elements of new standards:

- Stricter border between Trading and Banking books
- More risk-sensitive Standardised Approach (SA)
- Revised Internal/Advanced Model Approach (IMA)
- Replacement in IMA of VaR measure by the expected shortfall measure

Implementation date[1]: 1/1/2023

Impact on capital requirements:

Higher capital requirements, most pronounced under the revised standardised approach

CET1 capital ratio impact[2]:

2.3% reduction (3.4% for EU G-SIBs)

Other impacts:

Systems and data

Potential mitigating actions:

- Data cleansing and alignment
- Enhance model governance and understand modelling differences
- Assess regulatory and other programme overlaps for efficiencies
- Develop roadmaps for implementation and operating model
- Standardise modelling capabilities
- Build out secondary considerations and effects, such as capital allocation

More to come?

- Finalisation of BCBS market risk standards
- Finalisation of CRR2
- Impact of TRIM

Credit valuation adjustment

Key elements of new standards:

- New basic approach (BA-CVA) and new standardised approach (SA-CVA) for CVA risks in derivatives and securities financing transactions
- Enhance risk sensitivity, improve robustness and greater consistency with market risk framework

Implementation date[1]: 1/1/2023

Impact on capital requirements:

Higher capital requirements, mostly from removal of more advanced modelling approaches

CET1 capital ratio impact[2]:

3.8% reduction (5.4% for EU G-SIBs)

Other impacts:

Systems and data

Potential mitigating actions:

- Choice of counterparty
- Business model and product mix
- Meet requirements to use the SA-CVA approach

More to come?

CRR3

Operational risk

Key elements of new standards:

- Withdrawing the use of internal model-based approaches
- Single Standardised Measurement Approach (SMA)
- Business indicators, increasing marginal coefficients, internal loss multiplier

Implementation date: 1/1/2023

Impact on capital requirements:

Higher capital requirements – in particular for larger banks, banks with high historic operating losses, and banks moving from the AMA

CET1 capital ratio impact:

6.4% reduction (7.5% for EU G-SIBs)

Other impacts:

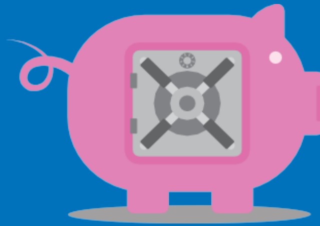
- Systems and data – in particular to meet the ten year loss data capture requirement.
- Reduced risk sensitivity and quality of risk management, compared with current more advanced approaches

Potential mitigating actions:

- Greater focus on reducing operational losses
- Change balance across business lines
- Reduce overall size of bank

More to come?

- CRR3
- Use of national discretions



Output floor

Key elements of new standards:

- Floor to constrain the extent to which banks can use internal models to drive down their capital requirements for credit and market risk
- Calibrated to 72.5% of RWAs under Standardised approaches

Implementation date:

Phased in from 1/1/2023

Impact on capital requirements:

Higher capital requirements, with most pronounced impact from 2025 onwards

CET1 capital ratio impact[2]:

6.5% reduction (5.4% for EU G-SIBs)

Other impacts:

Systems and data - ability to calculate floor using Standardised approaches

More to come?

- CRR3

Leverage ratio

Key elements of new standards:

- Revised exposure definition (derivatives, some off-balance sheet items and holdings of reserves at central banks)
- G-SIB leverage ratio buffer (set at half of a G-SIB's capital ratio buffer)

Implementation date[1]:

- Current definition from 1/1/18
- Revised definition and G-SIB buffer 1/1/2023

Impact on capital requirements:

Lower capital requirements – definition changes generally increase measured leverage ratios, and more than offset the impact of the G-SIB buffer

Leverage ratio impact:

1.0% increase (4.3% for EU G-SIBs)

Other impacts:

Leverage ratio becomes binding constraint for fewer banks

Potential mitigating actions:

Reduce balance sheet size

Gaps and Shortcomings

While Basel IV addresses several issues, there remain areas that may require further attention in future regulatory reforms. A major concern is the presence of ‘financial doping’ by poorly managed banks in the form of additional capital tier debt. Since the Basel III framework was introduced, a number of countries passed laws requiring large banks to maintain a financial cushion for protection during a downturn. In order to obtain this cushion, additional tier 1 and tier 2 bonds were a prime source of raising funds.

AT1s have triggers that allow the issuing bank to convert, reduce or completely erase the bond’s principal value in order to preserve its Tier 1 capital. BIS explicitly comments on Additional Tier 1 Capital in the latest Basel regulations as “neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors”. For investors who like their downside covered with a margin of safety, these bonds are disasters waiting to occur; as a number of AT1 bondholders found out on March 19th 2023 when Swiss regulators wiped out $17B of Credit Suisse’s additional tier 1 bonds.

There are a number of other observable gaps in the latest Basel papers, such as:

- Cybersecurity and operational resilience: The increasing digitalisation of financial services has heightened the importance of cybersecurity and operational resilience. Basel V may need to address these risks more comprehensively, incorporating cybersecurity risk assessments and capital requirements for banks.
- Interconnectedness and spillover effects: Basel IV does not explicitly address the interconnectedness of financial institutions and potential spillover effects from non-bank financial intermediaries, which may warrant additional macro-prudential measures.
- Climate-related risks: Although the Basel Committee has started to consider climate-related financial risks, Basel IV does not specifically integrate these risks into the capital adequacy framework. Future regulatory reforms, such as Basel V, may need to address the impact of climate change on banks' risk profiles, including the development of standardised methodologies for assessing and quantifying climate risks.
- Interconnectedness of the financial system: Basel IV has made strides in reducing the risk of individual bank failures, but it does not fully address the systemic risks posed by the interconnectedness of the global financial system. Future regulatory reforms

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should consider the implications of cross-border banking and the risks associated with global banks operating in multiple jurisdictions.

- Shadow banking and non-bank financial institutions: While the Basel framework primarily focuses on banks, there is growing recognition that non-bank financial institutions (NBFIs) and shadow banking activities can also pose systemic risks. Basel V may need to address the regulatory gaps related to NBFIs and shadow banking, harmonising standards across the financial sector to reduce the potential for regulatory arbitrage and contagion risks.
- Financial inclusion and access to credit: Stricter capital requirements under Basel IV may inadvertently lead to reduced credit availability for small and medium-sized enterprises (SMEs) and other underserved segments of the population. Basel V should consider balancing the need for financial stability with the promotion of financial inclusion, ensuring that capital adequacy requirements do not disproportionately impact access to credit for SMEs and economically disadvantaged groups.

Conclusion

Basel IV marks a significant step forward in strengthening the global banking system and promoting financial stability. Banks are adapting to the new requirements, which should improve the overall resilience of the financial sector. However, as the financial landscape continues to evolve, regulators will need to remain vigilant and consider addressing emerging risks and challenges in future regulatory frameworks.

In conclusion, while Basel IV has made significant progress in enhancing the resilience of the global banking system, there are still deeply unaddressed challenges and emerging risks that may need to be tackled in future regulatory reforms such as Basel V. By learning from the experiences of Basel III and IV, regulators can continue to refine and adapt the global regulatory framework to address the evolving risks and complexities of the financial system, fostering a more stable and well-capitalised banking environment.

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