BASEL III REFOMS: EU BANKS NEED CLARITY... NOT CHARITY!

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Axis Alternatives attended the large public conference held by the European Commission (November 12 th, Brussels) to review the finalization on **Basel III reforms** and discuss its future impact on the European banking system.

The conference took place few weeks after the EBA has released its capital impact assessment **- disclosing a sharp 25% increase in pillar 1 requirements for EU large banks** (whereas the impact is nearly flat for US peers according to BCBS analysis) - and while the commission is consulting on the CRR3 legislative proposal. In this context, the panelists from each camp stood firm on their positions and offered a quite predictable but passionate debate, **regulators pleading for a timely and faithful implementation of agreed international standards while Industry representatives advocated for European exceptions and expressed strong worries for EU banks profitability and impact on the real economy.**

Explanations for such an unbalanced impact between EU banks and US peers need further analysis. One of the main drivers is **the introduction of a 72.5% global output floor** - aiming at limiting the potential capital benefit arising from the use of internal model approaches compared to regulator-set standardized approaches - and the pre-existence of some sort of similar floor on US side. To smoothen the transition, **European legislators are considering a phase-in period for the floor until 2027** and, since the floor is meant to mitigate model risks, potential reductions in pillar 2 charges to offset the capital increase.

Nevertheless, pillar 2 charges are by essence discretionary, subject to the appreciation of national supervisory authorities. Should the EBA amend its SREP guidelines, it would still be difficult for banks senior management to predict what would be the effective capital offset. Anyhow, **according to EBA's assessment, the floor alone accounts for nearly 10% out of the 25% increase for EU large banks.** Knowing pillar 2 charges weigh approximately 2% of total RWAs, the offset, if any, would likely end up very modest consolation prize for the most impacted banks. Complaining about the lack of RWA predictability, Nordea's former CEO said during the conference that EU banks *"need clarity"*, *"not discretionary charity"* one could add.

Another consequence of the global output floor is **the banks reluctance to develop or maintain the most advanced measurement framework for market or counterparty risks** if IRB credit models on their own use up the full possible capital relief, or the temptation to deprioritize credit models not having a sufficient share on total RWAs. Unfortunately, neither the phase-in period nor the reduced pillar 2 charges will restore the sound incentive for banks to accurately measure and manage their risks, regardless of the size of the exposure.

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