BASEL III
TO BASEL IV
What impact on banking business models?

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Financial institutions must reinvent themselves to tackle their future challenges.

Despite calmer financial markets and a less prevalent banking crisis, we have seen regulatory requirements tighten from 2016 to 2019. From Basel II to Basel III to Basel IV (term not recognised by regulators yet), these enhancements to regulatory requirements force banks to review their business models, which will impact the profitability of the sector.

‘Regulatory constraints must be transformed into competitive advantage.’

While banks are just finalising their Basel III reform on solvency and liquidity, they are now faced with new regulatory standards which complement the initial requirements, and aim to mitigate any future crisis by enhancing the profitability and soundness of the banking sector.

The primary impact of these changes is on the denominator of the solvency ratio, and therefore more specifically credit risk, market risk and operational risk, with the objective of at last being able to compare the risk-weighted assets of different banks.

The changes relating to credit risk focus on an overhaul of the standardised method, which may include the application of external ratings, for jurisdictions that authorise it, setting up ‘floors’ to constrain the existing internal models and another review of the treatment of securitisations.

The changes relating to market risk are driven by the Fundamental Review of the Trading Book (FRTB) which aims to reduce the regulatory arbitrage opportunities between the trading book and the banking book. The FRTB introduces the concept of Expected Shortfall, which is less exposed to economic cycles than the more controversial Value at Risk method. Validation will be done desk by desk, including reinforced back-testing and profit and loss allocation.

The changes relating to operational risk focus on the implementation of the new Standardised Measurement Approach, which disregards the internal model methods, notably the Advanced Measurement Approaches and introduces a variable that is not just about Net Banking Income, but also a parameter that better reflects the bank’s business and operational loss history.
With respect to the standardised approach, and specifically the ongoing deployment of IFRS 9 for 1st of January 2018 (Phase 1 - Mapping of financial instruments and Management intentions and Phase 2 - Impairment - Treatment of provisions), expected loss provisions need to be applied at the time of underwriting. In the case of IRBA’s advanced risk measurement method, each bank will have to review their provisioning calculation engine and adapt the Basel parameters to meet IFRS 9 standards.

Finally, the next resolution measures introduce the MREL (Minimum own funds and Eligible Liabilities) and TLAC (Total Loss-Absorbing Capacity) which are broader than «bail-in», by including more eligible, mobilised financial instruments in the numerator of the «capital / weighted assets» ratio. The Single Resolution Fund will also be implemented, generating participation cost.

So much for the regulations – what do banks need to do? There are three main components that need to be addressed: Information systems, Business processes, Organisational structure.

Too often there can be a focus on just one of these. This limits the wider contextual understanding that brings the necessary perspective to measure tangible impact on business models, which is the necessary starting point to create the «bank of tomorrow».

30 years of prudential upheaval with the transition from Basel I to Basel IV has impacted bank business models and profitability.

Financial institutions must reinvent themselves to tackle their future challenges. Financial institutions, which still have many assets (recurring credit demands, large clientele, historical knowledge, risk management, privileged relationships with regulators …) must reinvent themselves to tackle their future challenges, particularly technological challenges (Digital Transformation) and competitor challenges (non-bank competitors are increasingly present).

A strong strategy combined with innovative action is required to succeed (bringing together key players in the sector, external growth, investment and technological disruption, continuous improvement in operational efficiency, retention of internal resources and talents). Simple, pragmatic management of existing resources is not enough.
PRESS CONTACT

Delphine MISSUD
Marketing & communication manager
+33(0)1 53 64 57 67
Delphine.missud@Harwell-management.com

© Harwell Management
www.Harwell-management.com
@Harwell_Mngt

63, Saint Mary Axe, London
40, rue la Pérouse 75016 Paris
367, avenue Louise 1050 Bruxelles
14, rue du Rhône 1204 Genève

CONTACT OUR EXPERTS

RICHARD ELAND
Partner
+44 (0)7500 308 277
Richard.eland@harwell-management.com

PASCAL DE LIMA
Chief Economist
+33(0)6 84 04 12 57
Pascal.delima@Harwell-management.com