

Preparing for Basel IV

Launch of MLAdvisory Basel IV series

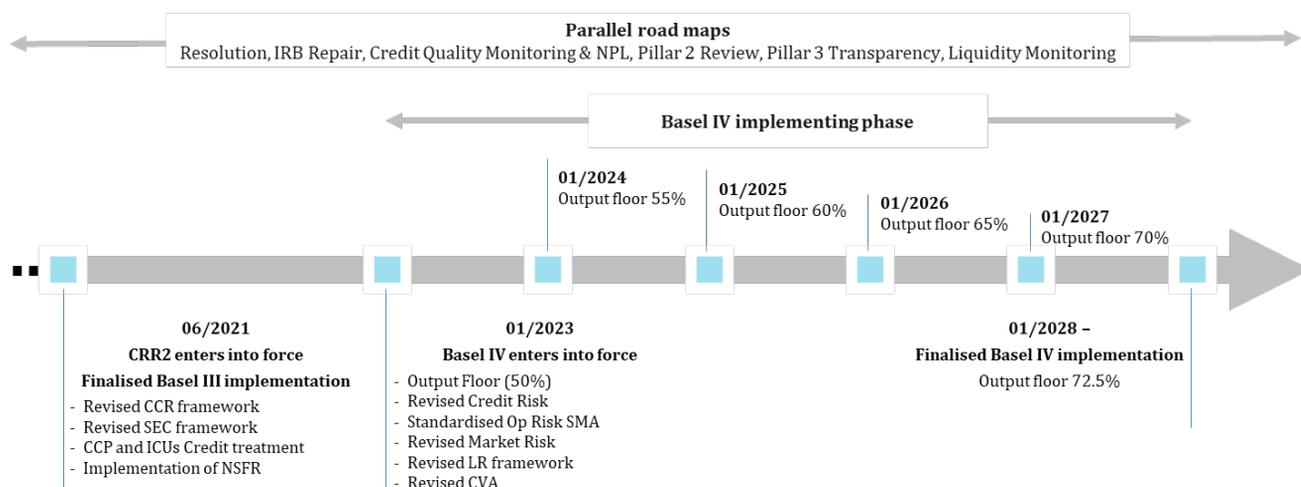
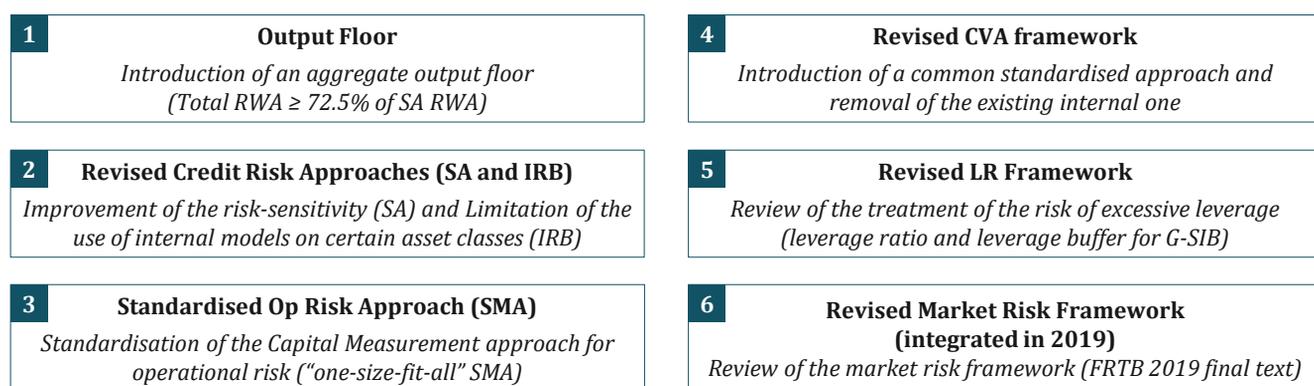
Background

The latest amendments to CRR2 put a final stone to Basel III standards (2010), applicable as of June 2021. **Basel IV¹** was lastly changed in 2020, which resulted in the second postponement² of the implementation period, as a **supervisory decisions to the COVID pandemic**

As a reminder, Basel IV was designed as complementary to Basel III in order to provide **harmonization and standardisation** of the capital measurement, to limit the use of **internal models**, and to define a common level-playing field to foster **comparability** among peers.

In this context, MLAdvisory is launching several series, which will be communicated between April and June 2021 in order to progressively prepare for the main Basel IV changes.

Basel IV Building Blocks & Timeline (as of April 2021)



Key European Stakes



At bank level, what are the **nature** (capital, organisation, business model) and **magnitude of impacts**?

Basel IV initially aimed at reviewing **Pillar 1** capital measurements. Yet, in Europe, **wider impacts** are anticipated on **business models & profitability³** and on **risk & capital management⁴** (Stress-testing, ICAAP).



How will banks **prioritize, allocate and manage** their **implementation resources** in an already **"saturated" regulatory context**?

The COVID pandemic brought **new priorities to the forefront** (business continuity & digitalisation) and **challenged existing challenges** (profitability & Credit Quality monitoring).

¹ Basel III (d424, 2017) as defined by the supervisor, Basel IV for the industry

² In 2019, with the integration of FRTB 2019. In 2020, following the COVID pandemic

³ Basel III Monitoring Exercises (2020): Basel III Reforms: Updated Impact Study (December 2020), European Scenarios vs. Basel IV initial scenario

⁴ EBA Public Hearing (July 2019), Presentation of impacts, "Scrutiny on the output floor interaction with Pillar 2 and macroprudential tools"

Basel IV and Risk Management MLAdvisory series

We have identified the following key challenges to implement Basel IV in light of COVID: European scenario

Aggregate Output Floor

The aggregate **Output Floor** limits the **use of internal models** in the calculation of minimum capital requirements, and serves as a **base for the calculation of capital buffers in Europe**.

These impacts have been reassessed in light of COVID and of a **dedicated European scenario**⁵.

Serie 1: What will be the impacts on banks' internal models organisation? business models? profitability?

Regulatory Program Management

The enforcement of Basel IV will require the capacity to allocate resources and prioritize implementation in line with parallel on-going requirements.

Serie 2: What are the lessons learnt from the past and how to structure a regulatory program management?

Revised Credit Risk Framework

The revised **IRB credit risk framework** aims at **limiting the variability in RW** for a given asset class. This will lead to portfolio migration, added floors on credit parameters and RW increase.

The revised **SA Credit Risk** aims at **improving risk sensitivity and granularity** of asset classes. This will lead to more granular asset classes and larger data volumes.

Serie 3: How will banks cope with these changes in parallel of existing Credit road maps (IRB Repair) ?

Standardisation of Op Risk Capital Measure

Op Risk Standardized Measurement Approach is based on a revenue (BIC) and a loss component (ILM). In Europe, implementation of the **national discretion (ILM=1)** is strongly considered: it would provide for a **pure revenue-based measure** of Op Risk Capital.

Serie 4: What are the implications for op risk management & monitoring in the aftermath of COVID-19 (lower revenues, new COVID-related losses)?

Beyond Basel IV implementation: Pillar 2 perspectives, complementary series

Capital Management: Pillar 2 and ICAAP

In 2020, the EBA published the updated ICAAP guidelines and provided some guidance on the expectations and key areas of improvement identified at European banking level.

Serie 5: Among the key improvement to be addressed: (i) Data quality and representativity; (ii) Adequation between internal measures and macro-economical context; (iii) Use of stress-testing as a continuous improvement monitoring tool.

Stress Tests

The EBA proposal to **review the stress testing framework** (bank leg / supervisory leg) seems to be on hold, although banks need to **strengthen risks coverage for Pillar 2 & ICAAP purposes**.

Serie 6: Among the current challenges on stress testing, we chose the following topics for discussion: (i) Inclusion of climate stressed indicators and scenarios; (ii) Severity and plausibility criteria of EBA driven scenarios; (iii) Operational insertion of stress testing (Risk & Finance articulation)

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⁵ Basel III Reforms: Updated Impact Study (December 2020), European Scenarios vs. Basel IV initial scenario