The Basel 3.1 impact on strategy and operations in the Nordics

The impact of the new Basel 3.1. reform on Nordic banks, in terms of strategy and operations, is likely to be significant. The capital requirements are expected to increase significantly for Nordics banks using IRB models relative to banks using the Standardised Approach (SA). Banks should therefore seek to eliminate any adverse ROE impacts, by adapting their business model and processes, including optimising the composition of their portfolios. In addition, considerable impacts are expected to the data, systems, and reporting where also banks' capital management and ICAAP approaches must adapt to the new rules.

This is the fourth publication in the 2023 "Basel 3.1 – Nordics ready!" blog series. The series covers various aspects of Basel 3.1 with a focus on considerations for Nordic banks, including minimum capital requirements, the regulatory landscape, the strategic and operational considerations, and how to implement Basel 3.1.

Key takeaways

- Basel 3.1. is likely introduce a shock to the competitive landscape in Nordic banking, due to changes in relative capital efficiency 1) between IRB and SA banks and 2) across customer segments
- Banks are expected to adapt their business strategies to the new regulatory realities, which will be reflected in revised risk appetite and derived lending practices. Many banks will review their IRB strategies as well.
- Pricing will be a key lever in execution of the updated business strategy across customer segments and products, however ensuring the new risk weight dynamics are accurately reflected in pricing tools will be non-trivial for IRB banks
- Changes to RWA calculation introduced by Basel 3.1. and the output floor requirements will impact Nordics banks calculation engines (Advanced and Standardised), external reporting and market disclosures (e.g., Pillar 3), as new data inputs are required
- Data quality requirements increase for Nordics bank using IRB approaches, as two sets of RWA numbers will be calculated, reconciled, and reviewed for each trade/exposure, where typically only one is calculated now
- Capital forecasting and management, stress testing and ICAAP approaches, and processes will have to be adapted to the new rules.

This blog zooms in on some of the key implications at both strategic and operational level in the Nordics following Basel 3.1 reforms and outlines the most important elements for banks to consider in the preparation of the implementation of the new rules in the beginning of 2025.

Strategic impacts of Basel 3.1. at Nordic banks

We have previously highlighted the major changes in the capital requirements following Basel 3.1 with the output floor being the main driver of the impact in the Nordics due to a higher concentration of low-risk mortgage portfolios and active use of internal models. In addition, the standardised approach to credit risk itself will increase in granularity and risk differentiation while application IRB approach is reduced including a recalibration of some parameters and introduction of input floors.

In general, the output floor will impact banks with high portfolio concentrations in segments with significant IRB benefits but understanding and managing the regulatory LTV metric over time will be key for the Nordic banks. In situations where the output floor is binding, banks may be incentivised to chase higher returns by taking more risk (all else equal).

The convergence of capital requirements between Standardised and IRB approaches may have competitive implications, by levelling the playing field between IRB and ST banks. As the IRB advantage is reduced in certain segments, competitive pressure may increase as smaller banks, traditionally on standardised approach, selectively challenge the larger players that have previously enjoyed a capital benefit from internal models. Banks should also revisit their current IRB or ST approach to identify the portfolios for which it would make sense to transition between the modelling approaches given the new cost-benefit mechanics involved as discussed in the white paper "To be or not to be IRB".

All these changes in capital consumption across customer segments imply adjustments to the ROE equation and create opportunities for RWA optimisation across banks' portfolios. This can translate into new customer segment priorities for banks, as business strategies are revised to reach financial targets under the new Basel regime. Factors such as availability and eligibility of collateral, and external ratings can redefine the absolute and comparative capital intensity of credit activities across segments in many business models.

Updated business strategies will have implications on risk appetite, credit policies, operational underwriting instructions, and pricing. Ensuring that pricing accurately captures the new capital dynamics will be challenging for all banks as SA becomes more risk sensitive, and the output floor is introduced. Where market realities do not support adjusting credit pricing for customer segments that will experience higher risk weights in the future, banks are expected to review fee levels for ancillary business such as cash management and become more active in cross sales. Banks are also expected to assess and optimise their cost-to-serve for customer segments that become more capital intensive by adjusting their coverage and service models in order to protect ROE. This will contribute to accelerated digitalisation.

As always, successful execution of the transition into the new regulatory realities and steering the business effectively according to potentially revised business strategy will depend on robust command of the operational aspects. In Basel 3.1, this includes data, systems and reporting as well as capital management.

Operational impacts of Basel 3.1. for Nordics banks

Other impacts of Basel 3.1 are related to data, systems, and reporting, on the one hand, and to capital forecasting and management on the other.

Data, systems, and reporting impacts
The introduction of more sensitive and granular weighting grids for calculating RWA using the standardized approach, requires banks to revise their current calculation engines to incorporate all the new relevant Basel 3.1 requirements. For Nordic banks, which are heavily exposed to real estate loans, this means integrating different LTV levels, new exposure classes, and exposure types into their calculation tools. Knowing that, LTV assessment mechanisms is not uniform across Nordics countries (e.g., collateral inclusion), banks will need to implement a bespoke calculation tool that take into consideration these specificities. In addition, processes and controls need to be established around the new metrics where another example is the required support of annual due diligence and governance for the use of external ratings.

Banks using the IRB method will be particularly affected, as they will need to recalibrate their internal models to meet Basel 3.1's new requirements, such as excluding exposure classes that are no longer eligible for the internal rating approach. They will also need to establish the necessary structure and organization to calculate the RWA for all exposure classes and risk types following the standardized method. This is a direct consequence of the output floor's introduction, which requires IRB banks to perform a double RWA calculation using both IRB and SA methods. As a result, a significant disruption to the calculation chain and all its related components is expected.

To comply with these new regulatory requirements, banks must upgrade their reporting infrastructure, data architecture, and risk and finance information systems. Banks must increase their vigilance regarding the quality of data used while also data reconciliation requirements are expected to rise. The regulator will likely scrutinize data quality and reporting, particularly as supervisors' interest in this area increases. This is further discussed in BCBS-239 resurfaces on the EBA regulatory agenda. Furthermore, it should be noted that the transition from CRR 2 to CRR 3 (which implements the new Basel 3.1 rules) needs to be carefully managed to address potential data management challenges within the CRR 2 scope during the transition period (such as parallel runs, data overwriting). This may have significant technical implications for banks. Complex Nordic banks with foreign entities and diversified risk profiles also need to ensure that the new standards are implemented across all these entities. Nordics banks can certainly capitalize on their experience with the implementation of CRR 2 projects to promote a successful implementation of CRR 3 across their legal entities.

In addition to the impact on information systems and data, banks should anticipate significant effects on the teams responsible for Basel-related subjects, particularly in the risk and finance functions. These two functions will need to work closely together to reduce discrepancies in the data they report to local authorities, ECB, EBA, and other regulatory bodies. The banks should also engage these teams to implement the new regulatory requirements which will probably increase workload. It is important to recall that the European implementation is expected by January 1st, 2025.

Capital forecasting and management
The previous Basel 3 reform focused on restructuring the composition of banks' capital, whereas the latest iteration, Basel 3.1, is concerned specifically, among others, with the denominator of the minimum required capital ratio, known as the RWA. The RWA is primarily used to calculate the minimum amount of capital that a bank must hold to comply with regulatory requirements, but it is also used in several other processes and ratios, such as RORWA (Return on RWA). Amendments to related performance measures are required.

These reforms will have impact on the ICAAP process, which involves capital forecasting and management and stress testing using different scenarios. On that note, it is worth mentioning that replicating the increased complexity of the standardised approach (e.g., LTV development under stress and changes to external ratings), will not be a straightforward undertaking for banks. Banks must indeed ensure the proper allocation of capital among their various business units, in accordance with their overall strategy. They must preserve their financial stability while financing their internal and external development and remaining within their risk appetite. In an inflationary context and rising interest rates, particularly for Nordic banks with substantial exposure to mortgage loans, adequate capital planning, in light with Basel 3.1 reforms, is necessary to limit headwinds to their business models. In addition, these expected requirements offer Nordic banks the opportunity to review and adjust their pricing tools in response to the observed impacts of the reforms and will likely increase their pricing intelligence mechanism to their competitors.

Stay tuned for the next blog summarizing the regulatory landscape in the Nordics which will be published in the coming weeks. If you have any questions or challenges to discuss about these topics, please do contact us.