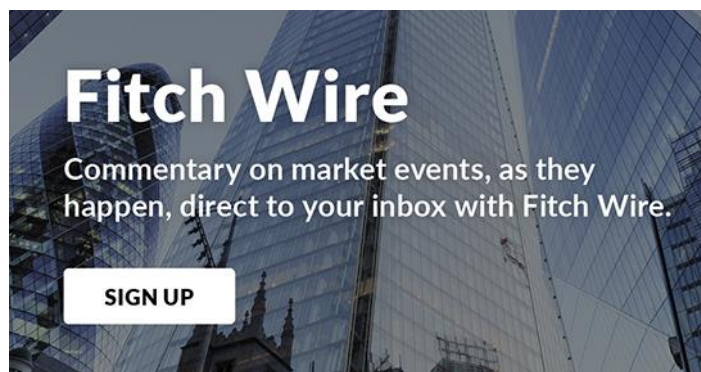


Basel III: Product Impact and Use of Ratings

Undrawn Facilities, Riskier Real Estate, Sub-Debt, and Unrated Entities All Face Higher Capital



Related Research

[Global Banking Regulatory Developments 2Q23 \(July 2023\)](#)

[China's Proposed Capital Rules to Align with Final Basel III \(April 2023\)](#)

[Basel III Status in Latin America: Capital \(April 2022\)](#)

[Basel III Field Guide – Updated to Reflect Final “Endgame” Rules \(November 2021\)](#)

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Impact on Banking Jurisdictions and Products

Fitch Ratings views the final Basel III (aka “Basel IV”) framework as [positive for bank creditors](#). It will ultimately require some banks – particularly in Europe and the US – to hold higher levels of capital, mainly due to the output floor which constrains internal models.

Small to medium enterprises (SMEs), low loan-to-value real estate loans, credit card balances repaid monthly, and high-quality infrastructure or project finance debt will need less capital under the regime. However, undrawn facilities, riskier real estate, sub-debt, and unrated (and sub-investment-grade) corporates face higher charges.

Rated Versus Unrated Corporate Treatment

The output floor fixes modelled risk-weights (RW) to a fixed percentage of the standardised approaches (SA), which can significantly increase capital needs for banks' exposures to unrated corporates and financial institutions (FIs). While the EU, China, UK and US propose lower charges for investment-grade corporates, the difference versus an ‘A-’ rating is still 15 percentage points (pp).

Portfolio Changes and Market Competition

Although unrated and sub-investment-grade corporate exposures and facilities may become less attractive to some banks, it is unlikely that the rule changes themselves will lead to significant portfolio shifts. Other factors will also have an effect, such as profitability, competition, and business model/strategy. However, non-banks may seek to grow their market share on credit portfolios that banks retreat from.

Capital Optimising Mitigation Strategies

Improved credit rating coverage for unrated entities can be helpful for banks and corporates. Banks might be incentivised to use sales or credit risk transfer techniques (e.g. securitisation), where the difference between the prescribed versus “real” (economic) capital need is big. Otherwise the output floor might disincentivise banks to retain and grow financing on low-risk assets or counterparties.

Bank Ratings Implications

The implementation of the final Basel III “endgame” standards will not immediately affect ratings, as Fitch expects most jurisdictions to adopt a lengthy implementation phase-in, and, in any case, the impact will likely be less than currently advised by banks, due to the optimisation of capital processes and management actions.

Status of Major Banking Jurisdictions

Go-Live Is Underway, but Cadence and Alignment Vary

Banks' internal models and their use in financial regulation have been among the most controversial topics in authorities' discussions since the global financial crisis. The final Basel III reforms, which generally apply to large internationally active banks, impose a permanent constraint on the benefits banks can obtain from their internal models, to 72.5% of the revised SA (see [Basel III Field Guide-Updated to Reflect Final "Endgame" Rules](#) for key changes). Not only does this limit the benefit a bank can gain from using internal models to 27.5% of the equivalent SA weight, but it increases the importance of the SA. From an operational standpoint it also means banks have to assess and report capital requirements under both the internal ratings-based (IRB) and SA credit risk approaches.

A majority of the G20 economies have published regulations to implement the final standard, with the exception of Argentina, India, Indonesia and Türkiye. A "frontrunner" cohort of Australia, Brazil, Canada, Saudi Arabia and South Korea will go live on 2023 (more or less in line with Basel Committee timescales); a second wave will implement the rules from 2024, including China, Hong Kong, Japan, Singapore, South Africa, and Switzerland; and the EU, the UK, and US will go live from 2025.

Final Basel III Rule – National Implementation Status

Location	Rule Status	Go-Live Date	2023	24	25	26	27	28	29	30	31	2032	Phase in (full)
Australia	Final	Jan23											0yrs (2023)
Saudi Arabia	Final	Jan23											5yrs (2028)
South Korea	Final	Jan23											5yrs (2028)
Canada	Final	Feb23											3yrs (2026)
Japan	Final	Mar24											5yrs (2029)
China	Draft	Jan24											5yrs (2029)
Hong Kong	Draft	Jul24											5yrs (2029)
Singapore	Draft	Jul24											5yrs (2029)
Switzerland	Draft	Jul24											5yrs (2029)
EU + Norway	Draft	Jan25											5+yrs (2030-32)
UK	Draft	Jul25											4.5yrs (2030)
US	Draft	Jul25											3yrs (2028)

Source: Fitch Ratings, Regulatory authorities

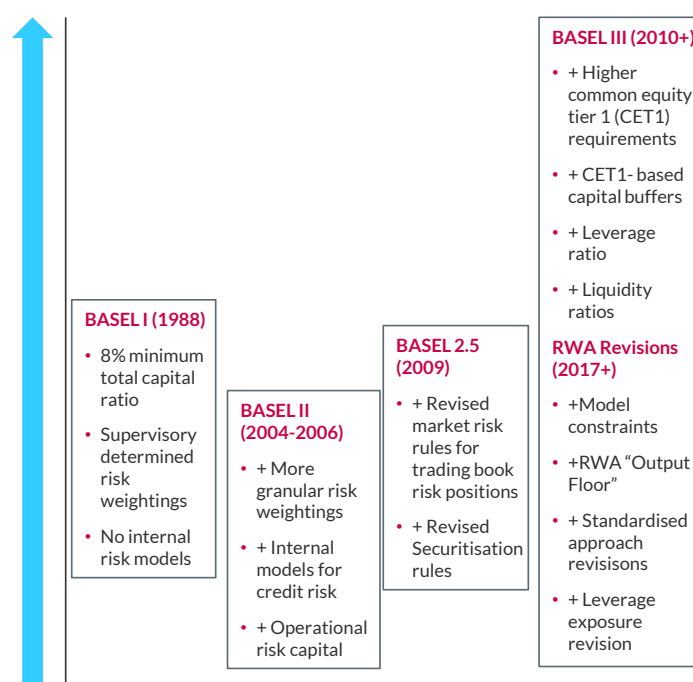
Moreover, policymaking will vary considerably, with the US and European displaying the greatest degree of variance versus the global standard (with the US being more conservative, and the EU least conservative).

Basel Model Constraints Mark A Paradigm Shift

Although the global Basel Accords have evolved over the past four decades, the most recent iteration of the standard marks a decisive turnaround from the historic embrace of internal models, mainly in response to a global loss of confidence in capital ratios following the global financial crisis, calculated in accordance with previous iterations of the Basel standard, i.e. Basel I and Basel II.

The Basel I regime (initial consultation 1 December 1987) introduced the basic capital adequacy ratio. Although it provided for a fixed risk-weighting approach for credit risk, market risk regulation already allowed for the use of internal models. The decisive move to fully incorporate banks' own estimates of risk came in 2004 under the Basel II standard, with internal models for credit risk (IRB approach), and model-driven risk charges for operational risk in the form of the advanced measurement approach (AMA). Basel II marked an important shift, with the power of capital requirements determination shifted from regulators to banks, when IRB models were authorised.

High Level Progression of Basel Accords



Source: Fitch Ratings

The global financial crisis revealed significant shortcomings in the pre-crisis regulatory framework, with a 2013 empirical analysis from the BCBS' highlighting an unwarranted degree of variability from the use of the IRB, via [hypothetical portfolio exercises](#) revealing notable dispersions around the estimation of PD and LGDs assigned to the same exposures when modelled by a sample of internationally active banks.

Average RWs have decreased globally for internationally active banks in the past decade, with average RW densities falling to just under 30% in 1H21 – from around 36% at end-1H14, just before the final Basel III consultation was issued.

Although this may reflect banks holding greater amounts of low-risk-weighted sovereign assets in an economically benign period with historically low levels of losses, it could also reflect potential under-estimation of internally modelled risks- for instance due to model risk and data uncertainties.

Higher and Lower Capital Charges Assessed

Focus on Credit Risk and Credit-Related Products

Credit risk is the most significant prudential risk class for most banks, and hence the main focus of this report, comprising a 63% share of minimum required capital for a sample of 37 large global banks monitored by the BCBS (data as at end-June 2022). The three major credit exposure classes tend to be corporate, sovereign (for liquid asset buffers and reserve requirements), and retail, including residential mortgage loans.

Relative “winners” under the new regime include exposures to corporate SMEs and credit card transactors, versus vanilla corporate and retail exposures respectively which will face higher capital charges. Similarly, high quality project and infrastructure deals can obtain a 20% reduction in capital in comparison to ordinary deals, provided certain criteria is met (mainly that creditors have certain protections and the main counterparty is a high-quality corporate or central government or local authority).

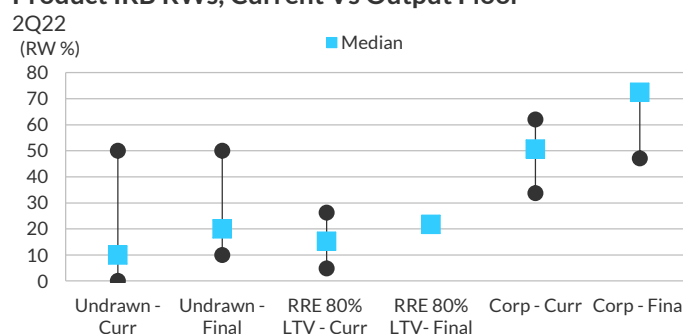
Entities/Products with Less Capital Under Changes

	Product	Capital Impact	Driver/Delta Vs Earlier Basel
SA	Corporate SME exposures	15pp RW improvement	85% RW (vs 100% unrated RW)
SA	High-quality project/infra exposures	20 pp RW improvement	80% RW (vs 100% unrated RW)
SA	Retail transactor exposure (credit/charge cards)	30 pp RW improvement	45% RW vs 75% retail RW
SA	Lower LTV (<80%) RRE exposures	5-15 pp RW improvement	20-30% RW (vs 35% RW)
SA	Lower LTV (<80%) CRE exposures	10-30pp RW improvement	70-90% RW (vs 100% RW)
IRB	QRRE transactor exposure	5bps improvement	PD input floor changes relative to QRRE sub-class

Source: Fitch Ratings, BCBS

In terms of the relative “losers”, the output floor and subsequent delta of IRB vis-à-vis SA RWs particularly affects banks with an extensive reliance on internal models. Hence the default 100% SA RW for an unrated corporate is more than double of some banks’ prevailing corporate IRB RWs (at end-2Q22).

Product IRB RWs, Current Vs Output Floor



Note: Black circles indicate the minimum and maximum values for each dataset
Source: Fitch Ratings, Basel Committee, Final RWs are SA RWs floored by 72.5%

Low-risk residential mortgage loans also face much higher capital charges, particularly in Europe where BCBS data indicate some loans attract less than a 5% IRB RW (the global sample indicates a median 15% RW). A 6pp RW increase (30% SA RW for up to 80% LTV, translating to a 21.75% RW under the output floor) would more than double the capital held on the lowest RW mortgage loans, or an increase of just over a third for most of the mortgages on the sampled banks’ portfolio.

Undrawn facilities look set to consume more capital, as the use of regulatory exposure at default (EAD) models (plus loss-given default – LGD – models) are halted for the large corporates and banks portfolios entirely, and output floor restrictions apply to the remainder of the IRB portfolios.

The difference between internal credit conversion factors (CCFs) – essentially the likelihood of the facility being drawn – and regulatory CCFs can lead to a significant increase in exposures being recognised. Historic BCBS surveys indicate that some IRB banks applied zero CCFs to significant, and sometimes substantial, proportions of their undrawn lending limits (of up to 100% of such facilities). On average, half of surveyed undrawn limits fell within the corporates bucket, followed by in credit cards.

However, under the final rules, the revised SA credit conversion factor (CCF) is floored at 10%, with most CCFs likely to be set at 50%. This could mean that half of an undrawn facility will require capital requirements from the time it is granted, from potentially none currently, and this may increase the cost of granting facilities.

Input floors under the revised IRB approach will also affect retail qualifying revolving facilities, which may contribute to a risk-weighted asset (RWA) impact of 140bp–210bp, on average, for a selection of large EU banks, according to European Banking Authority estimates.

Entities/Products With More Capital Under Changes

Approach	Product	Capital Impact	Driver/Delta Vs Earlier Basel
Output Floor	Undrawn facilities	10-50 pp EAD	Introduction of min 10% CCF
Output Floor	RRE mortgage loans	6 pp RW	Assume mean IRB RW 15.5% (vs. max 80% LTV, SA 30% RW)
Output Floor	IG corporate loan (100% RW)	10-39 pp RW	Assume IRB RW 34-62% applies (vs 100% SA RW)
Output Floor	Specialised lending	13 pp RW	Assume IRB RW 60% (vs 100% SA RW)
Output Floor	IG Corporate loan (65% RW)	13 pp RW, to 15 pp RW decrease	Assume IRB RW 34-62% applies (vs 65% SA RW)
IRB	Equities	50 pp RW	No IRB, just SA RW
IRB	FIs treated as corporates, banks	4 pp RW	Mean IRB increase 4pp to 28%, No LGD/EAD models, PD floor

Source: Fitch Ratings, BCBS (IRB mean RWs per [Basel III Monitoring Report February 2023](#), data as at 2Q22)

Impact by Jurisdiction: Rules, Balance Sheets

The effects of the implementation of the final Basel III regime will vary by member jurisdictions and between banks within a jurisdiction, due to rule differences between jurisdictions, balance sheet and business models of banks, and differences in their corporate structure.

Changes in Tier 1 Minimum Required Capital, Final Basel 3

	Real								
	Overall	Bank/CVB	Retail	Estate	Corp	FI	Equity	Funds	Subdebt
Europe	6.10	1.21	0.82	0.08	1.98	0.84	-0.13	0.22	0.01
Americas	-0.11	0.62	-0.78	-0.29	-2.16	0.04	2.61	0.23	0.00
RoW (APAC bias)	-6.67	1.51	-0.13	0.08	-5.40	0.11	-1.10	-0.07	0.17

Source: Fitch Ratings, Basel Committee (as at [2Q22 Basel III Monitoring Report February 2023](#))

European banks have low IRB RWs, and tend to retain mortgage loans on their balance sheets, and so are more affected by higher RWs for low-risk mortgages. This contrasts with the lower apparent impact for US banks for the same asset class. Despite generating similar IRB RW estimates (2Q22 US average IRB: 14%; Europe: 11.6%, per BCBS survey), it is common for US fixed-rate mortgages to be sold to the US government-sponsored enterprises or to private issuers of asset-backed securities, with the exception of jumbo mortgage loans, which are retained on US banks' balance sheets. This means US banks face higher capital requirements for residential mortgage loans, mainly on these jumbo loan portfolios, due to eliminating the use of the IRB regime, and higher US SA RWs than under the global standard.

Although national discretions and options have been drastically curtailed within the final global standard, many do remain, allowing

differences to creep into the way SA RWs apply. However, rulesets in regimes outside the US and Europe are broadly comparable, even if there are instances of greater conservatism, particularly within the Asia-Pacific region.

For example, Australia applies additional input floors for real estate loans and more conservative retail RW treatments, and does not apply a granular risk-weighting treatment for unrated bank exposures and project finance exposures. In addition, interest rate risk in the banking book, which is normally capitalised under the "Pillar 2" holistic risk requirements, is captured under the minimum requirements "Pillar 1" regime in Australia – and therefore captured under the output floor calculation, making the output floor less of a constraint for Australian banks. This is also partly why no phase-in period applies in Australia.

Several countries have used rule discretions to exempt unadvised facility limits from regulatory exposure computation (Korea, Hong Kong, EU). In addition, Switzerland has varied its SA rule book to focus on its Lombard and other securities lending products.

US Proposals Deviate Most from the Global Standard

The US's recent proposed rule deviates from the global and current US prudential framework in several significant ways. Most importantly, US authorities propose to completely withdraw internal models for credit risk, in contrast to merely limiting their efficacy – which means the Basel output floor only applies for market risks within the US. Furthermore, the existing US Collins-Amendment capital floor (that still uses the archaic Basel I regime for credit risk) will continue to apply alongside the final Basel III floor. US banks will therefore be subjected to two capital floors, adding further complexity to capital management (in addition to the leverage ratio, which is also a constraint on RWAs).

The changes to the US credit risk regime lead to an estimated 30bp increase in required capital ratios, according to the US agencies' impact analysis that accompanies the notice of proposed rulemaking, with negative impacts for lower-risk investment-grade corporate, residential real estate and undrawn facilities' portfolios. This is because the soon-to-be banished model-based capital and exposure-based requirements for these portfolios are lower than the SA equivalent. Conversely, the proposed rules would slightly decrease marginal RWAs for retail and commercial real estate exposures.

Meanwhile, authorities estimate the revisions to the trading book regime will increase large US banks' minimum CET1 ratio requirements by as much as 67bp, mostly due to it being recalibrated to a more conservative expected shortfall loss approach (instead of stressed VAR), and because trading book models will be approved and applied on a desk-by-desk basis (versus a global basis), reducing diversification benefits.

As a potential indicator of the stringency and conservatism of the new market risk regime, Japan's Norinchukin Bank's prudential disclosures following its early adoption of the final Basel III regime showed its market risk RWAs leaping to JPY5,199.5 billion in 1H23, from JPY1,573.6 billion 1Q23 (as per [end-June 2023 disclosures](#)). This outcome on its large bond investment portfolio mainly arose due to applying the new market risk SA regime, and switching off the use of the internal model approach entirely.

EU Regime to Lessen Impact on Banks Most

Authorities' quantitative impact analyses have consistently highlighted large European banks (and especially the global systemically important banks, or GSIBs) as those most affected by prospective rule changes, facing on average a 16% increase in minimum tier 1 capital requirements when implementing the generic global standard. This compares to just under a 2% increase for banks in the Americas – and almost a 4% fall in minimum requirements for the rest of the world (predominantly Asia-Pacific based).

Accordingly, the EU has agreed to a preferential 65% SA RW for unrated investment-grade corporates, and a 10% RW for very low-LTV residential mortgage loans, both solely for the purpose of the output floor calculation, for a seven-year transition period until end-2032. The removal of the historic 0% CCF for unconditionally uncancellable commitments was also proposed to be phased-in over a period of three years from 2030. These preferential treatments will result in a smaller capital difference versus banks' IRB estimates, and lessen capital requirement increases. Additionally, longstanding EU material deviations regarding CVA risks versus the global standard will continue. The European Banking Authority estimates these EU adjustments reduce the overall impact of the final Basel III rules by -3.6pp for a sample of large EU banks (-4pp for EU GSIBs), based on end-2022 balance sheet data.

Although the UK's initial consultative approach is overall more aligned to the global standard than the EU's, authorities have proposed to permanently risk-weight investment-grade-rated corporates at 65% and non-investment-grade corporates at 135% RW (where banks can distinguish between the two), or, alternatively, a flat 100% weighting per the global standard. According to the UK PRA regulator, this would lead to an overall blended portfolio RW of 100% for most UK banks, which is more or less aligned to the global standard. However, in light of industry responses to the UK consultation, it remains to be seen whether the final UK rule will shift the UK's alignment more closely to the EU rule, in order to maintain a more level playing field.

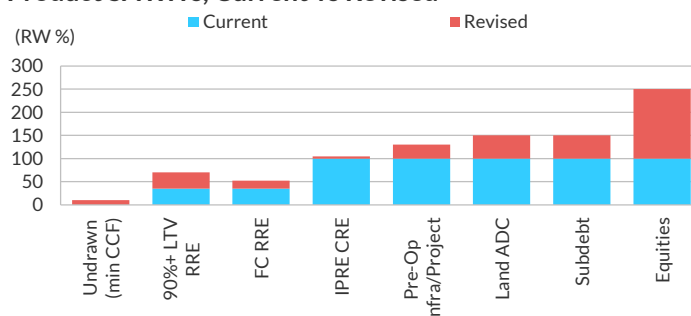
Revised SA Credit Risk Unpicked

RWs for Higher Risk Products Increase

The SA has been overhauled to provide a more risk-sensitive approach, affecting both banks operating under the SA, and IRB banks via the output floor (IRB RWs floored to 72.5% of the SA).

Higher LTV real estate lending will have granular RW buckets replacing the previous flat RWs, and higher weightings for income-producing real estate given the differing risk profiles. Riskier products such as equities, sub-debt, and land acquisition and development (ADC), and unhedged foreign-currency (FC) retail or RRE loans will also have RW increases.

Product SA RWs, Current vs Revised



Source: Fitch Ratings, Basel Committee

Other changes to the overhauled SA include revisions to corporate exposure RWs, the removal of implicit assumptions of sovereign support for credit ratings of banks (see below), changes to the risk weights for equity exposures, changes to off-balance-sheet conversion factors, and proposed due diligence requirements for use of external credit ratings.

Sovereign Support Is Excluded from Bank Credit Ratings

The final rules require bank credit ratings used for prudential framework to exclude implicit government support, with an exception for public banks owned by their respective governments. This supports the G20 Financial Stability Board's policy objective of removing sovereign support for banks in general and ending too big to fail. National authorities will be allowed up to five years from January 2023 to implement the Basel changes.

In response to bank investor and issuer needs, Fitch has assigned 'ex-government support', or 'xgs', ratings, which communicate Fitch's view of the creditworthiness of an entity or financial obligation excluding assumptions of extraordinary government support. The xgs ratings are typically assigned to banks that are i) not rated as policy banks; and ii) whose international ratings incorporate assumptions of government support. An 'xgs' suffix is added as a modifier to the corresponding existing rating, e.g., 'A(xgs)'.

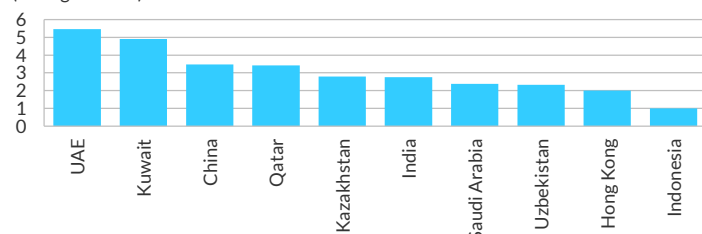
The impact of the Basel changes is determined by the mapping between ratings to the prescribed SA ECRA RW buckets, and the notching difference between IDRs and xgs ratings.

Fitch retains sovereign support in the Long-Term IDRs of many Middle Eastern and Asian banks, where resolution legislation has not progressed significantly, or where the sovereign remains supportive of its banks. The likelihood of an IDR based on sovereign support resulting in significant uplift from the VR is greater in jurisdictions such as the UAE, Kuwait, China, and India, which have higher sovereign ratings than their banks' standalone viability credit rating – over five notches in the case of some UAE banks.

Selective Jurisdictions' Mean Notching IDR vs XGS Ratings

Excluding branches

(Rating notches)



Source: Fitch Ratings

We expect further clarity on defining sovereign support and government ownership during national authorities' transposition and implementation of the Basel standards into binding legislation (i.e. more precise terms on the nature of public bank activities and quasi-government ownership). There is no requirement under the Basel rules to remove institutional support (such as from a parent bank) from a bank's credit rating.

Unrated Versus Rated Gap Shrinks

The existing External Credit Rating Assessment (ECRA) approach (used by a significant majority of BCBS members, bar the US), is revised to improve its granularity, but is joined by a new unrated Standardised Credit Risk Assessment (SCRA) approach that reduces the historical risk-weight differential versus the long-standing ECRA. The bank SCRA buckets exposures into one of four grades, and the unrated corporate approach into one of up to three categories (investment-grade at 65% – in theory where credit ratings are not permitted to be used but also used by European regulators; SMEs at 85%; in the UK, non-investment-grade corporates at 135%; and everything else at 100%).

SCRA Risk Weights for Unrated Banks (and where ECRA is not permitted, e.g. US)

SCRA grades (%)	Grade A ^a	Grade A	Grade B	Grade C
Long-term exposures risk-weight	30	40	75	150
Short-term exposures risk-weight		20	50	150

Source: Fitch Ratings, BCBS. ^a Not applicable in the proposed US rule

In addition, the exposures to bank counterparties rated between 'A+' to 'A-' under the ECRA benefit from a 30% RW, down from the 50% RW under the current regime.

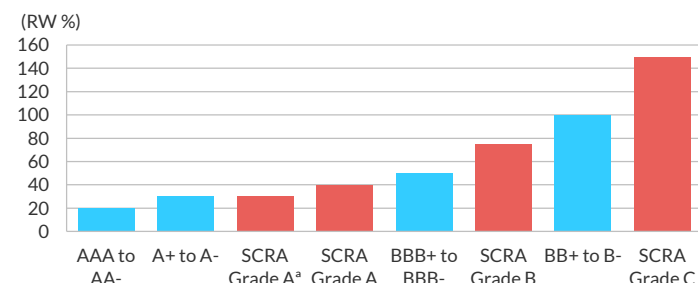
ECRA Risk Weights for Rated Bank Exposures

LT IDR	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-
VR	aaa to aa-	a+ to a-	bbb+ to bbb-	bb+ to b-
Base LT RW (%)	20	30	50	100
Base ST RW (%)	20	20	20	50

Source: Fitch Ratings, BCBS

The effect of the bank SCRA is to level the playing field in terms of applicable credit RWs applicable between the highest rated bank (20%) and high-quality but unrated peer institutions (30%).

Bank SA RW Differences - ECRA Versus SCRA



Note: SCRA is the sole approach in the US and China

Source: Fitch Ratings, National Authorities, BCBS

Corporate Risk-Weighting Differentials, Unrated vs Rated

The revised corporate ECRA includes a new mapping to 'BB+' to 'BB-' that used to be subsumed into the 'BBB+' to 'BB-' bucket, and lower investment-grade band RW.

For unrated corporates, two key changes are made in the SA – firstly, investment-grade corporates can be risk-weighted at 65% in jurisdictions where ratings cannot be used (e.g. US). Secondly, unrated SME corporates will have a 85% RW, instead of the default 100% unrated RW.

Risk Weights for Corporate Exposures

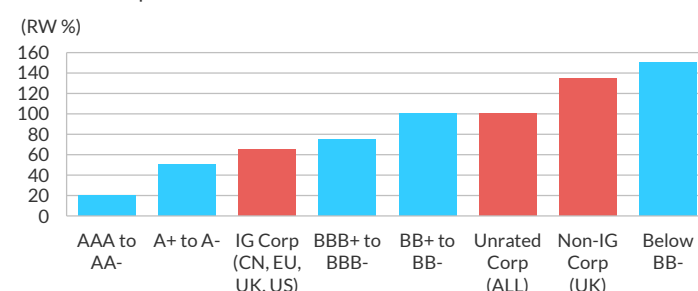
LT IDR	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	Below BB-
Base LT RW (%)	20	30	50	100	
Unrated, Corp IG ECRA can't be used					65%
Unrated SME					85%
Unrated, Other					100%

Source: Fitch Ratings, BCBS

However, in spite of the improved risk granularity for unrated corporate exposures, use of the ECRA can still result in significantly lower RWs, usually of 10pp–35pp RW, particularly for unrated corporates within jurisdictions that are not freely applying the preferential 65% SA RW (all bar Europe, US, and China). For example, an unrated corporate/SME rated in the 'BBB' category, or an unrated corporate in the UK rated in the 'BB' category.

Corporate SA RW Differences - ECRA Versus Unrated

Jurisdiction-specific RWs noted within brackets

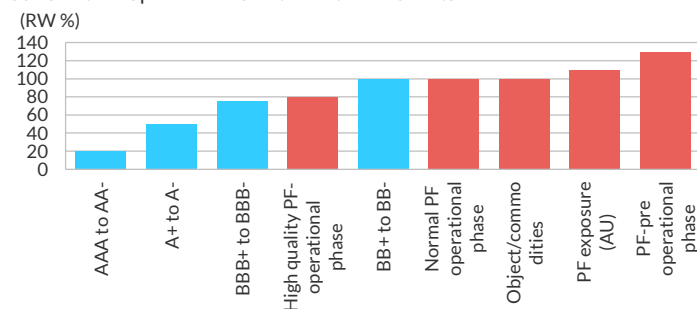


Source: Fitch Ratings National Authorities, BCBS

For project/infrastructure finance transactions, particularly in Australia (which applies a 110% infra/project RW floor), there are similarly gaps of 10pp–110pp of RW, for highly-rated ‘AA-’ or ‘A-’ transactions, versus the applicable unrated RW.

PF/Infra/Object SA RW Differences - ECRA Versus Unrated

Jurisdiction-Specific RWs noted within brackets



Source: Fitch Ratings National Authorities, BCBS

Mandatory Due Diligence When Using Credit Ratings

Banks will also have to undertake mandatory due diligence when using credit ratings for bank and corporate counterparties. This could lead to a bank assigning a risk-weighting at least one bucket higher than the “base” risk-weight. In Fitch’s opinion credit ratings have been effective in assessing relative credit risk and are widely understood and accepted. Fitch understands the BCBS’s approach of accepting the use of ratings, subject to mandatory due diligence, as an input for the assessment of relative creditworthiness with a view to achieving a stronger risk-sensitive capital framework.

Capital Optimisation, Competition

Regulatory capital ratios and returns on regulatory capital (particularly on a fully-loaded basis ignoring transitional provisions) remain key metrics for investors. Hence, banks that are most affected under the final Basel regime will be heavily incentivised to undertake management actions to optimise their capital efficiency.

Banks with relatively homogenous product portfolios could seek to securitise (either true sale or synthetically) in order to achieve regulatory derecognition – although some jurisdictions require consent from authorities, which adds uncertainty into the process. This is especially within jurisdictions with well-developed capital markets, such as in developed-market Asia-Pacific, or Europe, or in the US. For the US, the securitisation of jumbo mortgage loan portfolios could increase.

On more bespoke or smaller portfolios, bilaterally negotiated credit default swaps, or funded credit linked notes, can also be tailored to achieve RWA reductions, ideally with well-rated counterparties, or, alternatively certain assets might be disposed of directly.

As banks’ capital requirements for low-risk assets increase versus internal model-driven estimates (depending on the prevailing SA RW within a given jurisdiction), this may incentivise banks to consider reducing portfolio or business line exposure to such low-RW assets, while increasing exposures to portfolios where the internal RW estimate post-capital floor is aligned to the hypothetical standardised approach.

Non-bank entities such as life insurance companies and credit funds, could viably step into any void left by banks to intermediate in credit, in Fitch’s view. As well as being outside of the prudential framework, life insurers are well-positioned to harvest relatively illiquid long-dated credit assets, with contractually fixed or highly predictable income cashflows. This will also help to fulfill their need for long-duration risk to match their long-duration liabilities. Although this has been an ongoing and increasing trend that has accelerated more recently, this reflects increased competition traditionally occupied by banks, particularly for credit assets with attractive return metrics.

However, we do not expect banks to take more drastic decisions to exit business lines or products solely due to the impact of the final Basel reforms. Often capital consumption and hurdles based on capital are just one input into a broader business decision, that also considers other aspects of strategy, and competition. In addition, there might be a sufficient pricing margin to simply absorb the additional capital costs, or the phase-in of rules will be over a sufficient length of time to nullify the overall impact (as in the case of the EU’s seven-year transition period for RW adjustments when calculating the output floor).

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