HOW SHOULD BASEL BANKING STANDARDS EVOLVE NOW?

1. The Basel reforms already in place have proved effective

A Central Bank official described how the Basel III reforms are the policy response of the Basel Committee to address the weaknesses exposed by the great financial crisis of 2008 09. The recent Covid crisis dramatically showed the importance of having a robust financial system which acts as a shock dampener when unexpected events occur. With many elements of the Basel reforms already in place – such as the new capital framework and the new treatment of credit risk – banks faced last year's crisis in a much better position than 10 years earlier. As a longstanding member of the Basel Committee, the Central Bank official emphasised that it is pleasing to see that the work of the Basel Committee does not appear to have been in vain. Another Central Bank official suggested that the EU banking sector has shown significant resilience in recent times because of the improvements observed over the last decade, particularly in terms of solvency, liquidity, and asset quality. Indeed, the work of the Basel Committee has certainly not been in vain.

1.1 The temporary adaptation of transitional periods for implementing international banking and accounting standards was essential to weather the crisis triggered by the pandemic

A Central Bank official explained that the timetable for the implementation of the last parts of the reforms was agreed by the Basel Committee and confirmed by its oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS). When the Covid crisis hit, GHOS postponed the deadline for implementation to January 2023. This one year postponement was needed to free up operational capacity in the banking system and it helped support the real economy during the crisis.

Another Central Bank official agreed that the broad and timely fiscal and monetary measures that were implemented during 2020 were well complemented by the measures taken by financial supervisors and regulators, including the Basel Committee. These actions guaranteed that institutions could continue to finance the economy and absorb losses, which so far have not been very significant. There have been some changes to the timeline, but the Basel Committee took great care to find alternative transitional periods for the implementation of expected credit loss from the IFRS 9 accounting framework. The Capital Requirements Regulation (CRR) 'Quick Fix' was also important in ensuring that banks could manage the crisis.

2. Policy makers consider it necessary to complete the implementation of the international banking standards in the EU

2.1 There is a need for caution on the timing of the withdrawal of regulatory relief measures

An industry representative agreed that, during the Covid crisis, banks have been part of the solution together with monetary, regulatory, and fiscal policies. The impact of the economic crisis on banks' balance sheets has so far been limited because public institutions absorbed most of the shock. Banks will also absorb some of the shock eventually, but the materialisation of this risk depends on public policy. The pandemic is not over. There is still a need for the public authorities to support the economy and the most affected businesses. If this support is given, casualties will be limited.

However, the industry representative cautioned that procyclical regulations such as 'Basel IV' could 'derail the train'. At a time when Europe wants to support businesses and encourage a green and digital recovery, 'Basel IV' would freeze hundreds of billions of euros, which represents a financing capacity of thousands of billions of euros. The implementation should respect the political mandate not to increase significantly overall capital requirements or cause significant differences between different regions of the world. Another industry representative agreed, warning that the implementation of Basel III risks choking off the supply of capital to the banking industry in Europe and further distorting a playing field which is already balanced away to the detriment of the European banks. A Central Bank official noted that the pandemic is not yet over and there is still uncertainty about the pace of recovery and whether the effects of the crisis are temporary or permanent. It is important to evaluate carefully the timing of the withdrawal of relief measures to avoid cliff edge effects and permanent damage to households and companies.

2.2 Policy makers expect that the Basel framework will make the EU banking market more efficient

A Central Bank official stressed the importance of ensuring a gradual return to normality in regulation. The long transitional arrangements should allow a smooth adoption of the latest Basel reforms. For example, the 2028 deadline on the output floor will give banks enough time to rebuild their capital buffers. Implementing the Basel III standards will demonstrate the resilience of the EU banking sector to the market and will surely result in better and cheaper funding. The implementation of the Basel III standards is also about the level playing field between banks inside and outside the European Unio. The regulatory stability and comparability ensured by common standards will attract investors and further strengthen the EU banking sector. A Central Bank official agreed that the timely and consistent implementation of the remaining Basel III reforms would ensure a global level playing field and further strengthen the regulatory framework. As a first step, regulators should phase out the COVID 19 relief measures carefully and return to normality, which means restoring the pre Covid regulation standards. A public representative emphasised that global banking standards are essential for promoting financial stability and enhancing the quality of banking regulation and supervision in a multilateral world.

2.3 However, the effects on the lending of increased capital requirements are restrictive

An industry representative stated that, after years of endless academic debates, it is now well understood that higher capital requirements translate into less lending capacity in the real economy. €200 billion corresponds to roughly €2.1 trillion of loans being prevented by the need to freeze additional capital in the balance sheets of banks. €2.1 trillion is roughly three times the €700 billion in the European recovery plan. It is exactly because of this fact that regulatory flexibility was provided by regulators and supervisors at the onset of the COVID crisis: to free up capital in order to allow banks to lend more to the economy.

3. Key objectives for EU policy makers: taking account of European specificities and ensuring that there is no significant overall increase in capital requirements

3.1 The political debate on how to implement the last batch of regulations will start in Q4 2021

A public representative explained that a proposal is awaited from the Commission to start the political debate with the European Parliament and the Council on the remaining Basel III reforms. The Commission will table a proposal in September. Implementing the Basel regulations is not a question of 'if' but 'how'. This must also be the message to the public: it is not a question about whether global regulation is implemented in Europe; it is only a question of how this is done.

3.2 The Basel framework is confronted with the many specificities of banking in different regions globally

An industry representative emphasised that Basel III is not sensitive to the structure of the European banking sector in respect of factors such as the large level of unrated corporates, the structure of mortgage lending and how derivatives are managed. Basel III is misaligned to the financial structure of Europe, especially given the degree to which the economy is financed on banks' balance sheets. Today, the European banking industry faces regulatory challenges which create subtle disadvantages, including the treatment of derivatives; the implementation of the Fundamental Review of the Trading Book (FRTB), which may be different in the US and in Europe; the securitisation markets in the US and Europe; and the distortive impact of Freddie Mac and Fannie Mae on balance sheet structures. Additionally, there are subtle differences in the pillar 1 and pillar 2 implementations, for example around PruVal, which does not exist in the United States, or the treatment of capitalised software intangibles. The treatment of domestic systemically important banks (D SIB) in Europe also has several distortive effects, including in the treatment of transnational assets and liabilities in the D SIB calculation, which harms intra European financial activity.

3.3 It is important to ensure a level playing field between banks in Europe, the US and Asia

The Basel III framework will further distort the competitive differences between the European and American banking sectors, to say nothing of any future competition from Asian banks. An industry representative thought that the framework will exacerbate existing distortions and level playing field issues between the US and Europe. In relation to the level playing field, a Central Bank official noted that the implementation of FRTB would very much depend on accounting standards. A public representative emphasised that the European Parliament is keenly aware of these issues. It is important not only to discuss the level playing field between the EU and US, but to understand the level playing field between the different banking companies and sectors inside the European Union. However, an industry representative suggested that the idea of the unlevel playing field between large banks and smaller banks in Europe is a myth, because large banks have additional buffers. For instance, there are special buffers between 1% and 3% for large global systemically important banks (G SIBs), additional buffers for systemic risks and an additional buffer on the leverage ratio for G SIBs.

3.4 EU banks' capital requirements could increase by 25%, while US banks' capital would remain flat or decrease

An industry representative outlined how the Basel III final framework is intended to apply to banks' capital on a neutral basis, but quantitative impact studies have indicated that the European banks' capital requirements would increase by 25% while US banks would be largely flat or even decrease. The European banking sector would require another €350 billion of capital. Leveraged on balance sheets, this represents as much as €8.5 trillion of lending capacity to the economy.

3.5 Additional objectives for EU policy makers

A public representative emphasised that the European Parliament and the Council adopt legislation, not the Basel Committee. Europe accepts the common goals of the Basel Committee, but Europe must European ise the Basel rules. It is important to consider Europe's structural specificities and the consequences for institutions, users and citizens. There should be no significant increase in overall capital requirements. Some elements are essential for an effective financing landscape, such as a stronger small and medium sized enterprise (SME) supporting factor and the credit valuation adjustment (CVA) exemption for corporates. On the output floor, Europe must find a Basel compliant solution that implements the common goals of reducing the variability of risk weighted assets (RWAs) and ensuring better comparability. The Banking Union also needs capital and liquidity waivers in order to improve the integration of cross border groups. Based on the Commission's proposal and impact assessment, there should be progress on this subject in the summer, thanks also to the contributions from the European Banking Authority (EBA) and the affected authorities, central banks and stakeholders, and the experience of COVID 19.

An industry representative noted that there are some solutions involving the output floor and its implementation, agreeing that there are many vital topics for discussions about the output floor such as how unrated corporate treatment is implemented, how to consider mortgage lending on bank balance sheets and derivatives. A Central Bank official considered there to be a problem concerning the level of the output floor. Yet Europe should be cautious about not meeting international standards, because there might be issues

concerning competition if European banks are seen as less regulated or as having less strict regulation.

An industry representative stressed that there exists now an opportunity to fine tune the European solution. This should be achieved through detailed technical work before launching a public debate. However, it is important to consider what happens when a public debate is launched. In the years after Europe officially endorsed Basel III in 2010, there was a decrease in the amount of loan funding in Europe because the banks were forced to deleverage. This will happen again if the banks prepare themselves for the next part of Basel III.

A Central Bank official suggested that the full effects of the current crisis are yet to unfold, and many challenges lie ahead. Not less importantly, the final part of the Basel framework that has not been implemented concerns financial risks. This was fixed with what was called Basel 2.5, but there is a general view that it is not satisfactory that there was no comprehensive review.

3.6 The private sector still considers the policy targets to be ambiguous

An industry representative clarified the issues concerning the technical measurement of capital impact in the consideration of having no significant additional capital requirements. In the EBA's EU adapted scenario, there is a reference to a 13% increase in capital requirements. Adding 13% to the current capital requirements is an addition of €200 billion. At the same time, the EBA quantifies the additional capital required as €17 billion. This is a very significant difference. The EBA explains the figure of €17 billion by stating that they are only measuring the shortfall, i.e., the gap between the capital ratio of the bank and the minimum requirements once 'Basel IV' is implemented. Implicitly, this means that the EBA considers that after implementing 'Basel IV' the only requirement that would be imposed on banks would be the level corresponding to the minimum distributable amount, which is in the regulation. This means, for example, that there would be no additional Pillar 2 guidance (P2G) and no management buffer added to that. The Commission's impact study must clarify this subject so that policymakers can make well informed decisions.

3.7 The banking industry considers the idea of a progressive implementation to be illusory

Turning to the question of timescale, an industry representative considered that, as long as the Covid crisis prevents a return to normality, it is probably too early to discuss additional constraints and capital requirements. This is especially the case because the framework proved to be effective when the crisis came. When a reform is proposed for discussion, the markets immediately anticipate the final stage of the reform and ask all the banks when they are going to comply with the final rules. There is an idea of progressive implementation, but in reality, the banks rush to implement the final stage of the regulation.

4. The output floor is a hotly debated subject

4.1 The output floor penalises decentralised banks and banks with a low risk profile

An industry representative explained how the output floor measures the difference between the standard and the RWAs as measured by models. He reminded the audience that these models were introduced not by the banks but by supervisors at the end of the 1990s, because they considered that the standard was not a good measure of the risk. The output floor is highly detrimental for corporate banks using models for two reasons. First, the more decentralised a bank is the more it is penalised by the output floor. Corporate banks are very decentralised and therefore heavily penalised. Second, the lower the risk of a bank, the more it is penalised by the output floor. Corporate banks have low risks and are therefore heavily penalised. Indeed, in a centralised bank, different risks are mixed into the same structure. Because the average risk is closer to the standard, the impact of the output floor is reduced compared to the individual risk of each entity. When the output floor is applied to low risk retail banks in a banking group, there is a huge difference between the real risk and the standard. When these risks are added together, it gives a huge amount which cannot be averaged with the higher risk of the entity dealing with market financing, for instance. This is the mathematical consequence of averaging the whole risk or counting each risk separately. In each case, the averages are different.

A Central Bank official stated that there is a question of scope when dealing with the output floor. There had been a discussion of whether the output floor should apply at the consolidated centralised level or the individual unconsolidated level. Smaller banks have lower portfolio risk, but in some countries small banks tend to use the standard approach. The output floor might also be better for competition for small banks, because they stick to the standard approach due to its ease of implementation.

4.2 It is essential to address the variability of risk assessment approaches

An industry representative considered the output floor to be particularly impactful in Europe, given the structure of European balance sheets. While there is variability in the implementation of the risk weighted models across the sector, the output floor would be particularly impactful for companies with relatively low risk weighting on their balance sheets. A Central Bank official suggested that it is inherent in the concept that the output floor bites more for banks with a low risk-weight.

An industry representative stated that there is a myth concerning the so called variability of RWAs, which is the origin of the output floor. There are reports from the EBA which indicate that there is no greater variability of models in Europe than the variability of the standard approach. The solution to these issues is simple: first, apply the output floor at a consolidated level to neutralise the impact of differences in banks' structures; and second, apply the output floor as a backstop, as mentioned by the Basel agreement, using the 'parallel stack' approach to determine the minimum capital requirement without changing the solvency ratios. An industry representative noted that this assessment could be carried out as a quantitative impact study using a model portfolio. This would lead to a proper assessment of variability.

However, a Central Bank official stressed how banks have an understandable incentive to minimise their capital requirements, but at the same time this can be a source of concern for supervisors. There is clearly some variability, including variability based on the standard

model, and variability is the essence of risk weighting. It is obvious that banks with different risk profiles should have different risk weights. That is achieved by using both standard models and advanced internal models. The point is not to avoid variability across banks; rather, there is variability when the same standard portfolio of assets is put through different models used by different banks. Another Central Bank official suggested that the alternative to the output floor would be regulatory convergence of the internal models of banks. It is incongruous for models to be used for regulatory issues but also as a true and fair view of risk for the purposes of steering and control. The perfect model must be flexible and to the point. If there is variability between models, there must be some form of standardisation. The output floor is the solution to this.

5. The future of international banking standards

5.1 International banking standards must still address emerging challenges

A public representative stressed that global banking standards should evolve in parallel to the implementation of Basel III. The sector must be able to respond to common global challenges such as climate related risk, digitalisation, cyber risk, operational resilience and increasing debt levels. These risks exist across borders and sectors, and they have broad financial stability implications. Given its taxonomy and the environmental, social and governance (ESG) factors, there is a huge opportunity for Europe to be a rule maker rather than a rule taker of global standards. A Central Bank official noted that the pandemic has accelerated digitalisation and new ways of doing business in the financial sector, which should be reflected in future banking regulation and supervision. It is important for supervisors to ensure the accurate inclusion of ESG risks in existing risk models.

5.2 Achieving effective and systematic countercyclicality within banking standards

A Central Bank official emphasised the importance of seeking to learn lessons from the pandemic regarding the effectiveness of the implemented elements of the framework. This assessment could focus on the useability of capital buffers and avoid short term quick fixes. Europe should conduct an evidence based evaluation and implement rule based stabilisers which are available but not subject to excessive discretionary action. Micro buffers will only be effective if they follow a strict risk by risk approach.