IMPLEMENTING BASEL III IN THE EU: REMAINING CHALLENGES AND TIMING

1. Completing the work undertaken under the aegis of the international standard setter for bank prudential regulation to address modelling practices and trading book risk assessment challenges revealed by the international financial crisis required difficult compromises at the international level

An international public decision maker commented that while it is significant for Eurofi to discuss Basel III, it might be time to stop discussing and start implementing. The international public decision maker pointed to a recent letter by a majority of EU central banks and supervisory authorities which made a similar point. During the Global Financial Crisis (GFC), everyone, not only regulators, knew that the banking system's fault lines had to be solved, so an ambitious reform agenda was initiated. Basel III is an important part of that and not inconsistent or in addition to it. It aims to restore credibility in the risk-weighted capital framework, as that was obviously at stake in the GFC, by reducing excessive variability in banks' model capital requirements and developing a robust, risk-sensitive, and standardised approach, to serve as the basis of the output floor. A recent European Central Bank (ECB) paper models the reform's implications on Europe's economy. The net benefits are positive only if Basel III is fully implemented. If it is diluted, the benefits disappear.

Basel III reforms do not aim to increase overall global capital requirements. Outlier banks with aggressive modelling practices will face higher capital requirements but will have a transitory period to adjust. The crisis has not proven that this reform is not needed. The pandemic was an exogenous shock, and banks remained resilient due to public support for households and non-financial corporates. The standards are already a compromise. The Basel Committee follows a consultative process, and more than 10 papers were published after consultation and more than 33 adjustments made, many due to comments by European stakeholders. Financial stability is a global public good, and so the Committee designed and calibrated Basel III at the global level and incorporated flexibility via national discretions within the framework. Giving undue attention to the impact on individual banks, jurisdictions or regions risks 'missing the forest for the trees.'

A Central Bank official noted that international banking standards used to be unsatisfactory before the GFC, banks were one of the weak links during the GFC, and there were issues with quantity of capital, quality of capital, the treatment of risk, especially trading book risks, and excessively aggressive modelling under Basel II. These were tackled by the Basel Committee. The decision process was long; the implementation was longer and has not ended. The project should be completed. Since then, banks' capital has significantly increased. This is good and proved to be so during the last crisis.

1.1 The anticipated evolution of banks' business models throughout the transition period is an intended consequence of the reform, which should alleviate its actual burden on banks

A Central Bank official believed the significance of 10% is a terminology issue but the European Banking Authority's (EBA) estimates of the required capital increase for European banks have been decreasing over time. The reason is that each wave is premised on existing balance sheets and business models, but banks adapt to changes in regulation. Discouraging investment in certain activities is an intended effect of regulation. Risk treatment in the pre-GFC framework was lopsided, with disfavour for credit risk and favour for financial market risk. This had to be corrected, it has been, and banks are adapting. The time available before Basel III implementation is finalised will allow banks to do more and the gap will continue to shrink. Some banks are more impacted by the new rules and others less so, which was also intended. An additional capital requirement is an average concept, but the more impacted banks have the strongest incentive to adapt asset composition and business models and have room to do so. The governors' recommendation to the Commission about a timely and faithful implementation of the final Basel III rules is supported.

1.2 Public and central bank interventions helped the banking sector to weather the COVID shock. This stresses the need to implement the trading book framework reform featured in Basel III

A Central Bank official underlined the importance of not being complacent about the banking system's resilience during the last crisis. Public intervention, including substantial central bank intervention, was vital to prevent serious long-term turmoil in financial markets. Non-banking financial intermediation, with issues of open-ended or money market funds, should be aimed at making NBFIs capable of withstanding market turmoil without massive central bank intervention, which constitutes an obvious risk of moral hazard. This is true also for banks. The crucial trading book treatment reform in Basel III, which is to be completed, should be consistent.

An industry representative commented that, on attributing banking sector resilience to the massive intervention of public authorities, the EBA stress test included the hypothesis that public support will stop. The stress test measures banking sector resilience without this strong public support.

2. Heavy implementation of Basel III in the EU risks penalising decentralised banks and reducing the availability of bank financing needed for growth as EU banks are vital to address SMEs' needs

An industry representative stated that consistent Basel implementation should respect the principle in the Basel Accords' introduction not to significantly

increase overall capital requirements. It is not only a political mandate; it is in the Basel agreement. For consistency, the output floor must be designed as a backstop, as in the Accords, and should not rewrite the European banking solvency regulatory framework but complete it. A backstop means that the output floor does not change existing requirements or the calculation of existing solvency ratios but adds a minimum capital requirement as with the leverage ratio. The parallel stack is Basel's stack. The output floor must apply at consolidated level as the Basel Committee provides international standards at that level. Applying at consolidated level ensures business model neutrality. If it applies at solo level, more decentralised banks will be penalised by the output floor.

The industry representative stated that growth matters. More bank capitalisation does not always lead to more loans and long-term economic growth. If it did, capital requirements could be set at 100% and Europe would lead for growth globally. A balance must be found between financial stability and growth, which is based on bank financing in Europe. Supervisors have affirmed that European banks are adequately capitalised, as confirmed by recent stress tests. Basel III's implementation provoked a major deleveraging, which only ceased with measures taken in 2020 to stimulate lending. An ECB graph on outstanding loans to corporates shows a sharp increase from 2003 until the GFC, and the deleveraging effect ceased in 2020. Deleveraging must not be triggered, especially when Europe needs financial and banking power to finance a strong recovery through the Green Deal and digitalisation of the economy. A significant increase in capital requirements should be avoided.

An industry representative agreed that significantly increasing capital requirements for European banks will detrimentally impact European growth and competitiveness when uncertainty remains high, and financing is needed for the green and digital transitions. Higher capital requirements force banks to increase client´s funding costs and deleverage balance sheets. With the prominent role of bank funding in Europe's SMEs and households, this will negatively impact investment and growth capacity. If not adjusted, Basel III implementation will result in a significant, permanent drop in gross domestic product (GDP) of 0.5%. The assessment shows that the impact on other regions will be negligible or negative, so affecting the competitiveness of European banks. US banks' equity return is more than double that of Europe's, and Basel III could widen the gap. The benefits for financial stability do not offset the costs for growth.

Banks are well capitalised as proven in the recent crisis and as the stress test results show. Recognising that it was not a financial crisis and that public support helped, it is also true that banks supported and contributed to the recovery. This has not been for free. During the last years, banks have strengthened their balance sheets, so capital levels more than doubled, capital quality was enhanced, leverage and liquidity frameworks implemented and have put in place the comprehensive crisis management framework, that doubled bank's loss absorption capacity and implies new contributions to resolution funds, this effort should not be underestimated. Banks have committed to strength and to financial stability.

The last piece of regulation should not be about further increasing overall capital levels but ironing out unjustified outliers. Europe should make use of the flexibility embedded in the framework, for instance in the discretion allowed for implementing the new operational risk framework, to reduce the impact on banks' profitability and competitiveness. Strong banks are needed in Europe more than ever to finance the recovery and the green and digital transitions.

A sound and well capitalised EU banking sector suggests adherence to the 'no significant increase' principle. Banks' profitability will further deteriorate whatever transition period is proposed

An industry representative commented that supervisors and regulators agree that banks have high capital and liquidity buffers, which helped in the COVID crisis. The recent stress-test scenario was extremely severe and based on post-COVID balance sheets inflated by increased crisis loans. After simulation this harsh and unrealistic scenario, the average common equity tier 1 ratio of banks was 10%, which is too much. The tests check that in a crisis buffers are used or partly used and that banks remain above 4.5%. At more than 10%, 3-4% is wasted for the economy. A satisfactory result is 6% or 7%, so banks' capital should be considered satisfactory. Market participants also consider large EU banks to be over-capitalised. Taking the credit default spread (CDS) market as reflecting the credit quality appraisal by the market, the CDS spread for Santander and BNP Paribas is 31, with 43 for JPMorgan and 44 for Wells Fargo. The market believes that Europe's big banks are better capitalised and more solid than US banks, but the return on equity is lower, which means a lower price to book. On one day, the price to tangible book value was 0.8 for Santander and 0.7 for BNP Paribas versus 2.4 for JPMorgan and 1.4 for Wells Fargo. Above 1 is normal for US banks, and below 1 for European banks, because of this excess capital.

This overcapitalization explains why respecting the no significant increase mandate as crucial for Basel III implementation is a view shared by many and comments from key member states representatives in the panel are welcome. This approach should drive the Commission's forthcoming initial text. If the proposal does not include key adaptation elements and technical adjustments for limiting capital requirements increases, and if this proposition translates into a significant capital increase, it will create a negative effect in the market, as banks must commit to an adjustment plan without waiting for the final vote. The final vote of the initial Basel 3 package occurred in 2012, but as soon as 2010 banks adjusted and deleveraged due to pressure from shareholders, lenders, and clients. If deleveraging is needed to meet the regulation, it has to be done soon. Any significant inflation of risk-weighted assets endorsed by the Commission in its legislative proposition would be sanctioned by an immediate share price hit, particularly affecting the lowest-risk banks.

'No significant capital requirement increase' means a low single-digit figure and 10% is not low or insignificant. Central banks' representatives are too

humble in estimating their actions' efficacy over the last 10 years. The capitalisation level demonstrates that European banking supervision does not lack credibility. The thought remains that the models are tricked, while the targeted review of internal models (TRIM) happened and flaws that were maybe existing at the beginning in 2010 are now adjusted by the supervisor himself. The process took time but some of the purpose of Basel IV has now lost importance. Balancing financial stability and growth must consider the law of diminishing returns. In 2010, financial stability reforms were needed. Now, the impact on the economy is potentially more negative than the small benefit expected on the financial stability side.

An international public decision maker stated that the commitment not to increase overall capital requirements was at the global level, not for individual banks or jurisdictions. The Basel Committee agreement was at the end of 2017 and the G20 in 2018. Knowing the substance, content, and details of the agreement, its statement asked for a full, timely and consistent implementation. That is the political background of this technical exercise.

3. Complying with the international agreement requires a faithful implementation of the agreed framework, should avoid a significant increase in capital requirements and should preserve a level playing field between banks. EU implementation should target similar outcomes to other regions

An official commented that the Basel agreement is an important milestone for consistent prudential requirements and must be transposed faithfully and consistently in Europe. The G20 gave the Basel Committee a political mandate, as a multilateral political authority, for no significant increase in capital requirements and preserving a level playing field. That does not contradict the goal to improve comparability and soundness of risk-weighted assets but, at macro level, the political mandate is valid and more acute than ever. The time to get such standards is long, while the world goes faster. That does not mean giving up on Basel standards, it means considering the world as it is. For Europe, whatever the technicalities, the end result should be no significant capital requirement. If it is an average, it must be weighted to assets, to preserve a level playing field. There will be discussions about technicalities to achieve that, but it means being faithful to what was agreed and respecting the political mandate.

With the Basel agreement, as with any text, there is room for interpretation and discussion. The spirit might be discussed, but there is also the letter, which was heavily discussed and negotiated. The text was written carefully and being faithful to what is written is vital. Basel III's standards show the parallel stack is Basel's stack. A single stack in the European framework would be an over-transposition of the Basel agreement. The political mandate must be respected as giving credibility to Basel, and not doing so would question the trust placed in such multilateral exercises. Since these are valued, respecting the political mandate must be balanced with the best means to achieve it, being fully open but having this discussion in a trustful, faithful manner.

An official stated that it is vital to commit to a consistent and timely implementation of the final Basel III reform package, particularly for internationally active banks in Europe who must meet international standards. The balance must be struck between increasing banks' resilience, complying with international standards and preserving the ability to finance the real economy. It will soon be the 13th anniversary of the Lehman Brothers bankruptcy, and many remember those days. It was agreed that banks should have more capital, so a reliable and resilient framework for banks is crucial. Thanks to the Basel III reform agenda, the sector entered the COVID pandemic much better prepared. Banks have more capital, more liquidity and are far less leveraged than in 2008. Supervisors used the flexibility embedded in the regulatory framework during the COVID crisis, and the banking system has weathered the pandemic and shown resilience.

While increasing banks' resilience, the final Basel package must be in line with and not endanger real economy financing. The G20 expects that overall capital requirements will not significantly increase due to the final package, and colleagues in the Council and the Parliament have reiterated this commitment. Dealing with unrated corporates will be important for real economy financing. Most European companies and medium-sized corporates have no rating, and capital markets are underdeveloped to finance them, so a flat risk rate for unrated companies is a risk for the European bank-based lending model. The proposal made with France in 2020 is to apply adequate risk rates for financially sound companies. It is hoped that this can be agreed in the negotiations, to apply Basel consistently and support the needs of the European economy.

An industry representative commented that it is reassuring that speakers respect the political mandate to implement the Basel package without a significant capital requirement increase, which is in the Basel Accords. This decision was taken as, when Basel IV and the finalisation of Basel III was discussed in 2016 and due to the massive capital increase implemented in the post-crisis reforms, the level of bank capital was deemed adequate as an average and, although it may differ from one bank to another which is another topic to be addressed by supervision, not regulation. The capital market business is global beyond Europe and needs full alignment with US rules. In the past, Europe has been caught out by the US as ultimately US rules are becoming market practice not EU ones, so European players are penalised. An example is the day one profit accounting role for capital market activities, which the US considered implementing. Europe rushed to implement it first and then the US decided not to. This penalises European banks by several hundreds of millions per year. Another example is the minimum requirements for own funds and eligible liabilities (MREL) compared to total loss-absorbing capacity (TLAC). There is value in waiting until the US is clear about what to do and then to align, in content and timing, European implementation to the US. That is not to ask for any help or subsidy, but for a perfect level playing field.

An industry representative did not agree that parallel stacks are not compliant. The EBA states this, but without an argument. Legal analysis shows that they are

fully compliant. Indeed, parallel stacking is the right Basel stacking as Basel doesn't impose any Pillar 2.

3.1 Key success factors are consensus building on the rationale for the Accords and settling debates raised by the proposed framework. Addressing EU-specific challenges on Banking Union and SME financing requires defining adequate regulatory approaches for the EU to comply with Basel III

An international public decision maker highlighted comments on the trade-off between financial stability and growth. In the short term, growth may be higher, but at the cost of financial stability, which must be avoided. The ECB Governing Council's statement on the monetary policy strategy review from July is key in affirming that financial stability is a prerequisite for price stability and growth. Technical papers from the crisis show that banks with higher capital lent more. A Basel Committee exercise asked banks to model credit risk capital requirements for the same hypothetical portfolio. The resulting reported capital ratios varied by 400 basis points. This is a lot and is what created much of the non-confidence during the last crisis, so Basel III implementation is key.

A public representative welcomed the recent supervisors' letter, as the Commission proposal is expected and governors will be able to speak to the proposal. There are many European specificities, and perhaps not all of them are Basel compliant, but the Commission must present to the Parliament and the Council a fully Basel-compliant proposal as there will be other opinions from the Council and the Parliament. At least two European specificities can be differentiated, some of them completely Basel compliant in theory. The Basel Committee introduced these options to regulators, but other European specificities are not in the scope of Basel. The parallel stack is not Basel compliant. This is not only personal opinion; it is also the opinion of the EBA, so it is clearly not Basel compliant, although there will be another option to analyse the output floor. Evaluating or calibrating the capital requirement at consolidated level could be a good option to improve Banking Union consolidation.

Unrated corporations are a clear specificity, as Europe does not have the same capital market as the US. Another instrument that is not the same but similar is the SME-supporting factor. Improving the Capital Markets Union (CMU) is also key. Introducing incentives or elements to help the unrated corporation may not set the incentive to improve the CMU, but is also on the table, and is only a first idea. In the current crisis, the European banking system did better than before. The private sector supported SMEs, the real economy and households, but although the banking sector did better, an increase of capital requirement may be needed. This is an element for debate. Another is if financial regulation can advance the green transition. There are elements to increase disclosures and facilitate market discipline, but there should be discussion around a green supporting factor at the ECOFIN, as Finance Ministers must think about adapting fiscal rules to invest more. There is a clear commitment in the medium and short term, and market discipline or non-discretional measures could be needed, if useful and enough to comply with international commitments.

An official stated that there should be a balance between financial stability and financing the real economy. Putting financial stability first is key. An industry representative stated that there is no aggressive modelling in Europe, as after 15 years of implementation of the models, approved by supervisors, there were two EBA repair exercises and a five-year TRIM by the Single Supervisory Mechanism (SSM). The EBA reports showed no excessive variability of European models and that the model's variability is not higher than the one of the standards. Excessive variability or excessive aggressive modelling may exist in the US or globally, but not in Europe. Increasing the capital requirement is a strong incentive to adapt business models. The most impacted banks are those with the lowest risks, especially on mortgage and real estate business. If the new situation prompts an increase in risks in that field, or abandoning real estate financing for more risky businesses, it is not right for financial stability.

An official commented that the ECB studies compare 'pears and apples.' It is not a trade-off between financial stability and the impact on the economy; both must be considered. The ECB states that the impact is recessive for the first eight years, with aggressive assumptions that it is not recessive after that. In the first eight years, France has minus 250 billions of lending capacities - twice and half more than the domestic recovery plan - and the EU minus 800 billion, so of an order of magnitude compared to NextGenEU. This relies on an assumption that should be discussed based on facts. The ECB is thanked for its study, but it is not the end. It should be the starting point for discussions. Sticking to a level of capital requirements in a static way may not be best for financial stability. The ability to generate buffers for banks is also key, and that means profitability. This is a huge issue for the EU banking sector, and it requires a dynamic view. It is disappointing to see in the letter from national supervisors that many of them want a solo application of the output floor, as that frontaly denies the spirit of Banking Union and is against enabling EU banks to invest to manage their capital and liquidity. It is worrying as, if the ECB study is considered, what Europe does may not be in favour of financial stability.

A Central Bank official stated that, in the long run, there is no real alternative between stability and growth, as stability is conducive to growth. In the short run there may be trade-offs, but credit growth, beyond certain limits, is not always a good thing: there was an excessive increase in lending before the crisis, which was not sound; too much leverage can be a problem. Balanced growth can come with financial stability. Financial stability and growth go together. A public representative stated that not only is there no trade-off between financial stability and growth in the medium term, but there is also no trade-off between lending capacity and capital requirements. Perhaps there is in a partial equilibrium model, but not in a global equilibrium model. Banks with more capital requirements can issue more debt or can finance, and other non-banking financial entities in the market can provide finance to the real economy. The trade-off is not useful in the debate.

An international public decision maker noted that these arguments were made during Basel Committee discussions, and the outcome is already a compromise. This is an important moment internationally and the EU must demonstrate its commitment to multilateralism and to adopting a globally agreed message to address global challenges.

3.2 An essential effort to provide is on the proportionality of the framework

An official considered that Europe has good reasons to apply Basel to all banks, but rules must apply proportionately. The last banking package defined small and non-complex institutions, which was key to reducing administrative requirements on smaller banks. The new package should build on this and mitigate administrative burdens as proposed in the recent EBA study on the cost of compliance with supervision. For smaller banks, Basel leaves enough room for manoeuvre, for example, that due diligence requirements for external ratings should be appropriate to the size and complexity of banks' activities, but there is an expectation that a proportionate package will be discussed, as with the last banking package.

A Central Bank official commented that proportionality is one field where European specificities exist. EU regulation should take account of small banks' reality, with the aim not to make the requirements weaker, but to make them simpler. The solo or consolidated application has pros and cons. It must be considered in a reasoned way.

3.3 A cautious implementation of the operational risk part of the framework also deserves attention

An industry representative stated that an element of the Basel agreement that is one of the most challenging to implement but has been less discussed is the operational risk framework. It is the second biggest impact after the output floor and, according to the Basel impact assessment, it could imply an increase on capital requirements of 5%. A discretion used by Europe that does not link capital requirements to past losses could reduce the impact by half. Europe should make use of this flexibility to reduce the impact, but also because operational events are more uncertain than credit or market events, and extrapolation rules are not good predictors of future losses.

Even applying this discretion, the impact of the new standard model for operational risk will be significant for large and diversified banks through two other changes in the reform. The business indicator calculation at consolidated level does not allow diversified banks to take advantage of the "requirements cap" for operations in countries with high interest margins, and the progressive factor on the business indicator penalises large banks. Given the uncertainty of operational events, it would be better to focus on assessing key aspects, such as good governance, forward-looking scenarios and contingency plans, instead of increasing the Pillar 1 requirement.