Basel 3 implementation in the EU: key political stakes

1. Basel III in the EU for better stability of the banking sector

The Chair stated that the European Commission put forward a legislative package with a number of proposals to amend the Capital Requirements Regulation (CRR) and Capital Requirements Directives (CRD) in October 2021. These proposals addressed the final implementation of the Basel III reforms in the European Union. The European Banking Authority (EBA) very much welcomes the Commission's proposal. It believes it is a good step forward in the final implementation of Basel III. Basle III has been so far, a positive step forward in providing stability and resilience of the banking sector in the European Union. This implementation is not just a timely process, but also an urgent one to finalise.

1.1 The role of the European Commission

An official stated that the Commission is fully committed to making this general approach possible if member states want it. All member states seem eager to transpose the Basel standard in Europe without much more delay. The Commission is working hard on this to be one of the first major jurisdictions to transpose the Basel III agreement.

A public representative stated that he welcomes the well orientated proposal. The Commission has introduced many European specificities. Some are not Basel compliant, but even if they are temporary, the Parliament can live with them, at least in theory.

An official stated that the Commission proposal generally tracks the right balance between increasing the resilience in banks and preserving the ability to finance the real economy. All core elements of Basel III are included in the proposal and will be implemented in the European Union.

1.2 The EU's necessary compliance with the scope of Basel III, and the benefits it provides

A public representative stated that European regulation first has to fall in the scope of Basel III. His world will be focused on guaranteeing that what the Parliament and Council approve is fully Basel compliant. Europe has to be a partner in the international arena and banking regulation.

The rationality behind the output floor is important. The risk is a procyclical variable rather than a constant. Basel II reviewed internal models to internalise risk to calibration of capital requirements. However, without an output floor, banking and the financial stability is not as strong as would be desirable. Given that the risk is procyclical, it is necessary to introduce a bolt on to internal models. It is necessary to be aware of this reality and defend the result from Basel III.

An official agreed that it is important for the European Union to remain committed to a faithful implementation of international standards and the final Basel reform package.

An industry speaker highlighted the implementation of Basel III and why the European package should be as close as possible to Basel. He fully agrees with comments of Governor de Cos in his recent speech. Governor de Cos talked about multilateralism and the commitment to it, and the jurisdiction of an industry speaker is also fully committed to full, timely and consistent implementation of Basel III. In addition, in order to compete fairly on a level playing field, it would be useful if it stayed on that international level playing field. As allies, it is important that likeminded jurisdictions stick to international agreements.

An official stated that an industry speaker mentioned a system in Japan for smaller, non internationally active banks and larger banks. There is a different system in the European Union, and there are good reasons to uphold the same financial standards for all banks for a level playing field. That decision was taken in 2006 with the first implementation of Basel, and it is advisable to stick to this approach.

An industry speaker highlighted international comparison and the level playing field. There is a significant increase in the capital requirement for European banks. Following the 22 February 2022 figures of the Basel committee, the implementation of the 2017 Basel agreement would reduce the CET1 ratio of European banks by 300 basis points, which is a huge figure. An industry speaker understands the position of the industry speaker promoting a close implementation of the Basel package since apart from Europe other jurisdictions will have a neutral or positive impact: For America, it is nothing; for the rest of the world, it is -70 basis points. This is a problem. The international comparison is very interesting because it shows that Basel IV will not improve the comparability of bank solvency ratio or the level playing field. Therefore, there is no level playing field and the comparability of the solvency ratio will not be improved by the floor.

A faithful transposition of the Basel agreement would be one that is appropriate to the European context and in view of unifying the European banking market. One of the three overarching principles on the first page of the 2017 package is that it should not significantly increase capital requirements; the implementation of this agreement must observe this objective without a deadline. The speakers proposed in this context that the envisaged level of the output floor would be changed to bring it in line with the non-significant increase in capital requirements mandate.

An industry speaker quoted the result of the 2021 Supervisory Review and Evaluation Process (SREP) cycle published in February 2022. This reflects the resilience of Europe's banking sector amid the strengthening economic recovery. SREP's core remains broadly stable overall with significant institutions maintaining solid capital and liquidity positions and most banks going beyond the levels dictated by capital requirements and guidance. According to the SREP publication, European banks have enough capital. The average Common Equity Tier 1 (CET1) ratio is above 15% with an average requirement of around 10%. This means that there is a 500 basis-point management buffer, and it also explains why the banking sector was so robust during the crisis.

The speaker also stressed that the current framework already hinders comparisons. Indeed, for instance even though JP. Morgan has a higher CET1 ratio (the CET1 was 13.8% for JP. Morgan and 12.9 % for BNPP), at the end of 2021 debt holders considered that

BNPP is less risky than JPM (in February 10th the CDS quoted 58 (JPMC) Vs 39 (BNPP)). Finally, the industry speaker added that the last Basel 3 reforms would further hinder the ability to assess and compare banks' risk profiles. In this respect the speaker first stressed that the evolution of the regulatory framework would not improve banks' comparability since for example the application of the output floor to the residential real estate is expected to double the corresponding risk weighted assets of the French banks. This has the consequence to overlook the level of real risks, since these banks would have the same solvency ratios as higher-risk banks.

In addition, the speaker stressed that although the risk density in the US banks' balance sheet is higher than in the balance sheet of European peers (thanks to Fanny Mae and the securitisation of low-return risks), after applying the proposed output floor, such difference would disappear. Basel 3 reforms may lead to the fact that similar solvency ratios would conceal very different risk profiles.

2. Several remaining challenges

2.1 Finding the right balance while dealing with European specificities

An official stated that this is not a technical package; it is a very political one. The package has a very differentiated impact on banks, business models and member states. The starting point is that member states are coming from very different places, which explains why this is a difficult negotiation. It is also being conducted under the eye of a supervisor with its own views that it has expressed forcefully on certain issues. However, it is also for the colleges to decide, and the economic impact of the package must also be considered. Secondly, the Commission has taken the first step to address this in this proposal. Some Commission proposals are somewhat controversial.

However, the Council is still split on very structural elements of the Commission's proposal. Some member states also asked for a more level playing field between banks in the standard approach and internal model, while others asked for more proportionality. All of this needs to be considered to find a compromise. Taking this into account, there will also be a phase of negotiation in the European Parliament. It is necessary to ensure a compromise that is also acceptable for the European Parliament.

A public representative stated that there are some European specificities, most of which are in the proposal. He can live with them as transitional arrangements. However, other players in the Parliament and the Council intend to keep them permanent. This way, if the Parliament changes or lets the Commission review the current period of the transitional arrangement, there is a high risk of the European regulation not complying with Basel, not only in the short term but also from a structural point of view. This transitional arrangement is tolerable, so a public representative believes as a rapporteur that it should be kept permanently.

An official stated that the situation looks more like a trade off from the financial stability perspective of host countries like Lithuania. This is also the situation when a better capital position of banks at the aggregate level may come at the expense of worsened liquidity situation of banks in host countries. In this case, it is desirable to see not only a trade off between additional capital requirements and financial stability issues, but also some more balanced solutions. Capacity of banks to finance the real economy in host countries is also a key issue. Lithuania would like to have adequate safeguards in place for ensuring financial stability.

An official stated that this is a very positive proposal for the Commission to provide some transitional arrangements with regard to European specificities for the transitional period. This will give European banks sufficient time to adapt to the new regime.

2.2 Strengthening proportionality

An industry speaker suggested that some panellists look at examples showing how the US deals with the proportionality issue. Japan also has a proportionality approach. It distinguishes between domestic banks and internationally active ones. Having different requirements for those two groups helps to ease the tension between the need to cater to regional specificities and the need to keep an international level playing field. Proportionality works and is a good idea.

An official stated that she has three complete examples of where it is advisable to further strengthen proportionality and give comfort to smaller and medium sized banks. First, the Commission plans to introduce new requirements for material transfers. Second, there is a definition for small and non complex institutions from the last banking package. Third, smaller banks should have sufficient time to adapt the standardised approach and updated framework.

2.3 A European package still under construction and the question of capital requirements

A public representative stated that he welcomes the Commission's proposal to calibrate the output floor at consolidated levels. This is a good idea in the process of advancing the banking union, but it is also not possible to advance much on this matter without a truly European deposit insurance scheme (EDIS). The concerns of host countries are understandable when the regulation and supervision are European, but if there is any kind of problem, the national taxpayer will pay the cost through the national deposit insurance scheme. A public representative understands these concerns. Even if the proposal is well oriented, other capital waivers might be introduced in the regulation subject to real advances in the regulation of EDIS.

An official stated that it is necessary in the longer term to find credible solutions to increase the rating coverage to avoid extending the transitionary period. For the moment, it is important to have these types of transitional arrangements to allow the European economy and its banks to adapt with the new regime. Beyond the Basel implementation, the Commission has also proposed amendments to the existing regulatory regime. There is room for improvement in several areas here.

The Chair highlighted the quantitative impact of the reform. Both Basel and the European Council reached an objective that there should be no significant increase in capital requirements for the banking sector. Of course, that objective does not mean that the reform should not have any significant impact on every individual bank. There is also room for interpretation of what is considered significant. The current Commission proposal estimates an increase in capital requirements of between 7% and 8%. This is likely an overestimation because there are existing capital buffers that may be adjusted once the reform is in place, like some Pillar 2 adjustments, and part of the impact has been taken care of through bottom up repair. The Chair asked if the capital increases that may be necessary in some of the banks are intended consequences of the reform.

As highlighted by an industry speaker, the internal ratings based (IRB) repair programme targeted review of internal models (TRIM), combined with the wider context of issues already led to a capital increase for banks. Individual parameters can lead to a credit risk weighted asset (RWA) increase of 5%, or even 10% in some banks. Very small items can have significant outcomes. In the EU banking package, the key questions are whether this is justified; if it is due to risk variability, or if this is non warranted variability and RWA are being reduced.

A public representative stated that he does not buy this potential trade off between capital and loans. No fact can justify more capital representing less loans or less investment to the real economy; this is a fallacy. Basel II reintroduced the risk sensitivities in models, but the risk is not constant. It is a procyclical variable. 'Same risk, same regulation,' means 'Same risk, same capital requirements.' If the risk changes, it will be necessary to change the capital requirements or try to move the risk and the capital requirements.

A public representative stated that he can well understand the concerns in the host countries regarding the Banking Union. EDIS has been blocked for many years, and some countries do not like to take more steps in the banking union without any common insurance. Because the Commission opened this debate with its proposal to calibrate on the capital requirements in the case of the output floor at consolidated levels, there is at least a way to analyse if there is a moment in which to link this option that the Commission proposed to the advances in EDIS.

2.4 Could changes in the banking system have negative impacts?

An official reported the need to be cautious when changes are made in the banking system because this might have a negative impact in some regards. This is why Lithuania is looking with some caution at the Commission's proposal, particularly the issue of calculation of the output floor. Lithuania supports making the banking system stronger and more stable, but is concerned about some deviations from the Basel III standards in the proposal, which could alter the current fragile balance between home and host countries with regard to supervision of banks.

An official stated that he listens to the impact of some of the rules on CET1 if they are applied as they are. There might be a risk of deleveraging the banks, which will not be positive due to what has to be financed. Prior to the negotiation of the Basel III agreement, the G20 and the Ecofin stated very clearly that this new package should not lead to a significant increase in capital requirements for banks. The issue is what is significant.

2.5 An efficient but complex model?

An industry speaker stated that he understands that supervisors, regulators, and others feel uncomfortable due to the asymmetry of information. These are very complex models and there can be a perception that banks have an incentive to underestimate risks. However, these models are going through a very comprehensive assessment.

First of all, there is the approval process, and there has been a targeted review of internal models conducted by the European Central Bank (ECB). There have been 200 onsite inspections at 65 large banks in Europe which have led to, on average, a depletion of CET1 ratio of 71 basis points. The median is 51 basis points. This demonstrates that risk managers are doing a good job on average. This also gives quite some credit to internal models.

Parameters and internal models are also being discussed. In the IRB repair programme and the TRIM results, certain input parameters for internal models are being discussed where supervisors feel they are too aggressive. They are turned to a more prudential number, which is fine. They are addressing internal models directly. Beyond this discussion, it seems the output floor does not fulfil the objective, as highlighted by industry speaker. More capital adds more stability if that is the objective, but the output floor does not achieve an objective of same risk, same regulation.

An industry speaker stated that he agrees on risk sensitivity. Basel IV is very much a return to Basel I and a standardised approach to the application of the output floor to internal models. However, internal modelling was introduced by supervisors in the late 1990s after standardised approaches were found to be insufficient because they masked differences in risks. Following 15 years of implementation in Europe, a validation period of controls by supervisors, a repair exercise by the EBA, positive reports from the EBA on the stability of models, and an in depth review of the internal model by the Single Supervisory Mechanism (SSM) known as the TRIM exercise, it can be affirmed that they represent the most reliable measure of risk in Europe.

3. The steps going forward

3.1 There is room for improvement

An official stated that the financing of a real economy should ensure that European corporates have access to banking services from abroad. The Commission proposal might seriously limit the access of banks and other professional clients to financial services from third countries. The proposal should allow broader possibilities for the German Federal Ministry of Finance to provide cross border services in a balanced way.

Secondly, more proportionality is necessary. The Commission proposal is on the right track regarding the Basel implementation, but it should be more proportionate and contain new elements of the package beyond Basel.

An industry speaker stated that there might be room for improvement to reach the agreement. Once there is an agreement, it is important to stick with it as much as possible.

If the US decides to delay, then Japan is likely to also delay along with Europe and the US. This is positive from a competitive equality perspective, but it might not be from an international agreement perspective. It might be advisable to consider how to improve the process in the future.

An industry speaker stated that the process currently works in a certain way. There are four steps: the Basel committee publishing a consulting paper, the committee reaching an agreement, each of the jurisdictions putting their domestic rule making proposal out for public consultation and the regions reaching a conclusion on the rules. It might be better to switch the second and third steps so that all the necessary inputs have already been considered when the international agreement is being negotiated. This is going to be a choice between a more difficult process with an agreement that might have a better chance of being adhered to and an easier process with a lower probability of an agreement being adhered to.

3.2 Facing new challenges: how to finance the economy going forward (ESG, digitalisation, competitiveness...)

The Chair stated that the French presidency in particular is concerned about having a strong financial sector and a strong sector will help to finance the economy going forward.

An industry speaker stated that the opportunity of the banking package is to finalise the implementation of Basel III. This is a key reform to allow turning to the other elements under discussion and other challenges, such as environmental, social and governance (ESG) and digitalisation.

An industry speaker highlighted the financing of the economy. Huge investments in the future will be necessary due to a geopolitical crisis, digitalisation Europe lagging behind Asia and the US and the climate transition. Capital requirements are a way to oblige banks to deleverage and reduce their risks in proportion to their capital. It is necessary to think twice before implementing this 2017 package.

An official stated that the aforementioned is a key question. In order to sustainably finance growth, a resilient financial sector is necessary, and Basel is an important part of it. However, it is a matter of definition, but it is advisable to be clear that banks need to finance several important challenges ahead. The banks have been important partners of member states in dealing with the pandemics. The panellists are also counting on them to finance the green and digital transitions. For that purpose, it will be necessary to have a very competitive bank.

An official stated that one of the main themes of the French presidency is switching the narrative from risk reduction to competitiveness of the financial sector. This means a more integrated financial sector that completes the banking union. This will obviously consider the concerns of host countries and the Capital Markets Union (CMU) because both work in the same way. Banks and financial markets are working together to ensure a competitive European Union.

An official stated that the main question is how to adapt the economy to apply the rules and adapt to the new programme. The Commission proposal to have transitional arrangements is very positive.

A public representative suggested thinking more about climate and crypto asset risk. This topic will definitely be on the table in the European Parliament.

3.3 Building trust to make progress all together

An official highlighted the lack of trust between different stakeholders. Currently we have a fairly fragile balance between the home and host countries. We should avoid creating a precedent changing that balance as it could aggravate progress in the broader strategic debate on completing the Banking Union and future decisions in this regard. If we want to establish trust between all of the players, we need to agree on moving in all directions at the same time. Fully-fledged EDIS would have a much larger impact on completing the Banking Union while ensuring financial stability than just altering capital requirements.