Basel III implementation: global consistency challenges

1. Basel III implementation process

1.1 Important stakes behind the implementation of the latest Basel III package

An industry representative stated that Basel III has been discussed extensively, and the journey has started to ensure that banks are adequately capitalised for the risks that they take. Where banks are overcapitalised relative to their risk, the pricing ends up being uneconomic. The non-bank financial sector then steps in, and banking activity moves outside the regulatory perimeter. When banks are inadequately capitalised for the risks through the credit cycle and macroeconomic cycles, there are bank failures and financial stability concerns. Therefore, stakes are high. The Basel Committee on Banking Supervision (BCBS) sought to devise a solution that took local specificities into account but addressed the same risk with the same regulations.

A regulator explained that the EBA strongly believes in and works very hard on the standards negotiated, and the Basel standards already incorporated many of the national idiosyncrasies brought by various jurisdictions, including the EU. Basel III, being more recent, is more appropriate to ongoing idiosyncrasies of the European Union. The level of need to have specificity is decreasing.

1.2 In the EU the outcome of the trialogue is expected at the end of September 2023, though various issues are still being negotiated

A public representative stated that the objective of the negotiation team is to finalise the negotiations during the current semester. There have been two political trialogues, but not much advancement and the political problems remain. The Swedish presidency and the negotiation team from the European Parliament has not moved from its initial position in the negotiations, nor has the Council.

The European Parliament wants a clear end date to the transitional arrangement in the regulation but there has not been much advancement in this area. There has been no advance on other issues such as third-country branches, fit and proper chapter, ESG, and crypto.

There will be another trialogue in May and two in June. Aside from the political issues, the teams from the Parliament and Council have been working well at a technical level. Hopefully negotiations can be finalised in the next three political trialogues. A regulator hoped that the negotiations will be finalised by the end of September in line with timely global implementation.

1.3 In the UK, the aim is to have the rules effective from 1 January 2025. The consultation for implementing the last Basel 3.1 standards received significant feedback from industry

A Central Bank official stated that the set of objectives provided by the UK government included safety and soundness, and also competition, and UK competitiveness and alignment with international standards. The package is in line with the overall Basel approach, where the aims were to make the standardised approach more risk-sensitive, and to put a cap on the degree to which risk weights can be driven down using models by creating a new the output floor. The Bank of England had looked to align with international standards for safety and soundness reasons, with some targeted adjustment taking into account UK evidence.

The name 'Basel 3.1' might suggest that the package is small, however this is not the case. The Bank of England wanted firms to engage with the package and released a large consultation package so that firms can understand the thinking and provide feedback. The firms sent thousands of pages of feedback, which is positive, but will take time to review, triage and catalogue. With regards to timing, the aim is to have the rules effective from 1 January 2025, in line with the EU. Alignment across the major financial centres would be an advantage. The Bank of England will keep a close eye on the other jurisdictions, including the EU.

It was not necessarily the case that the Basel 3.1 package needed to change in response to recent events. This was not because there weren't lessons to learn on Basel 3.1, but because the areas covered by the package were not the main ones affected during the events. Recent events are a reminder that strong global rules that are consistently implemented are advantageous to everyone.

2. Main issues raised by the last Basel III package

A Central Bank official stated that the big issues in the UK are similar to those in the European Union such as the level and scope of the application of the output floor, small and medium-sized enterprise (SME) lending, infrastructure lending, unrated corporates, several issues around housing, credit conversion factors (CCFs) and securitisation.

2.1 Though the EU adjusted the package, EU banks still consider that it should eventually have a significant impact on the level of bank Tier 1 capital and would reduce the risk sensitiveness of the framework, which works to low-risk banks' disadvantage

An industry representative explained that one concern is that the banking package will significantly increase capital requirements in the EU. The latest monitoring report issued by the Basel Committee in February 2023 highlighted that the reform would result in a 19%

increase in minimum Tier 1 capital risk-based requirements for Group 1 European banks. In contrast, the impact on the Americas is nearly neutral, and the rest of the world will have a 4.8% decrease. The banking package being discussed would not dramatically change the impact because, according to the EBA Basel III monitoring report published in September 2022, the fully loaded impact is a 10.7% increase for all banks, a 12% increase for Group 1 banks, and a 20% increase for global systemically important banks (G-SIBS), which provide about 50% of EU financing.

The second concern is that the proposal would reduce risk-sensitiveness and ignore national specificities. Since the US inspired the Basel framework in many aspects, many of its features have been designed to address the specific conditions of the US economy. However, the situation is different in the EU, with a much smaller capital market and an economy based on a majority of unrated corporates, for example. Additionally, the output floor significantly reduces the risk sensitivity on mortgage loans in internal models. After such a reform, large retail banks would be able to double their risk on mortgage loans without any impact on capital requirements. This penalises European banks, which have lower risks, due to the double recourse to debtors and real estate assets, while US banks have recourse only to assets. Solvency ratios may be identical, but they conceal different realities, notably the higher risk density in the balance sheets of US banks, while medium-sized banks, such as Silicon Valley Bank (SVB), generate a $20 billion loss.

The banking package incorporates some adjustments to cope with the specificities. The most significant adjustments are temporary and European adaptations would give only a five percentage-point relief on the increase in capital requirements. This is a limited, temporary adaptation to the EU risk profile.

A regulator stated that there has been a long debate about the quantitative impact and the overall assessment of the impact has been decreasing over time as a result of the enhancing of banks' capital positions. This does not mean that overall capital requirements would not increase as there could be adjustments. It also does not require increases in the capitalisation needs of banks, because the number of shortfalls has significantly declined.

2.2 Smaller banks require simpler rules, not lowered ones.

The Bank of England is developing a regime which is more proportionate and simpler for smaller firms, called Strong and Simple. The idea was that the rulebook could, in certain cases, be too complex for smaller banks. The aim of Strong and Simple is to reduce unnecessary complexity that adds little prudential value for smaller banks, not to lower standards.

An industry representative stated that with regards to proportionality, the key principle is same risk, same rules. The failure of a medium bank in the US recently, 30 years after the bankruptcy of 1,000 savings and loans associations in the 1980s, shows that small size does not equate to small risks. The US example has shown that international standards have limited interests if they apply only to a limited number of banks and without proper enforcement. This also shows that the standard model can conceal the real risks and constitute a weak reference. International comparability will therefore not improve.

2.3 Banks active globally need consistent implementation across regions throughout the globe. However, one already observes an uneven implementation or features within existing standards

An industry representative was fully supportive of timely and compliant Basel III implementation globally and of phase-in periods being as brief as necessary to have an orderly transition to the new capital standards. Banks should be adequately capitalised relative to the risks that they are taking. BCBS will look at all jurisdictions globally, and the implementation will either be largely compliant, materially non-compliant, or non-compliant. There is hope that all jurisdictions globally will be compliant or largely compliant. Recent events such as the US middle-sized bank crisis have been a reminder that consistency of standards is a strength and that confidence in the financial sector is a global matter.

An industry representative commented that this would not be a problem for American banks, because it has no impact. For US banks, it will be easy to implement the reform. There is poor implementation of Basel III in the US because it applies to only 13 banks, with major carve-outs. There is no credit valuation adjustment (CVA) or operational risks in the American standard, so it is a 30% discount. There is also the fact that most banks do not apply these rules, and there is a poor supervision on them.

An industry representative stated that their firm is concerned because banks need adequate capital relative to the risks taken, especially given the macroeconomic challenges. It contributed over $500 million to the Single Resolution Fund levy. The money should not be spent, and the strong capitalisation of the banking sector would be the best thing to inspire confidence, which would be an absolute necessity for financial stability.

2.4 One unsettled issue for banks is that the actual impact of the latest bank regulatory package should be strongly uneven among banks and regions globally, which should trigger significant credit provision policy adaptations and raises level competition issues

An industry representative stated that the finalisation of Basel III, or Basel 3.1, was different from other regulatory reforms seen in the recent past. Basel III was originally focused on the capital itself, whereas it is now focused on RWA, and risk is different in every institution.

There have been many impact analyses with many different banks over the last months and years and the outcome of these impact analyses has been diverse. The average impact was around a 10% and 15% increase in the RWA. The average number is unimportant. More important is that there are institutions that will benefit significantly from the rules. The record is a decrease in RWA of 15%, while the highest increase is 40%. This depends on the business model of the bank and the

market in which it is operating. Banking markets in Europe differ from country to country. The impact is very different between small and medium-sized banks that use standardised approaches, versus large banks that use mostly internal models, especially due to the output floor. Even looking only at small and medium-sized banks, for example, which use the standardised approach, the impact can vary significantly depending on the business model and the type of clients. This is what makes the finalisation of Basel III so different, as banks will react differently to the new rules and will adjust accordingly.

When these impact analyses are presented to the boards of directors of the banks they might indicate, for example, that the total impact is an increase of 8%. The reaction from the boards of directors is that they can 'live with that', but then they are shown a decrease of 15% in one portfolio and an increase of 20% another, which is when they wake up and react. It must be done in a precise and strategic manner.

An industry representative stated that banks' business models would be heavily affected because banks in other jurisdictions would get a competitive advantage. The impact study on banks and the economy published by Oliver Wyman in January shows that on average EU banks face higher capital requirements than their US peers, with 10.6% of Common Equity Tier 1 (CET1) in the EU versus 9.9% in the US. The Basel III framework widens this gap further. In addition, only 13 banks apply the Basel standards, leaving others with weak requirements.

Apart from unfair competition, banks have the means to adapt to this situation by reducing their financing or increasing their margins and fees to cope with the extra cost of capital. The problem would mostly be for European borrowers. Copenhagen Economics published a study on the EU implementation of the final Basel III standard estimating that its finalisation could reduce banks' financing capacity by approximately €3 trillion. Copenhagen Economics also calculated that the annual cost of borrowing in Europe would significantly increase by €25-30 billion overall, and corporate customers are expected to be the most impacted, with an estimated 25-basis-point increase in borrowing costs on average in the EU.

As the regulation of the banking sector is tightening the market is moving. The share of shadow banking increases year on year and the banking sector is increasingly becoming an empty fortress. It is not clear that the overall financial stability would improve.

An industry representative stated that the Copenhagen study sponsored by the European Banking Federation (EBF) noted some methodological limitations. The risk-weighted asset (RWA) density variation between Europe and the US was not considered in the study.

The amount of RWA for the same risk in the US is higher than what it is on average in Europe, and so a lower percentage of capital in the US results in more absolute dollars of capital for many given risks. The US is already subject to an output floor, the Collins floor, which is why US banks have a smaller gap overall in terms of the capital raised. The US has increased its capital adequacy more from the point of the financial crisis than Europe. This has all led to a complex multifactor equation to ensure that the correct financial constraints are priced and considered, including things such as leverage constraints. Marginal economic pricing, rather than regulatory pricing, should be considered.

A public representative stated that there is an easy way to reduce the complexity of the Basel regulation. The capital ratio could be established at 25% and most of the regulation reduced but this would not be a good proposal. On proportionality and the difference between American and European banks, a lobbyist from the European banking sector would not, for example, focus so much on the different impacts between the US and Europe, because markets can understand that the European banks are not well capitalised. Europe will implement the latest Basel recommendations on time and negotiations should be finalised in the next few weeks.

2.5 The actual effect of bank regulation on day-to-day banking business and decisions raises questions

An industry representative commented that the finalisation of Basel III is extremely complex, and it will be important to widen the scope to include Capital Requirements Regulation II (CRR II), because there have been recent changes with a focus on RWA. One example is to look to the derivative transactions between banks. The risk weight changes for a bank using a standardised approach, for example. The CVA risk capital charge would also change. The standard approach for counterparty credit risk (SA-CCR) changed significantly one and a half years ago. There have been many changes in one product, and, for banks, this is an extremely complex tool to handle.

The output floor was a huge complexity. Many banks, including larger ones, focused on their internal ratings-based (IRB) or internal market risk models, but because they never had to calculate the standardised approach, they never paid attention to it. They now must calculate it with the same quality as an IRB approach because it will determine the RWA for the capital ratio. The standardised approach will become the even more important approach. These banks do not have much experience and may still use the old, standardised approach in their impact calculations. An impact analysis was performed and when the new standardised approach was calculated for the first time, it caused a 10% increase in RWA.

One of the biggest challenges for banks is that the output floor introduced non-linearity to the capital ratio, because the output floor was calculated on the highest level. All the RWA would be added up for market risk, credit risk and operational risk, and then the floor would be applied. In the future, changes in trading strategy used in an internal model would influence the RWA of the credit business, because it would have to be somehow redistributed. This becomes more complicated when considering the output floor, in that the RWA could be calculated for one single exposure and result in 100, but when calculating contribution to the total RWA, it will be 80 or maybe 110, causing pricing trouble. The finalisation of Basel III is one of the most complex changes in the framework so far.

A regulator noted that regulation always starts simple with complexity later added. The output floor is a backstop and there is a consensus between the trade-off about the use of internal models calculated entirely by banks and perceived to be being used initially, with the assumption that they would be risk-modelling, and then it is more about optimising capital. In the end, banks usually operate with an amount of capital above the capital requirements.

The opportunity cost of managing that capital is their economic capital, not their regulatory capital, and the pricing should be done on that opportunity cost, not on the regulatory aspect. It is difficult to understand how the regulatory aspect would be the binding part of the pricing rather than the effective economic capital that needs to be used for each product, given that the overall level of capital is above the minimum requirements, including the output floor.

3. Though they do not impact the content of the last Basel III package, important lessons should be drawn from the recent bank crisis

A Central Bank official stated that there are a few lessons, including one on resolution. The speed with which uninsured deposits can run in this digital world means resolution framework needs to be looked at. The need to think about liquidity regulations is driven by the same thing, which is that uninsured deposits can run quite quickly. It was possible that there would not be a wholesale need for big changes in these areas, but it would be important to make sure that these frameworks were working as intended. The resolution and liquidity issues are twinned because they are driven by the same thing. The final point is on interest rate risk in the banking book. Basel has a framework for interest rates in the banking book. What is needed is to check the way everyone has implemented is consistent across jurisdictions.

4. Current negotiations

4.1 The currently discussed transitional arrangements deal with various national/regional specificities, i.e., application of a complex package to banks beyond internationally active ones, local financing specific arrangements and perceived riskiness, role of national and EU level supervision authorities, activities' separation in the UK, crypto assets risk specificities...

A public representative stated that the most problematic European specificity is the decision made by regulators some years ago around implementing the Basel recommendations to every bank. The need to adapt recommendations and guidelines to the different business models constrains the ability of co-legislators to adapt or freely implement, or with more room for manoeuvre for the Basel recommendations. Banks may need time to implement the output floor for the first time, but the real estate exposures cannot be excluded from the implementation of the output floor. Europe would not implement the output floor at all in this case, so Parliament wants to establish a clear end date for the transitional arrangements. A regulator added that there is an additional specificity within the decision to apply Basel to every bank, which is to apply it to every level of application within a banking group rather than only at consolidated levels. This is also part of the agreement on the issue of the output floor between the Council and the Parliament.

A public representative stated that the Council's position is strong on the matter, and they have been unable to take any step in that direction. In Parliament, the argument has been to apply the output floor to both levels. There are fears and a lack of trust in some jurisdictions. The European Deposit Insurance Scheme (EDIS) is not there. The banking union does not work as well as expected in that context. The latest proposal to review crisis management is welcome, but there are not enough elements to incentivise the evolution of the banking union in general.

There are concerns in some host countries on the implementation of the output floor at consolidated levels only, but the position of Parliament is clear. A link between the evolution of the banking union and the implementation of EDIS has been introduced in the proposal. Parliament recognises that there are many elements around the banking union table but could not wait for everyone. There is a way to advance in other elements of the banking union regarding the implementation of Basel.

A Central Bank official explained that on the level of application, the UK has proposed that it applies at the consolidated level, with the addition of ringfenced banks. Ringfenced banks are philosophically viewed as being like a whole bank. The logic of the output floor has been taken to be calibrated and applied at a diversified level, and therefore the highest level of aggregation has been applied. It was also important to take account of level playing field considerations across different types of banks such as large building societies that have internal models.

In the UK, the Bank of England can only make certain rules where the Treasury has transferred the legislation on shored from the EU to the Bank of England. On the prudential treatment of crypto, some of the legislation needed to make the relevant changes hadn't yet been transferred to the Bank of England.

A public representative stated that this transfer is on the table. The European Parliament knew about the Basel recommendations on crypto in December and negotiations were closed in January, so there has been opportunity to introduce some elements. The proposal has not completely closed. Parliament wants to invite the Council to negotiate these articles to implement the Basel recommendations on the matter. The Council is open to debate with Parliament so that there will be at least a partial implementation of the Basel recommendations on crypto.

An industry representative stated that the different risk intensity in the balance sheet of EU banks and American banks is not in the Copenhagen Economics study; supervisors are aware that there is a significant difference in risk intensity. On crypto assets, there are two main issues. The first is to protect the regime set in Europe for the development of crypto. The pilot regime is important, and the Council and Parliament should take that into account. The second aspect is about a level playing field, as European banks do not currently deal with crypto assets. In the future, with proper regulation and supervision, the market will become increasingly safe. There should be no more constraints for the European banking system than other jurisdictions, as this regulation will apply in Europe in five years' time, which is when European banks should be able to compete on the same footing.

4.2 Expected timeframe for striking an agreement in the EU on the package

An industry representative stated that if there is no agreement during the Swedish presidency, there will be a problem in terms of the implementation of the package, as significant time will be needed for this.

A regulator stated that over 100 mandates are directed to the EBA in the implementation of the Basle package. Hopefully this will not be the subject of the discussion at the next panel. An industry representative shared the same view. A Central Bank official did not think that the topic at the next panel would be either Basel III or Basel IV.

A public representative stated that they hope the negotiations are finalised in the next few weeks and there will be agreement during the current presidency. There is more concern about non-banking activities in the financial markets, and the new players and stakeholders entering into financial activities. More needs to be done for a legislative point of view on the matter.

An industry representative believed that Basel III would be finalised on time, and that there would be a Basel IV, Basel V, and Basel VI, as the financial world is developing, and regulators will have to follow. A regulator agreed that this sounds like Basel V. Hopefully progress will be made in making systems more robust and continuing to finance the economy.