Basel III implementation challenges

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The implementation of Basel-III in light of COVID-19

We are living through unprecedented times. The COVID-19 crisis is not only affecting the health of our loved ones but also having a profound impact on our real economy and financial markets. A global challenge of this kind needs to be tackled with common, determined and coordinated action at all levels. Every one of us can, and indeed must, take over responsibility and learn the lessons for the future. If we do, then we will emerge from the crisis stronger. Robert Schuman knew this as long ago as 1950: "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."

Of course, the coronavirus is also impacting the EU legislative agenda, including the implementation of the comprehensive Basel-III reforms. Given the announced one-year deferral by the Basel Committee's oversight body, the legislative proposal by the European Commission – initially scheduled for the second quarter of 2020 – will be postponed according to its Executive Vice-President Valdis Dombrovskis. I very much welcome this decision since it increases the operational capacity of banks to support our real economy at these extraordinary times.

Despite the delayed implementation dates for amongst other the output floor, the revised market risk framework and the Pillar 3 disclosure requirements, the EU must remain committed to the implementation of global rules. We have learned from the financial crisis that banking regulation requires an international response and more cooperation, not less. This has proven very successful: Today, European banks are much better capitalised, have more liquidity and a higher leverage than before the financial crisis – which undoubtedly serves us well during the COVID-19 shock.

To this day, the political starting point is the European Parliament's resolution from December 2016, which urged for no significant increase in the overall capital requirements. While a "23.6 percent increase" is of course significant, the assessment by EBA needs to be seen in a differentiated way. Not all aspects are considered, such as the changes to the Pillar 2 framework. Also, the impact strongly depends on the size and complexity of institutions. In any case, not the percentage itself is the most crucial but the consequences in reality are – on financial stability, our economy, the end-users and citizens.

While the legislative train on Basel-III is delayed, it continues being loaded with the practical experience from all affected stakeholders.

Above all, we must ensure that our banking sector remains safe and strong. Its diversity is a strength to ensure less vulnerability to crisis, better access to finance and more competitiveness. Both, small and large banks must continue to be able to finance our real economy, which has a different structure than other jurisdictions such as the United States. Therefore, there will be no political majority in the European Parliament without the SME Supporting Factor on board, which we have successfully extended during the last legislature.

Certainly, the biggest elephant in the room remains the output floor. While its implementation is necessary to live up to our global promise, all options on its calculation remain on the table for the European legislator. Due to reasons of a level-playing-field, the necessary financial integration, comparability and lower implementation costs, its application on the highest level of consolidation seems most justified.

Various other screws will need to be adjusted. We must find a European answer to the treatment of unrated corporates as well as equity exposures and need to take the European particularities of financing businesses into account – such as commercial and real estate loans, leasing and specialized financing. And we need to continue our progress on better regulation and proportionality while preserving our Single Rulebook and balancing the risk sensitivity, simplicity and comparability of the framework. If done right, all these principles are not contradicting, but complementing. They go hand in hand.

While the EU legislative train on the Basel-III reforms is delayed, it continues being loaded with the practical expertise from all affected stakeholders – taking also on board their experience with the current impact of COVID-19.

Once the Commission's proposal is then on the table, the European Parliament will live up to its responsibility as co-legislator to ensure the legislative train arrives safe and well.

Eva Wimmer

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Finalizing Basel III – A regulatory foundation for a resilient banking system that supports the real economy

The finalisation of Basel III is an important milestone for the European reform agenda following the global financial crisis. In December 2017, the group of central bank governors and the heads of supervision (GHOS) adopted the final Basel III reform package. The aim of this package is to complete the reforms to global banking regulation initiated after the global financial crisis. Its European implementation will strengthen the regulation, supervision and risk management of banks operating in the European Union.

The Covid crisis shows the importance of sufficient capital and liquidity buffers. Buffers help banks to withstand stressed situations and enable them to provide necessary financing to the real economy in times of crisis. We should build on the lessons from the current crisis and implement the final Basel III agreement in a consistent way.

At the ECOFIN meeting in July 2016, European Finance Ministers have already noted that the reform package is not expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions in the world. Likewise, Finance Ministers and Central Bank Governors of the G20 concluded in March 2017 that the finalisation of Basel III would not significantly increase overall capital requirements across the banking sector, while promoting a level playing field.

For the German government, in addition to avoiding a significant increase in overall capital requirements and to securing a level playing field in global regulation, it is of utmost importance that the financing of the real economy, including the financing of unrated corporates and small and medium size enterprises, will not be negatively affected, and that the principle of proportionality is respected. The principle of proportionality is now a well-established principle in the Basel framework as well as in the EU regulatory and supervisory framework. It deals with the question how regulatory requirements to non-internationally active banks, especially smaller and less complex ones, can be tailored.

Other important topics include the implementation of the output floor, credit risks related to unrated corporates, commercial as well as retail real estate, equity and specialised lending as well as operational risks.

The aforementioned goals and topics will require further discussion once the European Commission has tabled its legislative proposal. The recent decision by the Basel Committee to postpone the implementa-tion date by one year will give us sufficient time. The Basel Committee reaffirmed its expectation of full, timely and consistent implementation of all Basel III standards. We should use the additional time wisely to enable banks to prepare for the new package as soon as possible. The objective is clear: The final Basel III package should be transposed into European law so that its stepwise implementation starts January 1st 2023 onwards until full implementation in January 2028. This will enhance the resilience of the financial system and will contribute to strengthening the European banking system.

The incoming German presidency is looking forward to the legislative proposal by the European Commis-sion and we will strive to enable constructive exchange and facilitate effective discussions within the Council of the European Union.

Alban Aucoin

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Financing the economy today, a necessity not an option

Successive reports, impact analyses and opinions on the Basel IV implementation, together with their respective figures persistently show negative and even alarming consequences for the European banking sector and for the economy. Whatever the results of these estimates, they are significant and inconsistent with the original G20 and European mandates of no significant increase in capital requirements (+23.6% for European banks).

Furthermore, Basel IV will significantly increase financing costs for European businesses and households, which will bring about costs far exceeding potential benefits. According to a recent study by Copenhagen Economics, the impact of Basel IV may reduce the credit capacity of European banks by €2,900 Bn, business investment by €700 Bn and European GDP by 0.4%.

Meanwhile we are facing a dramatic situation due to the Covid-19 pandemic around the world. The full economic impact is difficult to foresee, but it will be very substantial across the European Union. Taking into account the extent of supply side disruption in the productive capacity of countries and in global value chains (including intra-EU and extra-EU), and the severe drops in demand, we can reasonably expect this crisis to be deeper than the 2009 recession. Its long-term consequences will affect the recovery of our economies and societies, and profoundly change the economic context.

This time around, banks are neither the symptoms nor the causes of the crisis, but part of the remedy. European banks are now well capitalised and sufficiently strong, as a result of the accumulation of requirements (Pillar 2, MREL and additional counter cyclical buffers) which have no international equivalent.

In that regard, they can be relied upon when it comes to providing the necessary services and liquidity support to their clients, especially SMEs. In parallel, European and national authorities have taken extraordinary economic, supervisory and regulatory policy measures, to facilitate the steps banks needed to take to address the emergency efficiently and keep financing the economy to the best of their ability.

In the same vein, the BCBS considered appropriate to postpone for one year the implementation of Basel IV, acknowledging that it would help "to provide additional operational capacity for banks and supervisors to respond to the immediate financial stability priorities resulting from the impact of the coronavirus disease (Covid-19) on the global banking system". Additionally, the European Commission decided to use this extra time to adjust its work programme to the new priorities that would emerge from the crisis. Furthermore, in its 20 March statement, the ECB also announced a higher than expected capital-to-lending ratio to free up prudential capital: "a capital relief amounting to €120 billion could be used to absorb losses or potentially finance up to €1.8 trillion of lending".

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Somehow, both the BCBS and the European authorities admitted that, these additional requirements were likely to hamper banks' capacity to provide the adequate financial support to the economy, in response to the Covid-19 crisis.

The wake-up will be painful. Nevertheless, our collective task will be to rebuild the European economy, while drawing the lessons from this crisis. This will likely mean reviewing current policy priorities to focus on addressing the economic and social impact of the crisis. Banks are ready to keep playing their part and to provide massive funding to reach a stable economic balance. This however requires regulatory stability. The current crisis has proved the adequacy of the current high levels of capital and liquidity, and the appropriateness of the authorities' toolbox.

There is no evidence of a need for a significant capital increase, but there are clear signs of low profitability. The crisis also revealed the negative impact of pro-cyclical regulatory measures. The current situation provides the opportunity to put into perspective the EU prudential framework and the concrete evidence of the Basel IV impact to focus on what is efficient to pull the economy out of recession and support economic growth in a sustainable and less dependent way.

Stefan Simon

Designated Chief Administrative Officer, Deutsche Bank AG

Striking a balance – implementation of Basel prudential rules

The capital and liquidity reforms implemented in the wake of the financial crisis proved their value with the resilience of European Banks in the face of the economic shock caused by COVID-19. The ability of the sector to keep the EU financial system functioning through this period of stress and be in a position to provide credit to clients at their point of greatest need was testament to the work done to enhance the regulatory framework over the past 10 years. The EU banking system was less leveraged, more resilient and significantly better capitalised as a result. Average CET 1 was c.30% higher for large internationally active banks in Europe in 2020 than 2010.

The extraordinary challenge posed by COVID-19 has also highlighted how important it is for banks to be able to mobilise to provide lending support to European businesses. A less efficient, less risk sensitive capital regime might have left the banking sector less resilient and could constrain EU bank's ability to play their part in supporting recovery. The importance of striking the right balance in the implementation of prudential rules and value avoiding unintended increases in capital are clear.

It is equally clear that balance cannot come at the expense of a consistent approach to the application of standards globally. Members of the Basel Committee have an obligation to promote financial stability and enhance the quality of banking supervision in their jurisdictions. When implementing rules agreed at the international level into local legal frameworks it has always been accepted that there may be need for some deviation from literal transposition – the important point is to retain overall equivalence.

As Europe focuses on recovery in the wake of the economic shock caused by COVID-19, it will be all the more important that the final Basel III reforms are implemented without triggering unintended significant increase in capital. The desire of the Basel Committee to enhance the comparability of prudential models and reduce variability of outcomes through the final Basel III did not assume a significant shortfall in levels of capital within the banking system. However, that is exactly what the European Banking Authority's impact assessment of summer 2019 tells us will be the result of implementation in Europe, with an average increase of over 24% in the risk weighting of EU bank balance sheets. Even if a lower average of 10-15% is assumed, as suggested by the European Commission, some banks would be still seeing a much larger increase than that. Even an increase of only 10% would be seen as significant and would have direct consequences for the real economy and the proposals analysed by EBA would see European businesses find it more expensive to hedge financial risk, or to finance investment, undermining growth and investment that we all hope to see following the shock of the pandemic in 2020.

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Addressing these consequences will not require divergence from the globally agreed Basel framework, but calibration of specific rules to preserve existing risk sensitivity. In the absence of external ratings for the vast majority of EU corporates, it makes sense to look for other reference points – parent ratings, or internal model risks buckets – in order to avoid having to apply a blanket RWA that does not effectively differentiate between risks.

Equally, better aligning the capital cost of derivative exposures under the standardised approach to counterparty credit risk with the reality of risk – as has been done in other regions - would seem like a sensible approach. Avoiding the double counting of risks currently addressed through EU specific capital add-ons and aligning the scope of application for the output floor with international approaches – a so called 'parallel stack approach', would provide a further opportunity to maintain risks sensitivity.

Europe has put in place much of the new Basel framework whilst preserving sensitivity to EU specific risks. That system has so far proved resilient and we need to ensure that balance between risk sensitivity and resilience is preserved as the final elements of Basel III are implemented.

Dan Sørensen

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Time to reconsider the implementation of Basel III Finalization

The regulatory tightening of the financial sector following the financial crisis of 2008-9, with Basel III 'pre-finalisation' standards at the forefront, has made banks far more resilient and ready to face the next crisis. Right now as a result of the Corona virus pandemic, this crisis has occurred with a paralyzed real economy. This crisis may prove to be one of the fastest growing global recessions ever with long-lasting negative economic consequences.

It is therefore now that the updated framework on micro level (tightened requirements of development and use of internal risk models, better through-the-cycle provisioning and management of distressed exposures and sufficient buffers of highly liquid assets) as well as on macro level (better and larger capital base, building buffers in good times, buffers for systemically important banks and a stable funding structure) must stand the test and prove that banks are now part of the solution and not part of the problems in a global recession.

Looking forward, the final piece of new global standards in form of Basel III Finalisation is yet to be implemented in Europe. It is positive that the BCBS has decided to postpone the global implementation. However given the current 'live stress test' scenario, it should be strongly considered to assess the extent to which the already implemented Basel III 'pre-finalisation' framework will prove sufficient to deal with severe crisis situations.

The Basel III Finalisation standards have not been calibrated taking European specificities into account. In fact, European specialized low risk banking business models might end up being less resilient in a crisis. European banks have a much larger share of low-risk lending on their balance sheets compared to e.g. US banks, something that will be severely punished by the new 72.5% output floor which will greatly increase REA levels and thus capital requirements in spite of no clear risk reduction effects. An example is Danish mortgage lending with especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn in capital – corresponding to a 34% increase in capital requirements.

Thus, with the prospect of such a massive increase in capital requirements, for many banks it would be best to drop the low-risk business activities and instead onboard far more risky exposures into the lending book.

In spite of this, EBA has made clear that they recommend a full implementation of the Basel III Finalisation standard with no accommodations to the European context and applying the output floor to the full stack of European capital requirements. This seems ill advised.

Specialized low risk banking business models might end up being less resilient in a crisis.

There is no clear reason why the European financial sector – and thereby the real economy – should be treated so harshly in spite of the lower risk on balance sheets. A better solution could be implementing the output floor as a parallel backstop requirement based on the Basel capital requirements only rather than the full stack of European requirements. Such an approach would even be closer to the letter in the Basel standard and would retain the incentives for real risk management in European low risk lending.

The reforms implemented immediately after the financial crisis were well-founded and addressed fundamental lack of risk management in certain parts of the financial system. With Basel III Finalisation, this fundamental motivation for risk management is undermined and the ability of banks to make quick and flexible adjustments and support of the real economy in a crisis is reduced.

Based on the current shock to the global economy, it is time to reconsider the implementation of the Basel III Finalisation framework.

Jérôme Reboul

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Ministry of Economy and Finance, France

How to implement Basel III finalized without deviating from the 2016 political mandate?

The upcoming legislative proposal from the European Commission will aim at transposing the December 2017 Basel III agreement into EU law. One of the stated objectives of the agreement is to limit excessive variability in the calculation of risk-weighted assets.

At the same time, G20 leaders in Hangzhou in 2016 and EU Finance Ministry in the Ecofin of July 2016 clearly set their expectations that the finalized Basel III agreement should not result in a significant increase in the overall capital requirement for the banking sector and in significant differences for specific region of the world. Finding a balance between simplicity, comparability and risk-sensitivity will be the main challenge of the European implementation of Basel III. Two main topics will need to be addressed.

First, the issue of prudential incentives.

In order to limit the aggressiveness of risk-weighted assets that stem from internal models, the Basel Committee on Banking Supervision agreed to implement a capital floor - known as the output floor -, aiming at complementing the risk-weighted capital ratio and the finalized leverage ratio. The output floor will constrain the use of internal models, partly overlapping with the TRIM exercise from the ECB and the IRB Repair Roadmap from the EBA, while reducing the risk sensitivity of the prudential framework, one of its most important pillars.

Low-default portfolios, that have hence historically received favorable risk-weighting, will be the most heavily penalized by the floor. The one-size-fits-all characteristic of the output floor may lead to an unsatisfactory and prudentially-counterintuitive outcome. This all-encompassing feature of the output floor might prove damaging taking into account the different banks' balance-sheet structures between jurisdictions.

Second, the issue of the capital impact.

Additionally, according to the EBA impact assessment, this output floor will be the main driver in the increase of capital requirements in the years ahead for the European banking sector that are estimated to be around + 24% overall. It is moreover noticeable that the impact of Basel III finalized will be unevenly distributed, the European Union being the only jurisdiction suffering from a substantial increase in own fund requirements. This directly related to the political choice that was made years ago to authorize internal models subject to strict supervisory approval and review.

Consequently, taking into account this two-fold departure from the political mandate, the postponing of the release date of the European Commission's legislative proposal should enable stakeholders to reflect on the most appropriate way to implement Basel into EU law in order to help mitigate the impact of Basel III finalized on the capital position of the European banking sector in order to stay within the remit of the 2016 political mandate.