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Securing a robust recovery: how can banks be part of the solution?

Much has been said about how the banking system has remained broadly resilient thus far during the pandemic, and how banks have not been part of the "problem" to date in exacerbating the economic crisis. This is in no small part due to banks entering the pandemic on a much more resilient footing than was the case during the Great Financial Crisis (GFC), thanks to the initial set of Basel III standards and ongoing cooperation among Basel Committee members. In addition, the unprecedented range of fiscal and monetary policy measures to support the real economy have largely shielded banks to date from losses and the crystallisation of risks.

While the trajectory of the pandemic continues to be highly uncertain, it is clear that risks to the global banking system may heighten over the coming period. Bank losses could begin to materialise as a result of the unwinding of support measures and broader macroeconomic dynamics. The potential permanent economic "scarring" from the crisis, alongside rising debt levels, could increase the longer-term structural fragilities of banks' balance sheets. It is therefore critical that banks and supervisors remain vigilant to these risks.

Looking ahead, how can banks and authorities best ensure a robust and sustainable recovery?

A crucial factor to achieving this outcome is the full, timely and consistent implementation of the outstanding Basel III reforms. These reforms tackle some of the glaring shortcomings in the banking system exposed by the GFC, including the excessive degree of variability in banks' modelled capital requirements, the lack of robustness in mitigating banks' operational risks, and, ultimately, the credibility of banks' reported capital ratios.

Recall how, at the peak of the GFC, investors lost faith in banks' published ratios and placed more weight on other indicators of bank solvency; when asked to model capital requirements for the same hypothetical portfolio, banks' capital ratios varied by 400 basis points. In a similar vein, banks' operational risk models lacked robustness, with losses incurred by some banks far exceeding their estimated capital needs.

Covid-19 has only further reinforced the importance of addressing these fault-lines. It has underscored how a functioning banking system is one that is resilient and capable of absorbing shocks instead of amplifying them. A banking system underpinned by prudent global regulatory standards is also better placed to maintain the provision of critical services to households and businesses. Yet structural flaws and frailties in the banking system would remain unaddressed if jurisdictions do not implement Basel III in full and consistently.

The Basel III reforms have benefited from an extensive consultation process with a wide range of stakeholders. They are by design a compromise that reflect the different views of our members. They have been calibrated based on rigorous quantitative analyses and meet the Committee's objective of not significantly increasing overall capital requirements at the global level; capital requirements would increase by less than 2% in aggregate. Of course, some "outlier" banks may face higher requirements as a result of aggressive modelling practices, for example. Even in those instances, the implementation timeline includes sufficiently long transitional arrangements: the final element of these reforms will be implemented by 2028, fully 20 years since the GFC.

And it is increasingly clear that the Basel III reforms will have a positive net impact on the economy, as highlighted by a growing set of robust empirical studies. Safeguarding the resilience of the banking system through prudent and credible global standards will help reduce the likelihood and impact of future banking crises. Moreover, as the current crisis reminds us, it is healthy and well-capitalised banks that are best able to support the recovery by lending to creditworthy households and businesses.

Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. It is in all of our collective interests to lock-in the benefits from the Basel III framework by implementing the outstanding standards in a full, timely and consistent manner.