IMPLEMENTING BASEL III IN THE EU

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Covid-19 and the Basel framework: emerging lessons

The financial turmoil caused by the Covid-19 pandemic is the first global system-wide stress since the finalisation of the Basel III framework. While the pandemic is still far from over, the Basel Committee has started to evaluate the impact of the Basel III reforms on the global banking system and the economy. What early lessons can be drawn thus far?

First, in contrast to the Great Financial Crisis, when banks were a source and propagator of stress, the banking system has thus far remained resilient and has continued to provide core financial services to help cushion the impact of the pandemic on the broader economy.

Two main factors are behind this positive outcome. First, Basel III greatly enhanced the resilience of the global banking system, with banks entering the pandemic with higher levels of truly loss-absorbing capital and liquidity. Better capitalised banks increased lending to households and businesses more than other banks, highlighting the positive impact of higher capital requirements. Banks would have faced greater stress had the initial set of Basel III reforms not been adopted. Second, the unprecedented scale and scope of public sector measures adopted to mitigate the impact of Covid-19, spanning fiscal, monetary and regulatory measures, have largely shielded banks from losses to date.

Second, while the Basel III framework has largely met its objectives thus far, some features may warrant further evaluation. These include the functioning of capital and liquidity buffers, the degree of countercyclicality provided by prudential standards and the treatment of central bank reserves in the leverage ratio. Insufficient empirical evidence to date, coupled with the stabilising impact of public support measures, means that it is not yet possible to make any conclusive assessments as to whether any targeted revisions to the Basel framework are necessary. The Committee will continue to evaluate these issues over the coming year, alongside an evaluation of the broader impact of the initial Basel III reforms during the past decade.

Banks would have faced greater stress had the initial set of Basel III reforms not been adopted.

Third, the resilience of the global banking system cannot be taken for granted. As the pandemic continues to unwind, and as public support measures are unwound, additional bank losses could emerge. Rising public and corporate debt levels could increase the longer-term structural fragilities of banks' balance sheets. Additionally, recent vulnerabilities in non-bank financial intermediation (NBFI) have further highlighted the high degree of interconnectivity between NBFI and banks; the risk of spillovers to the latter cannot be excluded.

What are my takeaways from these early lessons? First, the implementation of the initial Basel III reforms has produced clear net benefits to the global economy and society more generally. We have collectively reaped the benefits from Basel III during this pandemic. Let us not forget this lesson.

Second, there is unfinished business in implementing Basel III. The outstanding reforms – encompassing a series of standards aimed at enhancing the robustness and credibility of the risk-weighted capital framework – address regulatory fault lines which remain as important today as they were pre-pandemic. The drafting of this series of standards benefited from an extensive consultation process.

Failure to implement these measures in a full, timely and consistent manner – as repeatedly agreed by G20 Leaders – would result in the remaining structural flaws and fragilities in the global banking system being left unaddressed, at significant cost to the economy and to global financial stability. Covid-19 has highlighted the vital importance of having necessary safeguards in place before the emergence of a shock; this certainly applies to prudential standards and the safety and soundness of the banking system.

Third, in parallel with the Committee's ongoing "backward-looking" evaluation programme, it is crucial to pursue a forward-looking supervisory approach to identifying, assessing and mitigating emerging risks and structural trends impacting the global banking system. Some of these risks and trends – including the digitalisation of finance, climate-related financial risks, and the evolution and sustainability of banks' business models – had already been identified before the pandemic. Covid-19 has further underlined the importance of addressing them.

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Striking the right balance – Financial stability and financing the real economy

Implementing the Basel III finalisation package in European Union law will be one of the major projects for the Slovenian Council Presidency and the following French Presidency. We are expecting the Commission to present a legislative proposal this autumn.

After the Basel Committee had postponed the implementation date by one year, from 2022 to 2023, at the beginning of the Covid-19 pandemic, there is broad political support for initiating the negotiations on the transposition of the finalisation of Basel III. We should continue to aim for a timely stepwise implementation and full implementation by January 2028.

Implementing the final Basel III standards in the EU is an important and complex task. We need to strike the right balance between increasing the resilience of banks and preserving their ability to finance the real economy.

Firstly, a recent report[1]by the Basel Committee on early lessons of the pandemic found the Basel reforms had an overall positive effect on banks' ability to weather the impact of the crisis. As the Covid-19 pandemic unfolded last year, it became apparent that adequate capital and liquidity buffers help banks to withstand stressed situations and enable them to provide necessary financing to the real economy in times of crisis. Therefore, the focus of the final part of the reform on reducing undue variability of risk-weighted assets is contributing to further strengthening the stability of the financial system.

At the same time, the Basel III finalisation package is not expected to result in a significant increase in the overall capital requirements for the banking sector, as agreed on by the ECOFIN finance ministers in July 2016 and by the G20 finance ministers and central bank governors in March 2017. A consistent and timely implementation in the EU that is in line with ECOFIN and G20 resolutions is thus essential to allow banks to continue to be part of the solution rather than the problem in potential future crises.

The package will be a milestone in ensuring banks' resilience and the financing of the real economy.

Secondly, banks' capacity to provide financing for the real economy must be maintained – not just for the immediate recovery from the pandemic, but also in the long term. We should ensure that banks are able to perform this function by taking into account the structure of the European economy and the financial sector. Negative side effects for companies that have not been externally rated (including small and medium-sized enterprises), and which are sound borrowers, should be avoided. This requires a short-term solution that allows institutions to adequately determine risk weights for such exposures. Additionally, we should also seek long-term solutions to increase the rating coverage in the EU for such sound corporate borrowers.

Thirdly, when it comes to smaller and less complex banks, we should not rest on the achievements of the last banking package. Instead, proportionality should remain a guiding principle and driving force of the Basel implementation process. We should continue to reduce the administrative burden for such smaller institutions. In this regard, the recent European Banking Authority (EBA) study on the cost of compliance with supervisory reporting provides a clear path forward. Additionally, disclosure requirements could be waived or reduced for non-listed institutions. Simplifying remuneration-related requirements where variable remuneration is relatively low could also reduce the administrative burden. Additionally, new elements from Basel III such as due diligence requirements for external ratings need to be implemented in a practical manner for banks that do not operate internationally.

The aforementioned goals will require further discussion once the European Commission has tabled its legislative proposal. We want to work constructively on the implementation of Basel III. It is our goal to find sensible solutions for a common approach within the Council of the European Union and to conclude the legislative work on this important file with the European Parliament and the Commission. The package will be a milestone in ensuring banks' resilience and the financing of the real economy.

[1] Basel Committee on Banking Supervision: Early lessons from the Covid-19 pandemic on the Basel reforms. (July 2021). https://www.bis.org/bcbs/publ/d521.pdf

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The case for an in-depth thinking on how to transpose the output floor right

In December 2017, Governors and Heads of Supervision have agreed on the final Basel III package, destined to be the last major regulatory change in the Basel framework. According to the BCBS, the prime objective of this package is to restrict the use of internal models, "restore their credibility", "improve the level playing field", and "increase the comparability of capital ratios". To achieve this, the package further limits the use of modelling of certain risks, introduces several model input floors, and most noticeably imposes an "output floor" (OF) on the risk weighed assets (RWAs).

There is no question that this agreement must be faithfully and timely transposed in every jurisdiction. But it is equally undeniable that in the EU it is up to co-legislators to ensure that the changes to the regulatory framework, given all EU specificities, deliver the intended results while respecting the other constraints set by policy makers.

EU leaders have expressed two such constraints early on, whereby the package should preserve the global level playing field across jurisdictions and ensure no significant increase of banks' capital requirements (see G20 2016/02 and ECOFIN 2016/07).

These political preconditions are legitimate and should not be overlooked: global competition is fierce and EU banks are losing ground; and there is no demonstrable need to increase capital ratios in the EU. In fact, EU supervisors have repeatedly confirmed the strong capital position of EU banks in the aftermath of the COVID shock, and the robustness of their modelling practices via the multiyear TRIM exercise, which has, according to the ECB, "boosted reliability and comparability of banks' internal models".

Looking at the preliminary impact studies of the new package, neither of these two conditions would be met. The EBA estimates that its preferred implementation option would increase capital requirements by +18.5% in the EU, mostly for GSIIs, versus a decrease in capital requirements for G-SIIs in the Americas. This striking result is mainly due to the OF and to risk-weights in the standard approach that inaccurately reflect the EU specificities on crucial markets, such as mortgages. This leaves no other option for EU co-legislators but to look for adjustments when transposing the package.

These design flaws are further reasons to pragmatically adjust the package where required.

Equally concerning is that parts of the package are actually not delivering the intended results. Indeed, the questionable design choice to compute the OF as 72.5% of the sum of standardized RWAs entails that:

- Floored RWAs will not be available at a granular (i.e. portfolio/activity) level, so the OF will not improve comparability, but only add complexity with a second set of RWAs – whatever the option to implement it;

- Banks will be incentivized to increase the relative share of activities for which the impact of the OF is nil or low – without making them safer nor better satisfying the needs of their clients, on the contrary;

- The OF will not discriminate between robust modelling and excessively aggressive modelling since the SA is poorly risk-sensitive, so the size of the add-on will not inform on modelling quality nor riskiness of assets;

- The OF will not be neutral in terms of bank structure – without any rationale for such an output – even if, rightly, the final Basel III package only requires the OF to be applied at the consolidated level, not at the solo level.

These design flaws are further reasons for co-legislators to pragmatically adjust the package where required.

Even if all Basel-compliant options to implement the OF will suffer from these structural flaws, one of these options, known as the "parallel stack approach", provides a way to minimize disruption to the status quo of previous EU banking packages (notably on EU specific buffers) and to reduce its actual impact on requirements (first by avoiding goldplating) while limiting deviations to Basel.

This should be enough for the co-legislators, and firstly for the Commission, to take due consideration of the parallel stack approach. Otherwise, we might be headed to dance yet another tango with usual "goldplating" and more "deviating" from «Basel».

Let's try to do better this time.

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Implementing Basel III in the EU: remaining challenges and timing

Owing to the stricter requirements established by Basel III, in the past several years banks have vastly improved their capital and liquidity position and begun to account for key risks in a more satisfactory manner. This process has significantly increased their ability to withstand external shocks. Faced with the COVID-19 pandemic, banks were in a position to continue supporting the global economy. They did not amplify financial disturbances, as they had during the financial crisis that started in 2008; in fact, they contributed to preserving financial stability and mitigated the real effects of the crisis.

The pandemic has been an especially challenging real-life test. Basel III has passed it successfully. However, not all the features of the new standards were equally put to the test by the circumstances, and complacency would not be warranted. Some important building blocks of Basel III still need to be fully implemented by jurisdiction. While it was right to suspend the Basel III timetable under the exceptional circumstances of the crisis, its implementation should now be resumed.

In Europe, the process will be initiated by the EU Commission, which is expected to publish a proposal by September. The negotiations on the future EU regulatory framework are likely to be complex. One hopes the co-legislator will be able to act in a reasonably swift and comprehensive way. Additional delays should be avoided as they would risk impairing banks' ability to withstand future shocks, which may well be different from the latest one.

Europe's diversity regarding bank business models should be preserved through an appropriate use of the proportionality principle. The process of implementing Basel III in the EU should not be an occasion for reopening settled issues or weakening the framework. Deviations should be kept to a minimum.

The new framework will increase the risk sensitivity of the revised rules and at the same time further reduce undue RWA variability and aggressive modelling practices. The actual impact on capital requirements will depend on the final policy choices. On the whole, it is not expected to be dramatic. Furthermore, recent analyses by the EBA showed that just confirming existing regulatory specificities would halve the potential increase in capital requirements. At the macro level, there is evidence that the economic costs of implementing the reforms are modest and temporary and that they are clearly outweighed by the longer-term benefits of a stronger financial system.

While it was right to suspend the Basel III timetable, its implementation should now be resumed.

Having said that, the Basel supervisory body, the GHoS, has committed to a regulatory pause after Basel III. A similar position has been adopted by the European Commission. The work on Basel III must be finished; beyond that, no further significant capital requirement increases are envisaged.

This by no means implies that regulators (or banks for that matter) can relax and ignore developments in the risk landscape. Technology offers the most obvious example. FinTech is an opportunity, but it also entails ever growing and changing risks. Under Basel III, technology risk is classified as an operational risk. This is quite possibly the least satisfactory piece of Basel III and the one that will age most quickly. Further thought on the issue of FinTech/cyber risk is in order. A better prudential treatment might recognise that capital charges are not the only, nor are they necessarily the best way to account for operational risk; organisational and governance requirements may take on a more prominent role alongside capital.

There is much debate about how the regulatory framework should take account of environmental issues. In principle, financial regulation is not the best way to provide direct incentives for the net-zero transition. Policy action in this direction, which I most welcome, should be within the remit of fiscal and general government policies and obey the rules of a democratically accountable process.

Regulation, entrusted to independent technical authorities, should remain risk-based and evidence-driven. Any special treatment of 'green' assets should therefore only be considered on the basis of robust evidence of lower credit or market risk.

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Tailor-made implementation of Basel-III in Europe

It has been nearly four years since the Basel Committee has endorsed the outstanding Basel-III post-crisis regulatory reforms. Implementing global banking standards is and will remain essential to promote financial stability and to enhance the quality of banking regulation and supervision in a multilateral world. There is evidence: Banks are much stronger now than over ten years ago. They have better liquidity, capitalization and leverage, which serves us well – also during the Covid-19 pandemic. While I strongly welcome the deferred timeline for Basel-III to increase the operational capacity of banks and supervisors to support our economy during the current crisis, the work on a full, timely and consistent implementation must now swiftly continue. Clearly, it is no longer about the "if", it is about the "how".

Ahead of the European Commission's legislative proposal announced for the third quarter of 2021, it is worthwhile to define clear guiding principles for the implementation of Basel-III in Europe:

First, it should be timely and faithful to the global standards to provide for legal certainty and signal the European Union's commitment.

Second, it should respect the mandate adopted by the European Parliament in November 2016 to ensure "no significant increase in the overall capital requirements".

Third, it must take due account of our structural specificities with a primarily bank-financed economy. The diversity of our banking landscape and business models is a strength. The flexibilities of the Basel standards should therefore be exploited and new adjustments considered, wherever duly justified.

Fourth, the principle of proportionality must be respected by further reducing compliance costs for smaller and less complex institutions without watering down prudential standards.

Fifth, competitive disadvantages for European banks should be avoided, especially in the area of trading activities where they compete directly at international level.

And sixth, the overall approach must be in line with the goals of our Banking Union and avoid any further fragmentation of the single rulebook. In short: all the consequences for banks, end users and citizens must be duly considered.

We must continue to implement global standards while taking due account of European specificities.

In this context, some existing elements that address EU specificities such as the SME Supporting Factor and the exemptions from the CVA framework must in my view remain undisputed. Concerning the Output Floor – our "elephant in the room" – a Basel-compliant solution should be achieved which implements our common objective of reducing excessive risk-weight variability and promoting comparability of risk-weighted capital ratios. "European solutions" are needed in the treatment for equity investments, unrated corporates and specialized lending. Using the discretion for historic losses in the operational risk framework would offer a simple and harmonized solution to decrease the overall impact without deviating from Basel. On the FRTB, disproportionate impacts for certain trading activities which are key to our economy would justify targeted calibration adjustments.

As the SA-CCR may have detrimental impacts on the availability and cost of financial hedges to end-users, it is essential to allow for targeted adjustments while pursuing an in-depth review of the appropriateness of its calibration. At the same, we should not shy away to address structural necessities: We need to move forward on capital and liquidity waivers to improve the integration of cross-border banking groups and complete our Banking Union.

It is of course the European Parliament and the Council that will adopt the legislation based on the Commission's proposal, not the Basel Committee. I am optimistic that we will find the right balance to square the circle of Basel-III – together with all affected authorities, central banks and stakeholders. The awareness about all the key elements is high. In parallel to the implementation of Basel-III, the global banking standards need to evolve.

We must find answers to our future common challenges, such as climate related risk, digitalization, cyber risk, operational resilience and increasing debt levels. These risks are crossing borders and sectors and we need global baselines to address them effectively.

This is not least a huge opportunity we must seize to strengthen Europe's role as 'rule-maker' of global standards.

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Implementing Basel IV in the EU

Recent years have been especially negative for those of us who believe in an international order based on liberal values, with the social emphasis that exists in Europe, and founded upon solid global institutions.

It is important to underline this principle before discussing how to implement the recent recommendations of the Basel Committee within the European legislative acquis. The defence of multilateral organisations is best served by ensuring that global agreements are applied with continuity across the different represented jurisdictions. The latest Basel recommendations is no exception. Of course, there is always a certain margin for interpretation or adaptation, which in turn strengthens the democratic legitimacy of transferring these global agreements to each one of the jurisdictions.

Even so, before analysing how to approach the regulatory reform of capital requirements, we must have one thing clear: European law should respect the international framework and integrate, in this case, the recommendations that are given within the scope of the agreement.

Secondly, the update to capital requirements must also incorporate an assessment of the current standards, especially after the economic and financial impact of COVID-19. It is worth pointing out that current prudential rules work well and have so far enabled us to address a downturn in activity while avoiding systemic problems in the European banking sector. The changes incorporated in the CRR quick fix in 2020, together with the rest of the policies to support the production sector in the framework of more stable regulation, have made it possible to get through a very complex period without major blows. Therefore, the implementation of Basel IV should not be seen as an opportunity to water down or reduce our prudential rules, but rather a chance to maintain current standards.

Turning now to how to transpose Basel IV into the EU legal framework, perhaps the most problematic point is applying the output floor. This instrument is supposed to set a floor for capital requirements irrespective of risk assessment. It is a challenge for the European banking sector, which has a significantly greater role in financing the real economy than the banking sectors in other jurisdictions, where capital markets play a more important role.

EU law should integrate (...) the recommendations that are given within the scope of the agreement.

In any case, and irrespective of the necessary push towards the Capital Markets Union (CMU), the Basel recommendations leave open different options for implementation in different jurisdictions. On the one hand, these additional output floor requirements can be calibrated on a consolidated and individual basis, as is already the case for all other requirements. Moreover, they could be applied exclusively on a consolidated basis. There are good arguments in this debate, linked to the development of the banking union, for applying the output floor on a consolidated basis only, although in some ways this would imply a revision of the European strategy to date. Finally, proposals for a possible parallel stack approach are, thus far, not Basel compliant, according to the analysis of the European Banking Authority.

In addition, the possibility of incorporating differential treatment of some kind for unrated corporations has been widely discussed. In this case, the EU's regulatory acquis already includes an SME Supporting Factor that could partially compensate for the effects of the greater weight of bank financing for the European productive sector. Certainly, the realities implied by the current SME Supporting Factor and a possible adjustment for unrated corporations are not exactly the same, but there is so much overlap that we cannot separate the two entirely. Moreover, we should not introduce regulatory elements that would clearly contradict the CMU project.

There are other European elements or specificities in the current debate that will need to be discussed in the coming months. In any case, I do not wish to conclude this article without making an additional reference to the internalisation of climate risks, which the ECB will incorporate into the implementation of monetary policy. The banking sector as a whole should be provided with more transparent regulations to not only help reorient its activity as part of an ecological transition, but also as a way to better quantify a source of additional risks that have not been sufficiently internalised.

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Basel IV: implementation is key

The Basel III reform decided in 2017 should be implemented faithfully to the philosophy of this reform and the political mandate given by the G20 and the European authorities. We are not questioning that consistency in capital rules' implementation is important both across EU institutions and globally across regions. Nor are we arguing for a policy shift towards deregulation.

When looking at the many successive reports from public authorities and from independent economists, the reform will increase total capital requirements for EU banks by 19% (compared to a 0.3% decrease for Americas) translated in a capital need of € 170-230bn, largely driven by the application of the output floor. We are far from the political mandate given by the European Council and Parliament of no significant increase in the overall capital requirements for the banking sector and no significant differences across regions of the world.

The philosophy behind the finalisation of the Basel Accord was indeed not to further increase capital requirements but to avoid unwarranted variability in risk-weighted assets and improve the comparability of banks 'risks profiles amongst different banking models at global level.

In that regard, the implementation of the output floor as the cornerstone of this reform is key, especially for universal banks using internal models, and is expected to have the single largest impact on banks' capital requirements.

The use of IRB approaches may be restricted, although they are validated by the supervisors and regularly recalibrated through the EBA repair work and the ECB TRIM exercise. Paradoxically the output floor may thus be damaging to banks with a low risk profile and create disincentives for the lowest risk portfolios. Were the output floor introduced at entity level it would therefore penalize decentralised banking models willing to diversify risks at group level. To avoid such unfortunate consequence, it is crucial that its implementation meets the policy intention behind its design.

We strongly support the application of the output floor at the consolidated group level. First the Basel committee provides recommendations at the consolidated level. Second it would be consistent with the ambition of the Banking Union. A solo approach would exacerbate fragmentation of the European banking market. Finally, it is the only way to ensure business model neutrality. Indeed, for the same risks, if the output floor applies at solo level, the more decentralised a bank, the more it is penalised by the output floor. In the case of a centralised organisation using internal models, low and high risks are mixed in the same structure so that the average risk is closer to the standard, reducing the impact of the output floor.

We strongly support the application of the output floor at the consolidated group level.

The output floor should also work primarily as a backstop, basically keeping the risk-based capital requirements approach through un-floored risk-weighted assets. To this end, we strongly support an application on international requirements only, to guarantee a level playing field. A recent legal opinion by a European Network of continental law firms found that such approach would be Basel Accord compliant.

Real estate financing is a concrete example. Based on a "Loan to Income and fixed rate" model the French market has historically very low default rates thanks to prudent lending practices and efficient credit protection mechanisms. And yet, the risk weights for such low risk asset would double due to the output floor and changes to the credit risk framework. The Commission should then consider other options that improve risk-sensitivity and granularity in the standardised approach.

It should be the same for specialised lending. The Basel methodology does not recognize properly the financial protective structures nor low risks portfolios while data show a low level of default over a long period of time. There is almost non-risk sensitivity in the standard approach nor in the internal model approach due to the level of LGD input floor and that no distinction is made between highly qualitative transactions and others. Adaptations are then required to maintain consistency between prudential rules and observed risks. The solution is to set a more granular standardized approach and to set a direct LGD input floor of 10 % for the A-IRB method.

The transposition should be faithful to the political mandate and the very intention of the Basel committee not to increase the capital requirements, but also the make sense in the European context. That means and targeted improvements and adaptations to the European post-crisis economic reality and to the structure of its banking sector. Otherwise, the package would have significant adverse impact on banks' capacity to finance the economy and support the recovery from the pandemic shock.

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Basel III impact in Europe: operational risk revised requirements matter

As the deadline to approve the final Basel III text approaches, Europe still has some important decisions to make.

Although the Basel III agreement has been discussed at great length in recent years, Europe needs the right balance between financial stability and economic growth and competitiveness.

Basel III's significant impact on European banks' capital requirements, coupled with the high dependence of households and SMEs on bank funding, will reduce Europe's growth prospects significantly.

According to some analyses, GDP could see a permanent decline of 0.5%. Higher capital requirements will inevitably drive up funding costs for households and SMEs, whose access to capital markets is limited.

We are reaching a point where the benefits of higher bank capital requirements to financial stability do not offset the detriment to economic growth.

The Basel III agreement will have a disparate effect on banks and economy in Europe.

It is bound to cause the gap in growth ratios to increase with respect to other regions. Four years ago, the Basel Committee did not expect banks' capital requirements to rise significantly; however, capital requirements for European banks are going to increase substantially, while in all other jurisdictions they are expected to stay almost the same or even fall! And experience with Pillar I shows that new requirements are always amplified by the other two pillars through supervisory add-ons and market buffers over the supervisory minimums. On top of which management buffers should also be built.

Moreover, uncertainty remains higher than usual.

Recovery from the pandemic will be asymmetric, as countries regain economic activity at different speeds. Furthermore, we have yet to fully understand the structural changes occurred in the last year and must keep our guard up.

Against this backdrop, Europe should take advantage of the Basel III agreement's flexibility and make necessary adjustments, particularly with regard to operational risk.

Europe needs strong banks to aid its recovery and drive its digital and green transformation.

The final Basel III package contains several critical elements for Europe, notably the output floor and the new operational risk framework. While much has been said about the output floor and its effect on capital and risk sensitivity, much less has been said on operational risk. The EBA estimates that 20% of the total capital increase resulting from Basel III is due to operational risk, which is the second largest impact after the output floor.

To reduce it, European authorities should not link capital requirements to past losses.

Because the Basel Committee considers operational risk a "tail risk", and, thus, even the most accurate models based on past data are not an adequate proxy to measure it, Basel III no longer allows internal models. However, it keeps historic data as the driver of requirements, a solution that takes the worst of two worlds: On the one hand, it undervalues accurate models able to recognize past signals that help forecast the future; on the other, it applies an overly simplistic rule based on past data. Basel gives national authorities discretion to build operational risk models based on past losses or not. Europe should take the right decision and make use of this discretion. Even if they use their discretion, it would only reduce the total capital increase by half due to the other methodological changes introduced by Basel III on operational risk requirements.

The framework should introduce the right incentives.

A tail risk is not an unmanageable risk, and regulation should give the right incentives that reward institutions with strong governance, sound risk controls, advanced metrics and scenario analysis to prevent or mitigate operational risk, and with effective business continuity plans to ensure operational resilience.

All in all, Europe needs strong banks now more than ever to aid its recovery, drive its digital and green transformation, and bolster its strategic sovereignty.

Therefore, European banks must be allowed to compete on equal footing with other players worldwide to allocate financial resources where needed in the economy.

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Basel III: a search for consistency

The COVID crisis evidenced that EU banks had enough capital. Banks brought a substantial support to their clients, well beyond public guarantee schemes, and even under the extremely severe stress scenarios applied on already stressed 2020 balance-sheets, their CET1 ratio would remain largely above the 4.5% minimum Basel requirement.

However, the capital requirement framework was deemed by supervisors to lack the necessary flexibility, and to require targeted softening to allow banks to play their shock-absorbing role and to continue to finance the economy, some of those measures being recently extended into 2022.

Nevertheless, 12 years after the Global Financial Crisis, the EU is facing the implementation of yet another piece of the post-crisis reform agenda, at a time where the EU economy needs to recover from an unprecedented health crisis, which provided a successful real-life test to the existing prudential framework, and in addition needs to finance huge green and digital investments.

How to reconcile those contradictions? It would be wise to draw the lessons of this real-life experience, as policy makers engage the transposition of the final Basel III: 1. Banks don't need more capital. The mandate given by the G20 to the BCBS, and by the European Council and Parliament to the Commission is all the more relevant.

The EBA "EU-specific scenario" with a 7.7% overall RWA increase, and a 19% RWA increase for G-SIBs, which represent a large part of the EU banking sector, is not a viable option.2. If the framework is deemed to need more flexibility, it needs even more to be predictable, with self-triggered mechanisms embedded in the rules, rather than arbitrary supervisory decisions. For example, some existing buffers should be automatically released in crisis time, for the buffers to play their intended loss-absorbing role.3. The CRR3 proposal needs to preserve the diversity of banks' business models.a.

As regards smaller banks, the revised, more complex, standardized approaches should not impose a significant implementation and reporting burden, for limited financial stability benefits. Otherwise, this would work as an implicit incentive to consolidate.b. On the other end of the spectrum, G-SIBs and D-SIBs, which finance 70% of the EU economy, should not be inflicted a significant increase in capital requirements.

Let's draw the lessons of this real-life stress test and preserve the diversity of EU banks' business models.

Otherwise, this would work as an implicit incentive to downsize, and the ability of those banks to compete with already dominant US players would be permanently damaged, and would ruin any EU ambition to develop its "open strategic autonomy" for the financing of its major corporates and sovereign debt.

Technical solutions exist to solve these issues while remaining faithful in the implementation of the international Basel standards. It is essential in particular to ensure consistent implementation of capital markets rules (FRTB, SA-CCR, SFTs) with the US and UK, in both timing and substance.