IMPLEMENTING BASEL III IN THE EU

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Basel III reform should not raise financial stability risks for host states

In face of the ongoing pandemic shock, the European banking sector demonstrated resilience and contributed positively to economic recovery. This showcases that steps taken to reform the banking system after the global financial crisis were indeed timely and effective. Nevertheless, more needs to be done to enhance resilience of the European banking sector to future shocks, and the Basel III package plays a key role in this regard.

By introducing additional capital requirements for internationally active banks, the Basel III package rightly moves in the direction of making the European and international banking system more bulletproof. The COVID-19 crisis is a good example of "black swan" events which cannot be predicted, but cause vast negative effects. In this vein, it is always better to be safe than sorry.

Given this, I welcome the ambitious package to implement the global agreement EU level proposed by the European Commission. Here I would like to stress that while adjusting the package to European specificities – such as those related to the mortgage market – is necessary, we should limit the scope of deviations and make sure that we do not alter the key pillars of the Basel III package. We need to remain committed to the agreement reached at the global level and strive for timely implementation at the EU level.

While Lithuania is overall supportive of the Basel III package, some elements tend to raise concerns. In this regard, the key outstanding issue is the level of application of the so-called output floor. The proposed way of applying it at the level of the banking group is understandable from the perspective of aiming to limit the increase in capital requirements and thus reduce the impact on the banking sector. Nevertheless, it creates risks in terms of financial stability, particularly in the host countries such as Lithuania.

Deviations from the Basel III reform in the EU should be limited.

I firmly believe that while striving for a more stable EU banking system, we should not unintentionally create new pockets of risks. The redistribution mechanism put forward by the Commission would allow distributing any additional capital resulting from the application of output floors between subsidiaries. However, it does not seem to sufficiently address all the concerns. In particular, the proposed solution would not sufficiently mitigate risks at the individual level of the financial institution, and could cause insufficient capital requirements with regard to underlying risks of exposures of individual entities.

This may result in negative financial stability outcomes in case of shocks. Until we have robust and credible safeguards, any changes to application of capital requirements should be treated with caution.

Furthermore, deviating from the principle of applying capital requirements at all levels of the banking group tends to move in the direction of altering the current fragile balance between home and host countries. It may also create an unwanted precedent and aggravate progress in the broader strategic debate on completing the Banking Union, where the issue of cross-border integration is among the most sensitive ones. Taking this context into account, the Commission and Member States should continue constructive discussions to find an acceptable way forward in applying the output floor. At the same time, we should refocus our ambition and push for completing the Banking Union, while introducing the missing third pillar – European deposit insurance scheme (EDIS).

The Basel III reform is a significant step towards creating stable, resilient and reliable banking system at the EU and international level. We should remain ambitious and implement the package in a timely manner, with as little deviations as possible and taking account of potential financial stability implications in individual countries.

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Implementing Basel III: strengthening the financing of the real economy

Implementing the final Basel III package will be the important last step of the post-crisis reform agenda. Following the global financial crisis, we agreed that taxpayers should never again have to bear the costs of bank failures. Thanks to the Basel III reforms, the banking system entered the Covid-19 pandemic much better prepared, with significantly higher capital and liquidity buffers. The final Basel III rules will help to further increase the resilience of banks and to further strengthen financial stability.

In October 2021, the European Commission presented its implementation proposal with amendments to the Capital Requirements Regulation and Capital Requirements Directive. The European Union is therefore one of the first major jurisdictions with a concrete legislative proposal to implement the final set of Basel III rules. Other jurisdictions have yet to publish their plans for implementation.

In Europe, we can build on extensive supervisory measures to improve internal models, including the ECB's targeted review of internal models and the EBA's internal repair programme. These supervisory efforts have already significantly reduced any undue variability in risk-weighted assets and boosted the reliability and comparability of banks' internal models – fully in line with the central goal of the final Basel III package.

The implementation proposal by the European Commission strikes a careful balance and is a good starting point for the upcoming negotiations. The European Commission proposes to faithfully implement the final Basel rules to strengthen the resilience of banks. We remain committed to this approach, which implements all elements of the Basel package while preventing any double-counting of risks and any undue and automatic increase in Pillar 2 requirements. Global financial standards will only work properly if they are implemented faithfully. At the same time, we have to take into account the structural features of the European economy.

We should further strengthen the principle of proportionality in EU banking regulation.

Firstly, we must prevent any negative impact on the financing of the real economy. In this regard, we very much welcome the Commission's proposal for longer transitional periods with more adequate risk weights for unrated corporates. Compared to other jurisdictions, rating coverage for corporates is much lower in the European Union. This holds true even for larger industrial corporations in Europe, which are often not publicly listed and contribute to substantial economic growth and employment across the continent. Hence, in the long-term, we need further measures to improve the availability of external ratings. In the short-term, we must ensure that European corporates have continued and unhampered access to bank lending, as the financing of the real economy is of the utmost importance.

Secondly, we should further strengthen proportionality. The new definition of small and non-complex institutions was a key stepping stone in the last banking package. We should build on this definition to further reduce administrative requirements without relaxing prudential standards. For instance, we should reduce disclosure and remuneration requirements for variable compensation. For unlisted small and non-complex institutions, these requirements are only an administrative burden without any meaningful positive impact.

Our real economy depends on a wide variety of bank business models. This diversity is a strength, as we have seen in the Covid-19 pandemic. Beyond Basel, the Capital Requirements Directive should leave member states sufficient room for manoeuvre to deal with this diversity. For instance, the fit and proper framework should respect existing rules, including on corporate law and the rights of co-determination and employee participation. Moreover, supervisory powers on mergers and acquisitions as well as material transfers of assets or liabilities should be more proportionate by exempting smaller institutions and internal transactions compared to the initial Commission proposal.

Proportionality is also key regarding the timeline for implementation. The new package will entail some major changes to the standardized approaches. In the European Union, we have chosen to implement these rules for all banks, large and small. As for the last banking package, banks, in particular smaller ones, will need sufficient time to prepare for the implementation in 2025. We should thus aim to finalize this package quickly and are looking forward to continuing the constructive dialogue between all member states in the Council and progress under the French presidency.

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A faithful implementation of Basel III can meet European specificities

The 2017 Basel Committee's package must be faithfully transposed, in a way that is appropriate to the European context, and in view of unifying the EU banking market.

One of the three overarching principles set out on the first page of the 2017 package is that it should not significantly increase capital requirements. To be faithful means, first, to respect this objective, which is not limited in time. The implementation of the agreement must therefore observe this objective without a deadline.

A key difficulty in implementing the Basel Committee's guidelines is that the European context is very different from that of other jurisdictions. Transposing, means putting something in another context. It is therefore important to apply the Basel guidelines faithfully to the European context.

First, the European financial markets are small and fragmented compared to those of their peers, and will remain so for a very long time. This forces banks to carry the bulk of the risks of the external financing of the European economy, which inflates their balance sheets. Therefore, any prudential constraint on the banks' balance sheet is also a constraint on the financing of the economy. Similarly, due to the weakness of the financial market, few European companies are rated, and this is a lasting situation. Hence, if this difference is not taken into account, and this as long as ratings remain scarce in Europe, then the finalization of Basel III will permanently penalize the financing of the European economy.

Second, the housing market and its lending practices are very specific in the EU. Thanks to a double recourse in Europe, both on the debtor and on the real estate, risks can be significantly reduced. If this difference is not taken into account in a structural way and for as long as it lasts, then the impact of the regulation will be very unequal across jurisdictions, because very different risks will be weighted identically.

The convergence of prudential banking standards contributes to the development of a global banking market. American banks, that now dominate the corporate and investment banking market in Europe, are taking full advantage of this. By contrast, Europeans have been fragmenting their domestic banking markets through internal prudential requirements, which have prevented a concrete banking union. It is therefore important that a faithful implementation of the Basel package also concerns the application of its rules at the consolidated level in Europe, starting with the application of the output floor at the consolidated level only.

It is important to take into account the reality of risks and the specificities of each economy.

Another important dimension of transposition is the level playing field. It is important to ensure that the application of new rules does not distort competition between jurisdictions and within the European jurisdiction. Thus, the provisions relating to market operations must be transposed with equal effect and at the same time in the different jurisdictions. Similarly, capital requirements on strategic holdings must be equally applicable to all strategic holdings, regardless of their nature, and regardless of the institution that holds them, whether it is in standard approach or internal model.

Finally, the finalization of Basel III will not improve the comparability of banks' solvency ratios.

Indeed, the finalization of Basel III is very much a return to Basel I and to a standardised approach, whether with the use of the standardised method or with the application of an output floor to an internal model. However, internal modeling was introduced by supervisors in the late 1990s, after standardised approaches were found to be insufficient because they masked differences in risks. After 15 years of implementation in Europe, after validation and periodic controls by supervisors, after a repair exercise by the EBA, after positive reports from the EBA on the stability of models and after an in-depth review of the internal models by the SSM (TRIM), one can affirm that they represent today the most reliable measure of risks in Europe.

For example, the application of the output floor to the residential real estate sector would double the corresponding risk weighted assets of the French banks. Hence, with the black box of the standardized approach obscuring the precise measurement of real risks, these banks would have the same solvency ratios as higher-risk banks. In another example, the risk density in the US banks' balance sheet is higher than in the balance sheet of European peers, thanks to Fanny Mae and securitization of low-return risks. However, after applying the output floor, this difference disappears. The solvency ratios may be identical but may conceal very different realities. Therefore, the current cap on the output floor must be changed to bring it in line with the permanent mandate of non-significant increase in capital requirements.

That is why it is important to take into account the reality of risks and the specificities of each economy.

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The EU Banking Package should allow banks to meet financing needs

After being deferred by one year, in October 2021 the European Commission published its proposal for the final implementation of Basel III in Europe, the Banking Package 2021. The proposal seeks to support financial stability and facilitate the financing of the economy in the aftermath of the COVID-19 pandemic together with the transition to climate neutrality.

As expected, and in line with the Basel documents, the new regulation narrows the scope of the use of internal models to calculate regulatory capital requirements. Management and business decisions will rely more on metrics defined by regulators rather than bank internal analyses and bank specific key risk indicators. The proposal includes the output floor which typically is a key driver of risk-weighted asset (RWA) increase for large universal banks making significant use of internal models. At the same time, the EU Banking Package allows for long transitional periods of different kinds. For example, the output floor will be phased in from 2025 until 2030. Unrated corporates with a probability of default below 0.5% will receive a lower risk weight in the standardized approach at least until 2032. A transitional pattern has also been included for real estate mortgages. However, investors and stakeholders are likely to ask for fully loaded capital figures early on. Thus, in KPMG's view, it matters whether banks can apply reduced risk weights transitionally or permanently, irrespective of EU discretion to extend transitional rules.

Europe still faces some country specificities related to historical lending practices. For example, in France and Germany many corporate banking clients are not rated. In the Netherlands, residential mortgages are a key banking product. In France, real estate loans typically involve a financial guarantee. Therefore, the new legislation affects different countries and banks in different ways. As a result, we believe that banks with significant portfolios of unrated corporates and real estate mortgages could eventually be more severely affected than mentioned by the EU Committee assessing an average increase of 6.4% to 8.4% in minimum capital requirements. In any event, many banks will have to review their portfolios' risk return profiles and adjust prices of banking products. Certain exposures may be transferred to other market players outside the banking sector. This could change the weight of bank financial intermediation in some economies.

The proposal seeks not only to support financial stability but also to facilitate the financing of the economy.

The EU Commission published the Banking Package at a time of accelerated progression. Economies are recovering from the COVID-19 pandemic and are witnessing longer term implications. Greening the economy is high on governments' agendas and prudential aspects of this are included in the Banking Package. Digitalization also requires significant investment by different economic agents. Considering these developments and increased financing needs, in our view the transitional arrangements for corporates and real estate mortgages should be made permanent. This could enable banks to appropriately meet corporate and household financing needs and at the same time sufficiently strengthen banks' resilience.

On a more general note, input floors for internal model variables together with the output floor established in the new rules and the limited risk sensitivity of the standardized approach have a tendency to affect exposures with lower risk profiles more than the same exposures with higher risk profiles. This movement towards standardization will influence the way banks define their risk appetite. It could create a trend of increasing exposure to corporates within a given risk weight bucket, moving away from financing lower risk corporates.

KPMG firms welcome the inclusion of ESG factors in the regulatory framework. This represents an important step at the disclosure level and sends a clear signal about the direction of travel for Europe in the coming years.

In general, we welcome the approach taken by the EU Commission compared to the standards published by the Basel Committee. In our view, certain transitional arrangements should be made permanent. Banks will continue to discuss impact assessments and implications to business models together with their internal ratings-based (IRB) repair programme, supervisory findings' remediation workstreams for internal models, and regulatory capital requirements such as counter-cyclical buffers or systemic risk buffers. Business and capital planning will continue to be demanding exercises for the years to come.

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Bank performance and Basel III implementation – A view from the far east

Banking sector performance during the pandemic: under-emphasised?

There is probably consensus that the banking system worldwide has been a source of strength during the COVID-19 pandemic. Cynics may say it was mainly the fiscal and monetary support provided by the public sector that did the job. While probably true, a careful analysis should also show that the support provided by the banking sector was meaningful.

Another piece of the well heard narrative is that the post-crisis regulatory reforms delivered that strength. Then the usual explanation goes on describing the capitalisation and liquidity levels of banks. While these are important facts, there seems to be under-emphasis on the roles that the banks played. The post-crisis regulatory reforms increased the levels of the minimum and introduced buffers. But it is not clear if the increase in what is known as the "headroom", i.e. the amount of capital or liquidity above the minimum and the buffers, results from those reforms, or if it was the determination by banks to stay well above the minimum and buffers. The increase in the minimum is important in itself, especially for ensuring there is enough room for maneuver when a ratio is falling to a level that requires public sector intervention. However, no major bank faced such situation during the pandemic. In such a circumstance, the ability of the banks to keep on lending to the real economy depends more on the size of the headroom than on the size of the minimum. It seems that it was the banking sectors' efforts to create a sizable headroom that has contributed to the sector's ability to keep servicing the economy in the face of a major shock, equally to, if not more than, the post-crisis regulatory reforms.

There is also the debate on whether or not the buffers are "usable". There may be a range of views, but from a practical viewpoint, it seems safe to say that most, if not all, banks are treating the minimum plus the buffers as the new minimum. Buffers are not usable from the perspective of banks. If regulators want them to be usable, the design of the buffers needs to be changed.

Value of "headroom", buffer non-usability, and enhancement to BCBS rule-making process are discussed.

Basel III Implementation

The Financial Services Agency of Japan (the JFSA) published for consultation the draft rules to incorporate the final portions of Basel III on 28 September 2021. The European Commission published its draft rules on 27 October.

Different regions face different specificities and there is a need to take those specificities into account. In addition, a democratic procedure to ensure the legitimacy of the rule-making process is indispensable beyond any doubt. Different jurisdictions have different rule-making processes in place, and they should all be respected.

At the same time, as an institution operating in Europe, the UK, the US and Singapore, with headquarters in Tokyo, we highly appreciate globally harmonised standards. In addition, like-minded jurisdictions, such as Europe and Japan among some others, should lead the world by showing the value of multilaterally agreed standards. If at all possible, providing excuses to some actors for not sticking to internationally agreed frameworks should be avoided.

It seems the market is treating European banks as somewhat weaker than their US counterparts with the same capital ratios. Japanese banks faced similar situations in the past. Even if unreasonable, following the demands of the market and international organisations may be the quickest way to overcome such situation. From this perspective, the final pieces of the Basel III package, including the limits to some inputs and the floors, should improve global comparability.

There is the need to strike the right balance between taking regional specificities into account and maintaining globally harmonised standards. There may be no easy answer, but debates taking place at platforms such as Eurofi should contribute to reaching a better balance.

More practically, the following ideas may provide some improvements: As for this round, BCBS members should go back to the Committee once their domestic rules become clear, and report on any major deviations from the December 2017 document. Then, the BCBS should discuss any necessary actions. As for the future process, the way in which international standards are developed and implemented across the BCBS member jurisdictions may need to be improved. One idea might be to reconsider the sequencing of international public consultation and national rule-making processes, and to carry out consultation in the following order: 1) BCBS public consultation, 2) public consultation at each jurisdiction, 3) finalisation at international level, and, 4) finalisation of rules and regulations at the domestic level (currently, these are conducted in the order of 1, 3, 2, and 4).