

BASEL III IMPLEMENTATION



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Climate, crypto and carrying through Basel III

The dual shocks of the war in Ukraine and resurgent inflation have darkened the outlook. Growth is losing its momentum. The transition from pandemic to endemic is proving tortuous and wracked with uncertainty.

Against this backdrop, elevated financial vulnerabilities will continue to test the resilience of the global banking system – with challenges coming from increased debt levels, stretched real estate valuations and proliferating links with non-bank financial intermediation.

What's more, structural trends continue to brew, with important implications for banks. In particular, climate-related financial risks and the digitalisation of finance loom increasingly large in the risk priorities of banks and supervisors over the medium term.

While there is no shortage of work for the Basel Committee, I would highlight three “Cs” that are of particular relevance right now: climate, crypto and carrying through the implementation of Basel III.

Climate change will result in physical and transition risks that could undermine the safety and soundness of individual banks, as is now generally accepted, to say nothing of the broader financial stability implications.

Banks worldwide are potentially exposed to such risks regardless of their size, complexity or business model. The scale of such risks is potentially tremendous: a recent study estimates that G20 financial institutions have exposures worth almost \$22 trillion to carbon-intensive sectors, of which on-balance sheet bank lending accounts for 60%.

The transition to net zero is likely to be a bumpy one, as recent geopolitical events have shown. So it is crucial to ensure that banks are resilient to climate-related financial risks as we navigate the uncertain path towards net zero.

To that end, the Committee is pursuing a comprehensive programme to mitigate climate-related financial risks to the banking system. A series of analytical reports have assessed the transmission channels of such risks to the banking system and measurement methodologies. And, to follow these up, we recently published a set of high-level principles that seek to improve risk management and supervisory practices. We are

now assessing whether additional global measures are needed, spanning supervision, regulation and/or disclosure.

Another area of focus is cryptoassets. Despite the frenzied activity in such markets over the past few years, banks' exposures to cryptoassets are still relatively limited; at their peak last year, cryptoassets represented only about 1% of total global financial assets.

Yet we know that such markets have the potential to scale up rapidly, posing risks to individual banks and financial stability. This calls for a forward-looking approach to regulation and supervision to ensure that we meet our mandate both today and in the future as technology and markets evolve.

This is why we are in the process of finalising a prudential treatment for banks' crypto exposures. The Committee will be guided by three principles in this area: (i) simplicity and caution in the design and calibration; (ii) treating assets with the same risk profile and activity in a similar manner; and (iii) setting global minimum standards for jurisdictions to build on.

Collaboration on both climate risks and cryptoassets is key. For this reason, the Committee is closely liaising with other global standard setters and forums. It will also continue to actively seek the views of a wide range of interested stakeholders.

But the benefits of global agreements will not materialise if the Committee's agreed standards, endorsed by the G20, are not implemented in a full, timely and consistent manner. This takes me to my third “C”: carrying through the implementation of all aspects of the Basel III framework. I take heart in seeing that all member jurisdictions have recently reaffirmed that they expect to implement the outstanding standards as soon as possible. It is now crucial to translate this willingness into action. Otherwise, the regulatory fault lines from the Great Financial Crisis will remain unfixed.

Finally, the Committee recently published a set of high-level considerations on proportionality. These aim to support authorities that seek to apply proportionality in their regulatory and supervisory frameworks in a way that will not compromise financial stability. They provide another lever for implementing Basel III.



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The Banking Package: a prudential framework fit for purpose

In October 2021, the European Commission adopted a package of legislative amendments to the Capital Requirement Regulation and Directive ('CRR3' / 'CRD6'). The package is currently being negotiated by the co-legislators, i.e. the European Parliament (EP) and the Council. The rapporteur in the EP tabled his draft report on the package at the end of May. In the Council, the French presidency tabled a first draft compromise text in June and discussions are now continuing under the Czech Presidency. It is expected that consolidated positions of the EP and the Council will be reached by year-end, with an agreement between the co-legislators in the first half of 2023.

The package strikes a delicate balance between several objectives. Most notably, it implements the Basel III international standards faithfully, without leading to a significant increase in capital requirements, on average. The Commission's proposal adapts the Basel standards to tailor them to the specificities of the EU banking sector and economy, inter alia:

- It is proposed to keep the adjustments that have already been adopted by the co-legislators in the last banking packages, such as the small and medium enterprises (SME) supporting factor and the exemptions from the credit valuation adjustment (CVA) framework.
- The proposal does not treat EU banks' equity holdings as speculative investments, in cases where they are of a long-term and strategic nature.
- The proposal also sets out specific transitional arrangements for banks using the internal ratings-based approach for their exposures to low-risk mortgages on residential property and to non-rated corporate borrowers. These transitional arrangements are supplemented by European Banking Authority's (EBA) reports and carefully designed so as not to become permanent treatments.
- Lastly, the Commission proposes pushing back the implementation date by two years, i.e. to 2025. This takes into account our legislative process, implementation efforts, and not constraining banks in their ability to support the economic recovery in the coming years.

The nature and calibration of these provisions is still being discussed both in the Council and Parliament.

Another key issue is the implementation of the output floor and whether it should be applied at the level of a consolidated EU banking group, or separately for each local banking subsidiary. An application at consolidated level would be fully consistent with both the international Basel III standards and the logic of the Banking Union, as it reflects the benefits of risk diversification within a group. The proposal incorporates a distribution mechanism to ensure

that capital requirements that result from the output floor calculation are allocated fairly across various subsidiaries of the group according to their risk profile.

Overall, and to put things into perspective, we estimate that the average impact of our proposals would be lower than a 10% increase in capital requirements at the end of the long transitional period. Also, significantly, the impact of the proposal would be below +3% when the new requirements start to apply in 2025.

We want a robust, competitive and sustainable banking system. The banking proposal will help to deliver on this goal.

Among the non-Basel III-related aspects, the Banking Package will pave the way for the integration of environmental, social and governance (ESG) risks into the EU prudential framework. With regard to the supervisory framework, the Package also contains a number of improvements, for instance to further harmonise the following: the rules on fit & proper assessment, the assessment of certain prudentially relevant transactions, as well as the powers related to sanctions and penalties. Lastly, we are putting forward a comprehensive framework for the regulation and supervision of third-country bank branches in the EU, including specific provisions on systemic branches.

To conclude, we are finishing the job we started over a decade ago. We first increased the quality and the amount of capital, then we introduced liquidity and leverage requirements as well as a framework for large exposures. Now it is about measuring risk and ensuring that banks using models are adequately framed. We want to ensure that in the EU there is a robust, competitive, and sustainable banking system. The banking proposal will help to deliver on this goal.



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Towards Basel-compliant EU banking legislation

After a delay to the pre-established calendar, explained in part by the impact of the COVID-19 pandemic, last October the European Commission presented its proposal for the banking package that essentially looks to implement the Basel recommendations in the European regulatory framework. During the first semester of this process, both the European Parliament and the Council of the EU have made a start on their work.

In my opinion, the European Union must implement the Basel recommendations in an accurate and timely fashion, although some delays already seem unavoidable. In any case, no one should call into question the need to faithfully implement the Basel standards, given that many of the European specificities cited to introduce local deviations were considered at the Basel negotiating table. Europe can not play two different hands while negotiating in international fora.

We cannot have one stance to bring our particularities into line with international standards and then a second stance once in Brussels, to surpass the agreements reached. Indeed, the G20 mandate states that the new recommendations should not lead to excessive capital increases in the banking system, and this is the case based on the numbers produced by the EBA. But that mandate should not be dictated by the impact on individual banks, some of which will need to work with more capital. This is the objective of the reform.

The Commission's proposal, despite everything, includes new, mostly temporary, deviations from the Basel standards. These deviations, materialized in transitional arrangements, not only do not imply an immediate capital increase but rather allow for a reduction of capital in certain cases, at a time when our banking system must prepare for a long transition, threatened by developments in the Russian war on Ukraine. This is why, contrary to the strictly temporary shock that came from the pandemic, there is no space at present for reducing capital. Instead, we should be safeguarding banking stability in preparation for the coming period of uncertainties.

Therefore, my initial report on the Capital Requirements Regulation (CRR) has focused on eliminating or minimising the impact of the new deviations proposed by the Commission. Furthermore, I recently proposed new economic and political incentives to implement a full Banking Union. To this end, I decided to address some of the uncertainties of host countries in the framework for the implementation of the output floor. I have added amendments to ensure that its calibration at an exclusively consolidated level is conditional on the development of European deposit insurance and to also facilitate the application of capital and liquidity waivers as the Banking Union moves forward.

Moreover, in my initial report, I have reduced the scope of application for some transitional regimes in the implementation of the output floor within the internal models. As stated, we should not ease capital requirements at this time. Additionally, there can be no doubt that such transitional arrangements are indeed temporary.

Furthermore, this summer we have once again seen the risks linked to global warming. These climate risks must be internalized in our credit risk calculation models. In this area, I have proposed adjusting the infrastructure supporting factor to apply to projects that comply with EU taxonomy and limiting the preferential temporary treatment of low-risk mortgages to those that also mitigate climate risks. Other possible options will very likely come to light during the negotiations. We will have to consider, given that the elements of transparency and market discipline in Pillar 3 will not be sufficient.

**I am confident that the EU will
strengthen the resilience
of our banking system.**

Finally, it is essential to improve the governance systems of banks through the fit-and-proper framework chapter of the directive proposed by the Commission. In Spain, we have suffered in the past from the effects of inefficient governance models, and the reform promoted by the Commission to improve them should serve as a guide for implementing such control mechanisms throughout the European Union.

Parliamentary negotiations are underway to reach a broad agreement and open the debate with the Council of the EU. I am confident that the EU will honour its international commitments and strengthen the resilience of our banking system. That will be my endeavour over the coming months.



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A misleading international convergence

According to the most recent progress report on adopting the Basel regulatory framework published by the Basel committee in October 2021, most countries including the EU, US and UK have not started the implementation of the final Basel III Accord. Some of these countries have published a draft regulation, with a few having adopted and implemented it.

However, the main issue is the level playing field. Adopting an international recommendation does not mean it has the same content or impact in all jurisdictions. For instance, the US only applies Basel III to the largest banks, and the standard approach does not include operational risks nor the Credit Valuation Adjustment – which roughly represent a 30% reduction from Basel. Moreover, economic structures matter. Many features of the Basel framework are designed on the US economic model and penalise Europe, which has, for instance, a much smaller capital market and then a majority of unrated corporates.

International convergence of prudential regulations is desirable to avoid distortion of competition. However, if international standards do not take into account the specificities of the different jurisdictions, they may actually lead to distortion of competition. For instance, the output floor significantly reduces the risk sensitivity on mortgage loans in internal models. This penalises European banks, which have lower risks thanks to the double recourse on debtors and real estate, when American banks only have a recourse on the assets. When Americans speak with one voice, European countries are divided between them to take into account European specificities in international fora and in their own transposition of the Basel III Accord.

In addition, Europeans usually gold-plate international standards, so that the convergence is often theoretical. For instance, MREL requirements are higher than TLAC, and both the Systemic risk buffer and Pillar 2 requirements add another layers to the already thick capital buffers.

According to the European Commission, Europe will require EUR 500 bn per year in additional investment to meet its 2030 environment targets. The digitalisation, and the economic and strategic autonomy of Europe also require huge investment. As European capital markets are small, most of the external financing of these much-needed investments will rely on European banks.

However, further increasing banks capital requirements limits their financial capacity and the finalisation of Basel III will reduce this capacity by roughly 20%. The impact study for this reform, published by the Basel committee last February, shows a 300 bp reduction in the CET1 ratio of large banks in Europe. Clearly, the overarching principle of the 2017 Basel

accord of no significant increase in capital requirements is not being respected. The Commission's proposal to implement this reform includes temporary alleviations, but, fully loaded, the overall impact will be around the figure calculated by the Basel committee. Copenhagen Economics, an independent think tank, evaluated that this significant increase in capital requirements would reduce the financing capacity of European banks by roughly EUR 300 bn.

Higher capital requirements would indeed have a deleveraging effect, which is the very purpose of capital requirements (see also the measures taken by the SSM during the pandemic, based on a leverage between capital requirements and financing capacity). The experience of the two last decades is very clear: Basel III and following prudential regulations had a significant deleveraging effect, as shown by the ECB data, and the loans to non-financial corporations are still lower than they were in 2009. When saying that banks will adapt their business model to absorb the new capital requirements, supervisors simply imply that banks are going to reduce their outstanding loans!

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As calculated by Copenhagen Economics, the cost of borrowing in Europe is also going to increase, by EUR 25-30 bn. For the EU, average, corporate customers will be the most affected with an estimated increase in borrowing costs of some 0.25% points. Banks are intermediaries: all these capital costs will ultimately be passed on to consumers.



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Is there room to improve the international rule-making process?

How are countries progressing on Basel III implementation?

According to the “Progress report on adoption of the Basel regulatory framework” published by the BCBS on 14 October 2021, Canada, Singapore and Japan were the only jurisdictions that had published draft rules for all of the final pieces of Basel III (covering the revised standardised and IRB approaches to credit risk, the revised CVA framework, the revised market risk framework, the revised operational risk framework, and the output floor), as of end-September 2021. As well known, the European Commission published draft rules on 27 October 2021, just after the publication of this BCBS report. (Australia and South Korea did not have the draft rules for the revised CVA framework and market risk published, but did for the other elements.)

There has been no official consistency assessment of these rules with the Basel standards to date. However, track record suggests that countries like Australia, Canada, and Singapore tend to at least fully apply the Basel standards, if not more stringently.

International vs domestic?

Following the debate on Basel III implementation in such arenas as Eurofi, a couple of thoughts come to mind. The first is that it would have been ideal if these debates took place ahead of the finalisation of Basel III. The second is that things may have been easier if there was a differentiated treatment within the EU between large, internationally active banks and those that are not.

First, on the latter point. It is well understood that the question of whether or not to have a differentiated approach for small domestic banks in Europe has been raised in the past, and that a decision to not do so has already been made. It should also be noted that, given the implications for the competitive equality among different banking groups, this is a decision that needs to be made by each jurisdiction, with which outsiders should not interfere.

Nevertheless, it may be worthwhile recollecting that some things have changes after this decision. One is that some jurisdictions, like the US, have expanded the range of differentiated treatments, and some others, like the UK, are considering newly introducing differentiated treatments. Another change is that there has been an introduction of differentiated treatment within the Basel framework with the introduction of the G-SIBs notion. There are now more stringent treatment for G-SIBs compared to non-G-SIBs, even though both groups are internationally active and subject to the Basel standards. The rationale for the increased stringency for G-SIBs is their higher systemic importance. Then, it should

be possible to argue that less systemic banks may be subject to less stringent standards.

Although we make these observations, the decision should be left with the relevant jurisdictions as mentioned above.

Improved process?

Regarding the issue of the timing of the relevant debate, our impression is that the stakeholders’ views do not seem to be fully taken into account in the current international rule-making process, at least in some jurisdictions. The ideal scenario is for all relevant stakeholders to respond to the public consultation by the BCBS and to make all the points during that stage. However, the reality is that not all the relevant stakeholders take this process as seriously as one would hope. An example within a bank could be that it is only the regulatory affairs team that reads the Basel documents seriously, and the staff of the front and middle offices only react when the domestic consultation starts.

One suggestion to better reflect the stakeholders’ views in the international rule-making process.

If this is the case, one idea might be to conduct the domestic consultation ahead of the international agreement to finalise a Basel standard rather than the other way around which is the current case. By doing so, representatives at the BCBS will be able to take account of all the views of the relevant stakeholders and thus the international agreement can better reflect those views. In addition, the implementation timetable may become more realistic.

One drawback could be that the process after the domestic consultation leading to the international agreement may become more difficult. We could ask ourselves the following question: do we prefer an easier process with a lower probability of adherence, or a more difficult process with a higher probability of adherence and improved legitimacy?