

Basel III implementation issues

1. Where does Europe stand in the preparation of the implementation of the last Basel III evolutions?

1.1 The challenge is to address European specificities without deviating from the Basel agreement

A public representative in June attended a meeting in Basel with the officials of the Basel Committee who gave a presentation about the application of the Basel recommendations and how different jurisdictions had applied the previous recommendations. There are some specificities in all jurisdictions, but it is not clear why other parliaments or legislators are not able to implement the Basel recommendations with a final proposal more or less in the scope of Basel except Europe, especially when Europe always claims to be in favour of an international order based on rules.

In their draft report, a public representative tried to move the initial proposal of the Commission toward the Basel recommendation. The G20 mandate noted that the final increment of capital requirements does not need to be very high. Knowing the numbers set down by the European Banking Authority (EBA), the direct implementation of Basel does not represent an important increment of capital in Europe. Europe must be a reliable partner in international fora.

1.2 The Czech Presidency is fine-tuning the regulatory package which might be agreed at the level of the EU Council before the end of 2022

An official explained that the Czech Presidency was now in the middle of the discussions within the Council working party on the proposal implementing the final Basel III, as well as other changes to the CRD.

French colleagues have concluded their Presidency with the first draft of a compromise that was shared with the member states in June. The member states sent to the Czech Presidency all their written comments, and the Presidency is now analysing these over the Summer, discussing with the member states bilaterally and with the Commission, and preparing the upcoming meeting of the Council working party scheduled for September.

The Council working party should continue discussions on the substance as well as technical changes that are necessary but need further discussion, especially as there are more options how to proceed further. The Czech Presidency plans to have these discussions done in September, in order to be able to draft a revised draft compromise text that will be built on the French one because it already strived a good balance and there is a majority of member states clearly saying that the French compromise text should be the basis.

The Czech Presidency will check the accuracy of the legislative texts and make some targeted changes, in order to improve either the technical formulation or the solution of the issues that are still pending. The revised draft compromise text is to be issued to the member states within a four weeks' time – at the turn of September to October. The member states will again have time to go through all the details and give feedback, both at the Council working party as well as in writing. The Presidency hopes to a compromise before the end of its term.

The Presidency is trying to move as fast as possible because the banking package is seen as one of the crucial files within the financial services. It has been assigned the highest priority, with a clear goal to get the general approach done by the end of the Presidency. That means for it to be approved at the November or December meeting of the ministers at the Economic and Financial Affairs Council (ECOFIN).

1.3 The topics discussed encompass the evaluation of the real estate as collateral, the transitional arrangements, notably regarding nonrated corporates, and the output floor, which is expected to stay at solo level

An official called for a brief discussion on the real estate evaluation because mortgage credit represents a significant part of the loans issued by the banks. The evaluation of the real estate as collateral is quite crucial, and the rules need to work and capture all the specificities of EU markets.

There are transitional arrangements which should again help the European banks to implement the rules more smoothly and to avoid any sharp cliff effect in the implementation. But in general, the overall goal in mid-term and long-term is to be in line with Basel.

There is a major view of member states that the level of application of the output floor should stay at solo level, which is a change from the original Commission proposal. This is a part of the overall package where there is a consensus that that should be one of the pillars of the future compromise within the Council. But there may be a possibility to go for a sub-conso level if applied inside a member state.

A public representative stated that there is a clear European specificity within the transitional arrangement on the rating corporation, but more should be done to correct this European specificity. There is now opportunity to think what should be done from the demand side in this market.

This is the reason the scope of the transitional arrangement for the unrated corporation has been reduced for only the minor unrated corporation. There is not public interest to protect by avoiding a better

credit condition for unrated corporations with millions and millions of profits. These companies need to be moved to the credit rating agency market. There is the transitional arrangement for doing this; if nothing is done during this period, at the end this specificity will remain. This is the moment to do more on the demand side.

1.4 Many policy makers in the EU consider that transition measures should be sufficient to smooth the adoption of the full Basel package and address EU national specificities

An official related that Finland supports the closest possible implementation of Basel standards, though it also understands the need for the transitional periods. It is interesting that an economic area with such a diverse banking sector needs these exceptions. This is not only being discussed in the context of Basel III but also crisis management. The system does not converge very quickly, so understanding these specificities is important. The French Presidency did positive work and now the Czech Presidency is on a very good track in finding the compromise.

Economists who look at legislation often think 'first best', and it has to be accepted that if everybody is a bit unhappy, then it is probably about right. Finland is definitely supportive of the idea of getting this through as quickly as possible because it has been discussed with the industry for the longest time, and they are worried about many things. This discussion will continue, and once the transitional arrangements are there, hopefully they can be got rid of before moving to the fully implemented accord.

A public representative stated that some banks will have to live with more capital, but this is the objective of the regulation. After many years, some banks applied the internal models with more room for manoeuvre than they should, even though the direct implementation should not represent a very important increment of the capital requirements. With the Commission proposal, and even more with the transitional arrangements, in the short term there is a decrease on capital. Such a decrease should not be done, especially given the crisis now, a very different crisis from the one suffered during the Covid pandemic.

The European banking industry needs time to apply the Basel recommendations. It is also true that they cannot be kept indefinitely in the regulation because in that case the deviation introduced will represent a very relevant deviation from Basel. This could create some problems in the level playing field between banks which use internal models versus banks with a standardised approach.

The Commission proposal for the transitional arrangements is welcomed. The issue is that they cannot be kept indefinitely.

The Chair summarised that it is important to negotiate efficiently in view to the deadlines agreed in the Basel Committee. The Commission is determined to facilitate this process. The Commission's proposal is a very good basis for the negotiations. The Commission has suggested some targeted exemptions to take into

consideration EU specificities that should however be limited in time.

2. Industry concerns that the 'no significant increase' pledge will not be met are reinforced by the recent impact assessment published by the Basel Committee in February 2022

An industry speaker noted that concerns remain. The Basel Committee published an impact study last February that shows a 300-basis-point reduction in the Common Equity Tier 1 (CET1) ratio of large banks in Europe, representing the equivalent of an increase in capital requirements of 20%. The overarching principle of the 2017 Basel Accord 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. This has consequences because this freeze of capital implies that there will be less resources to finance the European economy. Copenhagen Economics evaluated that this significant increase in capital requirements would reduce the financing capacity of European banks by roughly €3 trillion.

2.1 An effectively faithful implementation of the Basel accord should encompass the 'no significant capital increase' pledge, and the calculation of the output floor at the consolidated level

Many people speak about a faithful implementation of this accord, but not on the two main aspects of this agreement. There is no significant increase in capital requirements, and there is the implementation of the output floor at the consolidated level because the Basel Committee only proposes rules at the consolidated level. This position is supported by the Commission and the European Central Bank (ECB), and it is very surprising that the industry is backing down on this issue, looking at the proposal of the French Presidency, but also the many amendments proposed at the European Parliament.

2.2 The calculation of the output floor at the consolidated level is one of the key components of the Banking Union

A public representative agreed with the Commission proposal regarding the debate on the level of application of the output floor. Applying the output floor at consolidated level solo is a good sign for advancing the Banking Union. Banking Union cannot advance more without a common insurance network because some host countries now have doubts on this matter. More capital cannot be put in the host countries if the host countries do not have a European Deposit Insurance Scheme (EDIS).

On the debate on the level of the application of the output floor and on the crisis management framework, there is a need to recover the debate on EDIS because otherwise some countries will be lost in the process for advancing in the Banking Union.

2.3 The assessments of the anticipated level of regulatory capital in the EU banking sector are controversial

An official stated that the debate on the impact is very interesting. Reference is made to the old figures, but with all the transitional arrangements and adjustments done, an initial analysis shows that it does not actually increase the capital requirement.

3. Defining the avenues for applying the Basel accord to Switzerland raises very specific questions given the unusual size of its banking sector

An official commented that Switzerland's draft regulation is currently in public consultation until October, and looking towards entering into force on 1 July 2024. Switzerland discussed if it should have worked harder on certain definitions, especially the one on what an internationally active bank is, coming up with the solution that all banks are going to be covered under Basel III. Questions remain on the definition of internationally active and whether there would still be a level playing field in Switzerland. It was agreed that Basel III would apply to all banks in Switzerland.

Switzerland reached a consensus. The pillars were ready in terms of what could be agreed before hammering out the details of the regulation. The deal was for Switzerland to aim for a compliant rating by Basel III. Furthermore, it is easier than for the EU in that it is not necessary to go to Parliament. This is going to be built into existing capital adequacy requirements ordinance and will be a decision by government.

3.1 Specific trade-offs made in Switzerland

There are three trade-offs in achieving this. First, as a small country with an average-sized economy, a huge banking sector and huge exposure on the risk side international compatibility, following the international standard and being part of the group of best-in-class was absolutely beyond discussion; secondly, having high capital costs and not being able to gather this regulatory capital due to other jurisdictions not doing so and investors not considering them as attractive; finally, there is the absolute robustness of the global system.

In Switzerland, it is necessary to be very clear about the costs and benefits of every bit of legislation. Banks put the cost of implementing Basel III across the board at nearly € 740 million because of the change of systems that goes with it. It was important to come up with an explanation as to whether that change of ordinance would be worth it.

The stability of the system, clarity, and the robustness of the Swiss financial market and banks that are internationally active are worthwhile. However, there will be very clear and sometimes maybe very controversial or harsh reactions to the consultation that is out, but it is ready to be done after coming so far.

3.2 Accepting any reduction of regulatory capital for the banking system, is not envisaged in Switzerland

Switzerland is in a rather different position from the EU. The EU fears that capital requirements would or have to be raised. Switzerland has the opposite problem, that in a one-to-one implementation of the standard there would be a reduction of the capital requirements, especially in the hotly debated real estate market.

Switzerland needed that extra stability, so there was also a consensus on neutrality, neutral capital movements along the system. This is not going to be an easy task and solutions have been found that are compliant with the standard. It will be necessary to wait for the assessment.

3.3 Switzerland closely monitors the consistent implementation of the Basel accord in other important geographies

The many banks that are in Switzerland might not think there is a consensus yet. The text is now finalised, and it is being consulted on.

What makes it so important to be here and to know what happens, in the EU, the UK, the US and elsewhere, is of course the international solution that is needed. This is no time to go back on the promise. Switzerland cannot afford to not be ready for whatever crisis strikes next, but also has more particular interests.

4. The implementation delays observed in the EU and US lead the Japanese FSA to also delay its Basel accord implementation rules

An industry speaker stated that Japan is waiting for the Europeans (and others) to finish the job. The Japanese Financial Services Agency (JFSA) published the draft rules in September 2021 with a one-month consultation period.

The European Commission came out with a proposal in October of last year saying that there will be a two-year delay in the implementation compared from the international agreement. The JFSA decided after the Paris Eurofi meeting that it would push the implementation back to 2024.

4.1 Some Japanese banks, notably international ones, will adopt earlier Basel latest demands

In addition, the JFSA stated that financial institutions are allowed to go for early adoption if they want to, and some banks are planning to go early. Banks are weighing the benefit of being able to free the resources needed for the related system changes against the increase in the capital requirements.

A distinction between internationally active banks and domestic banks is useful in dealing with the trade-off between the international level playing field; the other one is the consideration of the effects on the real economy. Internationally active banks will be subject to

international rules and then, for the domestic banks, the authorities can think about the best way to adjust from the international agreement to suit national specificities. This is one of the reasons some jurisdictions are being able to implement the Basel standards in line with the international agreement.

An industry speaker stated that the unrated corporates issue is more a non American specificity because Japan's banking sector is more dominant than the capital market. This is likely the case around the emerging markets that are members of the Basel Committee or the Financial Stability Board (FSB). This is not a European specificity; the US is rather the outlier, and the rest is more like Europe.

5. The challenges faced defining a regulatory framework with a single set of requirements which fit all regional specificities and level the playing field

An industry speaker stated that, although supervisors in Europe could have promptly adapted the potential requirements after the Basel Accords through the systemic buffers or Pillar 2, the modifications have been limited, showing that there might not be as huge a regulatory capital gap as suggested by Basel.

Implementation is not a big deal for countries where the Basel III overarching principle of no significant increase in capital requirement has been respected. According to the most recent progress report published by the Basel Committee in October 2021, most countries, including the EU, US and UK, have not yet implemented the final Basel III Accord.

5.1 In certain geographies the scope of the standards implemented is reduced

The main issue is the level playing field. Adopting an international recommendation does not mean there is the same content or impact for all jurisdictions. For instance, the US standard approach does not include operational risks nor the Credit Valuation Adjustment (CVA), which roughly brings about a 30% reduction from Basel. Moreover, economic structures matter, and many significant 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.

5.2 Factoring in the global framework the specificities of the risk profile of the different regional banking systems as well as local Pillar 2 practices proves challenging

The consequence of is that while an international convergence of prudential regulation is desirable to avoid a distortion of competition, whenever international standards do not take into account the specificities of the different jurisdictions, they may actually lead to distortion of competition.

In addition to that, Europeans usually gold-plate international standards so that the convergence is often theoretical. For instance, the minimum requirements for own funds and eligible liabilities (MREL) are higher than the total loss-absorbing capabilities (TLAC) and both the systemic risk buffers and Pillar 2 requirements add other layers to already thick capital buffers.

An official explained that the EU is quite prudent. It applies many requirements to all banks, including the MREL. On the other hand, one of the goals and also advantages if the prudent approach in the EU is that it continuously tries to be more resilient and stable, in order to rely on resilient banks as the major suppliers of funding to the economy as well as to be ready to fight potential crises in the future.

An official explained that the concerns of the banks must be taken seriously. The Swiss Finance Ministry was not at the table when Basel III was negotiated, although was writing the legislation. The Swiss Government had to implement a standard that it did not negotiate. The Ministry made the best of its experiences when finding solutions to include the private sector. There is room for manoeuvre to not only be suspicious of the market actors but include them in solutions.

6. One challenge is to improve the Basel and EU regulatory/standard setting processes in order to identify earlier what are the specifics of each jurisdiction globally

6.1 Ways for involving at the global level all the stakeholders at an early stage should be further worked out

An industry speaker explained that Japan tried to involve all stakeholders at an earlier stage so that authorities and representatives at the Basel Committee can figure out where the red lines are. Once there is an agreement because those red lines have been tested, it is easier to follow on the agreement.

The international process can be improved to find out the red lines for the different stakeholders. The idea would be to have at least one round of international negotiations after at least one round of domestic consultation in all the relevant jurisdictions. It would be good to come up with a proposal that would make it easier for all the jurisdictions to get a positive implementation without having to change any of their domestic rule-making processes.

An industry speaker stated that the proposal to better associate the private sector in the process of designing these international rules is very interesting. The way international agreements are designed could be improved with an earlier and better association of the banking sector.

An industry speaker stated that currently there are public sector bodies that are not involved in the Basel

process that could be involved from an earlier stage by the improvement in the international process.

6.2 The legislative process in the EU is complex and lengthy

An official stated that the legislative process in Switzerland is much faster while in the EU, it is much more complicated as national legal frameworks of member states need to be adapted on revised regulations and directives need to be transposed into national laws. In general, some countries in other jurisdictions have a much quicker legislative process, like Switzerland, than the EU club of 27 member states, with 27 national legal systems.

The Chair stated the decision-making process in the EU has changed a lot over time with an increased role of the European Parliament and a much higher focus on stakeholder consultation.

6.3 The limited role for market finance in the EU compared to certain regions, and the current competitive state of play in the single banking market, compound any possible negative consequence stemming from the global common framework

An official believes strongly in common rules, particularly internationally, for competitive banks. Banks should move with the times and with the competition.

The world is changing and European banks are forced to change. They can be protected and isolated, but in the end, this needs to be a global financial market and not a fragmented one, as now seems to be the political scene, due to the Russian aggressive war in Ukraine.

A public representative stated that the debate around the structure of the competition level in the banking sector is very relevant. The Commission proposal does not include any significant increment on capital. When the industry claims that more capital represents less credit, it depends on the level of competition in the banking sector. If this trade-off is true, the EU still has to evaluate whether competition is increased and whether it leads to a clear reduction of lending by the banking sector.