BASEL III IMPLEMENTATION

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Basel III - Finishing the job

The 2007-08 global financial crisis revealed significant shortcomings in the regulatory framework for banks. According to the Basel Committee on Banking Supervision (BCBS), there was a 'worrying degree of variability' in the calculation of risk-weighted assets (RWAs) during the peak of the crisis[1], undermining the consistency and comparability of firms' capital ratios. Ultimately, investors lost confidence in the credibility of capital ratios, exacerbating the crisis with devastating consequences.

In response, the BCBS developed the Basel III standards to improve the resilience of banks. Initial phases, globally implemented, increased the quantity and quality of regulatory capital held by banks and introduced new requirements for leverage and liquidity. The final phase, which we call 'Basel 3.1' in the UK, addresses weaknesses in the calculation of RWAs, the denominator of banks' capital ratios. Its implementation is vital to fully realise the benefits of earlier phases.

Since the BCBS published its standards in 2017, the PRA has become an independent 'rule-maker' as a result of the UK leaving the EU. It is in this context that we developed Basel 3.1.

The PRA has a primary objective to support the safety and soundness of the firms it regulates. The PRA also has a secondary objective of facilitating competition and a new secondary objective to facilitate, subject to alignment with international standards, the international competitiveness and growth of the UK's economy.

Although the implementation of Basel 3.1 is conducted under a legal framework where this objective of competitiveness and growth does not strictly apply, it has informed it. By maintaining confidence in our banks, the Basel 3.1 reforms promote stable and reliable financing to the UK real economy, thereby supporting UK growth. And by aligning with internationally-agreed standards, our finalised proposals will advance competitiveness by promoting confidence in the UK as a global financial centre. A clear and robust prudential framework is therefore an important contributor to maintaining the UK's status, reputation, and competitiveness.

So where are we in the UK's implementation process of Basel 3.1? We issued proposals in November 2022 and in December 2023 published the first set of final rules, covering market risk, credit valuation adjustment risk and operational risk. The remaining policy proposals are scheduled for Q2 2024, with the whole package then coming into effect from 1 July 2025.

Other jurisdictions around the world have also been on a multi-year journey to implement the new standards. As we get closer to implementation, we have seen a number of differences in approaches across jurisdictions. Some are temporary (e.g. implementation timelines or transitional provisions), but others are not.

Some of the more material differences that we have had to consider when developing the UK package include: the treatment of small and medium-sized enterprise and infrastructure lending, the treatment of lending to unrated corporates, and permitting the use of internal models across the capital framework.

We support the call for a timely and full implementation of the Basel standards.

Some differences between jurisdictions are to be expected as regulators seek to reflect the specificities of their domestic markets and banking systems where the evidence supports it, as the PRA has done in the UK. What is important, however, is that the core resilience that underpins the Basel 3.1 standards is not damaged. If there are significant differences in implementation across jurisdictions, we risk undermining the credibility and comparability of banks' capital ratios, or risking a 'race to the bottom', ultimately undermining the rationale for Basel III.

Capital ratios and minimum capital requirements are a core element of ensuring banking systems are resilient to shocks. When implemented consistently, they help avoid the build-up of systemic vulnerabilities and mitigate the risk of costly bank failures. The recent failures of international banks like Silicon Valley Bank and Credit Suisse remind us of the importance of robust global financial regulation. With this in mind, the Governors and Heads of Supervision (GHOS), the Basel Committee's oversight body, have expressed their expectation of implementing all aspects of the Basel III framework in full, consistently, and as soon as possible[2]. We support the call for a timely and full implementation of the Basel standards and look forward to finishing the job!

1. *Basel III: Finalising post-crisis reforms (bis.org).*
2. *Press release: Governors and Heads of Supervision endorse initiatives in response to the banking turmoil and reaffirm priority to implement Basel III (bis.org).*

PAULINA DEJMEK-HACK
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Finalising Basel III: the international state of play

Basel finalisation is not about urban planning for the Swiss city, but about bank regulation. The 'Basel Framework' is a set of global standards, developed over the years by the Basel Committee of Banking Supervision (BCBS). This Committee started its work in 1974. Whilst the BCBS had developed several earlier sets of standards, its most ambitious reforms to date were those initiated after the 2007-2008 Great Financial Crisis, dubbed 'Basel III'. The first part of these reforms, already implemented in the EU and in most other jurisdictions, imposed more and higher quality capital, less leverage and stricter liquidity requirements. Jurisdictions around the globe are now moving towards implementing the second and final part of Basel III. These standards focus on how banks measure risks and, for banks using their own internal models, they provide minimum rules, based on a standardised measure, the so-called 'Output Floor'.

The Basel III standards were designed and approved by the BCBS, which brings together supervisors from 28 countries, from across the world. A consistent implementation of standards across jurisdictions is necessary, not only to deal with potentially systemic issues in a globally interconnected banking sector, but also to ensure a level playing field. The merits of a global prudential framework were clear during the banking turmoil of Spring 2023, as highlighted by a recent Basel Committee report.

The EU has implemented all Basel standards. In summer 2023, the European Parliament and the Council reached an important milestone by finding an agreement on the EU implementation of the last Basel III elements. Recently, two of the EU's important international partners, the US and the UK, have put forward draft rules as well, for finalisation in 2024. It is at this stage difficult to compare rules between jurisdictions, as the UK has published only part of its final rules. The US authorities have finished their stakeholder consultation process and is facing significant resistance from US banks. In terms of the application date, the EU will start phasing in the new regime from 1 January 2025. The US and UK have announced their intention to start applying the new rules from mid-2025.

However, as mentioned, regulatory discussions are still ongoing in these two countries. In terms of the scope of application, i.e. to which banks the rules are applied, the EU made the choice several years ago to apply the Basel rules to all its approximately 4,500 banks, including to smaller banks with mostly domestic activities. This approach provides an important and additional layer of resilience in the banking system. Following the banking turmoil in March 2023, the US regulators are proposing to enlarge the US scope of application from the current 9 international banks to close to 40 banking groups, while keeping a different set of rules for smaller banks. In the UK, which still has the same approach as the EU, reflections are ongoing on a potential separate regime for smaller banks. In terms of jurisdictional specificities, national choices often reflect the characteristics of the local banking systems and their role for the economy.

In the EU, existing specificities have been maintained, notably the supporting factor for small and medium enterprises (SME), which are an important part of the EU economy. For the final elements of Basel III, the EU has introduced a limited number of permanent specificities. Instead, the co-legislators agreed on transitional arrangements phasing in the reforms overtime. This applies, e.g. to the use of models for exposures to low-risk residential mortgages and to non-rated corporate borrowers. In these areas, EU banks are important providers of long-term financing. In this way, banks and their clients get more time to adapt to the new rules. The US has proposed to abolish the use of internal models for credit risk, retaining such models only for market risk. To ensure a domestic level playing field between large and smaller banks, the US regulators have also proposed several parallel sets of requirements – likely resulting in the Basel Output Floor becoming less relevant in practice.

As in any journey, the last stretch is important. A continued effort is needed to reach the finish.

As regards the UK, it is too early to comment on national specificities, including the potential specific regime for smaller banks. One area where differences could have an impact beyond local banking systems are market risk rules. These affect the capital markets business of global banks, for which an international level playing field is essential. The EU rules empower the Commission to adjust or postpone the market risk rules, if necessary given developments in other jurisdictions.

To conclude, we are reaching the last stretch of a long journey. We have come far, but there is still some way to go.[1]

As in any journey, the last stretch is important. A continued international effort is necessary to reach the finish.

1. *See a recent post by the European Commission with details on the Basel III implementation in the EU.*

DANIELA STOFFEL

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Why Switzerland implements the final Basel III standards in 2025

Switzerland is consistently implementing the final Basel III standards. At the end of 2023, the Swiss government (Federal Council) adopted the new Capital Adequacy Ordinance for banks. This bill transposes the final Basel III standards adopted by the international Basel Committee on Banking Supervision (BCBS) into Swiss law. The amended ordinance will enter into force on 1 January 2025. We are committed to the internationally agreed rules and are implementing them within the planned timeframe. We expect and are confident that the world's major financial centres will also adopt the final Basel III standards into national law within the planned timeframe. This will strengthen financial stability globally.

The global financial crisis has undermined confidence in banks' published risk-weighted capital ratios. Empirical analysis by the BCBS revealed excessive variability in the calculation of variability in the calculation of risk-weighted assets (RWA) across banks. One of the main objectives of Basel III final is therefore to reduce the excessive, unwarranted variability in risk-weighted assets that affects banks' published risk-weighted capital ratios. Basel III final should now result in sufficiently transparent and comparable risk-weighted capital ratios to enable the market to assess risks effectively. With Basel III final, the BCBS aims to strike an appropriate balance between simplicity, comparability and risk sensitivity, while avoiding excessive model optimisation. The objectives of the BCBS also make sense for Switzerland, by strengthening the financial system and financial stability.

For the internationally oriented Swiss financial centre, an implementation of the global BCBS standard and a corresponding assessment by the BCBS is sensible and important. Accordingly, we are sure that the amendments to the ordinance will be positively assessed within the framework of a Regulatory Consistency Assessment Programme (RCAP) conducted by the BCBS. This high degree of consistency with the Basel minimum standard allows a certain amount of leeway.

The Swiss implementation aims to make sure that the greatest possible benefit and the lowest possible implementation costs are achieved for the Swiss financial centre and the financial market law objectives of systemic and creditor protection are not compromised.

Basel III final and its implementation in Switzerland are intended to reduce and internalise the external costs that banks impose on society. However, direct benefits are also expected for the banks: Conformity of the domestic market with the Basel standard may facilitate access to foreign markets. In addition, the signalling effect associated with compliance with the standard and better international comparability may facilitate banks' access to international sources of funding. A high level of confidence in the Swiss financial centre is also important for the Swiss financial centre is also important for the international wealth management business.

The national implementation of the final Basel III standards centres on the fact that higher-risk areas of the banking business must be backed by more capital, and lower-risk areas by less capital. No significant change in the total capital requirements is expected for the Swiss banking sector on average. However, the capital requirements for UBS in particular are likely to increase. In addition, the amendment to the ordinance will limit the scope for internal models to determine capital requirements and achieve a transparent and internationally comparable calculation of capital.

Switzerland is consistently implementing the final Basel III standards.

The BCBS adopted the finalised framework in December 2017 and completed it with a revised minimum standard for market risks in February 2019. The national implementation of the Basel III final standards began long before the takeover of Credit Suisse by UBS in March 2023. This crisis emphasised their necessity even more and their implementation will further strengthen the stability of the Swiss financial centre and the foundation for Swiss banks' international business.

An evaluation of the too-big-to-fail regulations for systemically important banks is currently being carried out as part of the Federal Council's report, which should be available in spring 2024.

MAKOTO MINEGISHI

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No benefit from inconsistent implementation of global minimum standards

In the mid-19th century, U.S. Admiral Perry arrived off the coast of Tokyo, demanding Japan to abandon its 200-year policy of national seclusion. His fleet of "black" warships was truly frightening. The fear was then engraved so deeply in the mind-set of the Japanese that, even today, any unknown factor from abroad that could have a major impact at home is often labelled as "an arrival of black ships". Indeed, since Basel I, international discussion around prudential rules has tended to be regarded as such, as we sit at negotiating tables to have Japanese specificities reflected in global minimum standards.

Against this background, similar to our predecessors who worked hard to convince domestic stakeholders that "black ships" presented an opportunity to modernise Japan, we have made conscious efforts to enhance understanding and support from a range of domestic stakeholders, making a case to defy temptation to dilute already-agreed elements, and highlighting merits of globally operating under a single rule-book. I am reasonably confident about our success, though with caution, because scepticism could easily re-emerge at an indication of non-uniform international implementation.

We need to be aware of a negative spill-over of inconsistent implementation of the internationally agreed minimum. A jurisdiction may be induced to deviate, so as to gain support from its own constituencies. A failure of full, timely and/or consistent implementation in a jurisdiction, particularly a large one, tends to ignite level playing field concerns in others, thereby further weakening support for the international framework. There is an embedded danger of a vicious cycle leading to the race to the bottom.

This is a serious concern for jurisdictions that faithfully move to domestic implementation. Japan has kept a good record in implementing international agreements. Our regulatory body, the Financial Services Agency, has finalised the rules and all elements of Basel III are already in the implementation phase. The past assessments under the Regulatory Consistency Assessment Programme (RCAP) by the Basel Committee on Banking Supervision have found a high degree of conformance of Japanese rules to international agreements.

No simple solution exists to prevent an obviously worse-off situation for everyone through each jurisdiction's rule-making process, except for tenaciously calling supports from stakeholders, so as to minimise an incentive, in the first place, to deviate. Akin to the famous quote by Jean Monnet on how crises have forged Europe, episodes of financial stress should serve as a good opportunity to reflect on the merits of international agreements. For example, Covid-19 has served as a reminder of the importance of the resilient banking system, which the implemented Basel III standards have helped to ensure. Analytical reports from the Basel Committee and the Financial Stability Broad that evaluate effects of the post-crisis reform initiatives have provided evidence that stronger capital bases have generally facilitated banks to provide credit to the economy, contrary to prevalent fear that enhanced regulation would be simply a burden. These evaluation reports have also allowed us to reach out to a wider range of stakeholders beyond traditional close-watchers in financial industry, including academics and civil societies at large. The recent banking turmoil has also been an opportunity to reaffirm the critical importance of implementing Basel III framework in full, consistently and as soon as possible.

In the future policy discussion, the key is to internalise concerns from all stakeholders in international negotiation. A two-step process, where international agreement is first reached, and then domestic negotiation starts would not be optimal. A case can be made for using the consultation process by international standard setting bodies more strategically and effectively. Equally important is to avoid a coordination failure though international cooperation. Much can be done at the international level.

The key is to internalise concerns from all stakeholders in international negotiation.

I believe coordinated communication at the Basel Committee has convinced stakeholders that the Basel III will be implemented by all Basel jurisdictions, alleviating concerns of earlier adopters. At the same time, communication that none of the new initiatives should interrupt the imperative of implementing Basel III allowed both authorities and banks to focus on the implementation of any remaining part of the international agreements.

Back in 2019, under the Japanese Presidency, G20 addressed the issues of market fragmentation that would arise due to discrepancy of implementation of international agreements. The thrust of the message under this agenda is still valid. Consistent implementation remains at the core of the international agenda, as the questions extend into emerging areas, such as crypto assets. Authorities continue to work hard, together with stakeholders, both domestically and internationally, to avoid creating a fragmented world.

THILO SCHWEIZER
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Ensure an international level playing field - Keep an eye on future challenges

For more than five years, the EU has been diligently working on its implementation of the latest Basel standard ("Basel 3.1"). This process is now drawing to a close. In December 2023, a final compromise agreement on the Banking Package has been endorsed by Parliament and Council.

While work on the final text versions of CRR III and CRD VI by the EU's lawyer-linguists continues in the background, the EU has almost completed a process that is still ongoing in many other major jurisdictions. Discussions in the U.S. have recently reached the level of Senate banking committee hearings. With industry consultations closed just weeks ago, the FED is currently reviewing their proposal. In the UK, the PRA intends to publish the final set of applicable rules until May 2024. Notably, both jurisdictions have declared their intention to delay the date of application by six months until July 2025. The EU's legislators decided not to align with this date despite severe industry concerns. It is fair to state that this will somewhat hamper a level playing field. For banks operating around the globe, however, an international level playing field is of the essence – in particular with regards to the implementation of the Fundamental Review of the Trading Book (FRTB). In the Asia Pacific region, divergent implementation deadlines are creating additional complexities for banks.

Going forward, a key challenge for banks will consist in carrying out the internal implementation of the new rules and regulations: To be ready for application of the new Basel rules once they enter into force – and once respective reporting obligations kick in. In the EU, we expect that banks will only have about eight months for the transition. This is in strong contrast to previous Basel implementations, where banks were given a 24-month implementation period. Therefore, we advocate for swift adoption and publication of the EU's final Level 1 texts.

That being said, a lot of relevant Level 2 work in the EU still remains to be performed by EBA. They will have the challenging task to complete all 140 mandates that are referenced in CRR III in time, including reports, guidelines and technical standards. This work will be essential to render CRR III and its reporting obligations practically applicable. This obviously implies additional regulatory uncertainty for the banking industry. We call on EBA to ensure a timely delivery on the outstanding mandates, as set out in their ambitious roadmap.

Yet, discussions about the implications of the Basel III finalization will not end with its entry into force. In the EU, regulators have prudently decided to phase-in certain requirements until 2032, particularly those in relation to the Output Floor, with the recognition of certain "*European specificities*". It is obvious that an international standard cannot account for specific regional considerations. I welcome these compromises, which adapt the Basel standard to the realities of banking in Europe. Of course, such adaptations should not run counter to an international level playing field. The EU has done a good job calibrating these accordingly. Interestingly, the current political debate in the U.S. is also focusing on issues like the treatment of unrated corporates, residential mortgages, or operational risk. It will be exciting to observe in how far the "landing zones" will finally be comparable.

A key challenge for banks will consist in carrying out the internal implementation of the new rules.

Nevertheless, let me emphasize the following: In order to maintain the long-term competitiveness of the European banking sector, long-term solutions for the remaining challenges will have to be established. In particular, this applies to the treatment of unrated corporates. Should there not be a significant uptake in rating coverage for corporates over the coming years, we will have to discuss creative solutions in the EU before the deadline comes closer. An international benchmark analysis that considers the approaches and solutions of different jurisdictions should inform this conversation.

Finally, – after Basel is before Basel, to slightly adapt a famous German saying. The steady integration of ESG and climate risks into prudential regulation will be a major task going forward. We are calling for a careful and diligent assessment – and we agree with the EBA's view that such rules should only be implemented on the basis of a broad international consensus. Consequently, the Basel Committee's work will continue to be of great importance in the coming years. Against this backdrop, I look forward to a lasting dialogue between supervisors, legislators, and industry and to our discussions here at EUROFI.

HENNING DANKENBRING
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Basel 4 – Harnessing the transitional period to achieve convergence

There has been much debate on the extent to which the EU interpretation of Basel 4 deviates from the standards set out by the Basel Committee for Banking Supervision. EU banks contend that specificities in the market require additional consideration to maintain a level playing field. Regulators, on the other hand, are concerned that all jurisdictions target a full, faithful and timely implementation.

At this stage, timeliness is something of a moot point. Finalisation of the rules and the journey to implementation have been a long time coming, and there is now consensus that it needs to get done. On the more complex subject of EU application of the standards, it seems unlikely that there will be an outcome to the debate that satisfies everyone.

Should the EU do whatever is needed to comply fully with Basel rules now? Not necessarily – and instead of continuing to focus on whether the EU's stance is appropriate, perhaps the better questions to ask are what should happen next and what can the EU banking sector do to create an environment that supports future compliance?

For European banks, at the very least the final Basel reforms will impact profitability, influence the design and pricing of individual products, and require a major overhaul of IT and reporting solutions. For banks with a high percentage of RWAs calculated using internal models, and significant exposures to both retail mortgages and unrated corporates with low probability of default, these impacts may be particularly material.

The European Commission has committed to a holistic, fair and balanced assessment of the state of the banking system and applicable regulatory and supervisory frameworks in the Single Market, stating[1] that 'where possible, adjustments to the international standards should be applied on a transitional basis'. Such adjustments include arrangements for the impacts of the output floor on low-risk residential mortgages and unrated corporate lending exposures.

In the past, investors have been keen to understand banks' fully loaded capital ratios post any transitional rules. Should this apply again, the response time for banks will clearly be reduced unless, for example, management actions are included as a counterweight for the phase-in of the output floor. However, given the flexibilities and potential extensions of transitional periods for different aspects of the banking package, we believe there might be more breathing space than in previous CRR and CRD changes.

So, what are the key actions that European banks and other stakeholders could take now and during the transitional period to mitigate the business implications of full compliance with the Basel accord?

First, and to state the obvious, any advancements of the Capital Markets Union that would allow for real economy financing without involving banks' balance sheets would clearly reduce the overall impact of the banking package.

Second, an action within banks' own control, is to identify business areas where originate-to-sell, rather than being easier said than done, as has often been the case, is actually achievable. Given the significant increase in regulatory capital for the same assets, any opportunity to reduce RWAs with limited implications on return to capital should be embraced. The transitional period can provide the time for banks to review their portfolios with this goal in mind and identify potential buyers. Pension or special opportunity funds might seize the opportunity to invest in appropriately risk-return-profiled assets, enabling the banking package to contribute to the development of capital markets in Europe.

Third, banks need to re-assess individual products thoroughly in the context of the new regulatory capital charges which may change their risk-return profiles. Certain businesses or products (for example, those that involve low-risk and low RWA density under an IRBA-approach but proportionally higher risk weights under a standardized approach) may no longer be viable and sustainable. Unless, as described above, originate-to-sell opportunities arise, these may need to be discontinued. Businesses or products where the standardized approach, and ultimately the output floor, result in the same or lower RWAs than the internal model approach might offer new opportunities.

What can the EU banking sector do to create an environment that supports future compliance?

In short, EU banks are unlikely to be in full compliance with the final Basel standards from 2025. This does not mean that they have any less work to do – indeed, there will be a very significant and challenging workplan to get through in the coming months and years to implement the revised CRR requirements.

There is potential for convergence, but it is some way off. Although there will likely always be some differences, if used well, the transitional period can ultimately move the EU closer to global standards.

1. *CRR consolidated trilogue text, December 2023*