

Basel III implementation: global consistency challenges

1. The Basel 3.1 internationally agreed standard is being implemented to addressing weaknesses in the calculation of risk-weighted assets

The Chair stated that this is the third phase of post-global financial crisis (GFC) reforms. Two previous tranches have been successfully implemented. The quality and quantity of regulatory capital held by banks was increased, which was a critical step in fortifying the financial system. New requirements were also introduced for leverage and liquidity. Several jurisdictions are now at the threshold of implementing the final phase, and completing this phase is vital to fully realising the benefits of the other phases. Strengthening the accuracy and consistency in calculating risk-weighted assets (RWAs) will enhance the credibility and reliability of banks' risk-based capital requirements and bolster resilience in the system.

A policymaker added that in addition to the importance of the standards themselves, it is also important for the credibility of international as the Basel Committee, the International Organization of Securities Commissions (IOSCO) or the Financial Stability Board (FSB), that jurisdictions implement the agreed standards.

1.1 Progress is being made on Basel 3.1 implementation but at different speeds across jurisdictions.

The Chair explained that the UK is an independent rule maker after leaving the EU and is implementing Basel 3.1 rules in that context. The UK has published its near-final rules on many aspects of the reforms, such as market risk, credit valuation adjustment (CVA) and operational risk. The second near final policy statement is due Q2 2024, which will cover credit risk, the output floor, and other issues. Other jurisdictions are at various stages of policy development and implementation. There are going to be some differences in countries, in both the substance of the reforms and the timing. Those differences can be appropriate, especially where they reflect the specificities of local markets provided that the main thrusts of the Basel reforms are faithfully delivered.

An official noted that it took almost five years for the bill to be finalised by Switzerland's government, and Basel III will be implemented by 1 January 2025. Switzerland aims for a largely compliant implementation of Basel III, and has applied the rules to all its banks. Significant negotiation with Swiss banks took place to find a way to not have overall capital go below the levels seen before Basel III was implemented.

An official added that the banking sector put a price tag of about 1 billion CHF on the implementation costs, but Switzerland is interested in an efficient use of Basel III. Another condition that had to be fulfilled was to be in sync

with other major jurisdictions that are also international competitors with Swiss banks. Switzerland is examining other jurisdictions to see if they will be able to meet the deadline.

A Central Bank official stated that Basel III implementation has already happened in Japan. Japan's regulatory agency, the Japan Financial Services Agency (JFSA), conducted public consultation and finalised domestic rules in 2023, and carefully monitored development in other jurisdictions to pick up the right implementation timing. Japan's general implementation date will be March 2024. Japanese rules are consistent with the international agreement, and the full package is applied to internationally active banks.

A Central Bank official highlighted that Japan's early and internationally consistent adoption could put Japanese banks at a comparative disadvantage. Financial Stability Board (FSB) members have repeatedly expressed that Basel implementation is important, and they have a strong expectation that the full implementation will be shown in all jurisdictions. If Japan should need to reopen its issues through its domestic process, that would end up weakening the case for having a globally consistent framework. Japan has been encouraged by the positive development in Europe and the US, and can now take the full benefit of the post reform package.

1.2 The EU has agreed to implement Basel III from 1 January 2025

A policymaker explained that EU started the process relatively early and put a proposal forward in October 2021. An agreement by the EU co-legislators was reached in 2023, and the text is now being finalised. The European Banking Authority (EBA) is working through many of the technical details to prepare for the implementation. The application date is 1 January 2025, which is a strong signal that the EU wants to stick to the internationally agreed timetable.

A public representative added that an agreement was reached to keep the initial transitional arrangement proposed by the Commission, but with a clear deadline. The agreement now has a clear end date in the regulation where the transitional arrangements expire.

2. Adaptations to the standards were made to cater for specificities of European banking markets

2.1 Key policy objectives included the package being implemented in time and being as close to the recommendations as possible

A policymaker highlighted that in addition to implementing the Basel III framework, the EU banking

package has the rules around environment, social and governance (ESG) and the processes that banks must have in place to deal with ESG matters and transition plans. The legislative text is a faithful implementation of the Basel agreement. Some small adaptations were done to cater for specificities of the European banking markets. Transitional periods are in place, which will give European banks more time to adjust to some of the new rules. The EU applies the Basel framework to all its 4,500 banks, which is different to some other jurisdictions.

An official added that global consistency is vital, as well as a level playing for the Fundamental Review of the Trading Book (FRTB), the net stable funding ratio (NSFR) and other special regulations.

An industry representative noted that the agreement is not yet officially published, and the lawyer-linguists are still working on the final text. The final text is needed before private banks can implement it, and if it is published in April then private banks will have eight months to get everything up and running.

A public representative highlighted that institutions are aware of the proposal. The regulation contains transitional arrangements to let banks implement the new rules in time. The ECON and Parliament passed the proposal, and after the vote in the ECON Committee the EBA can work to develop the level two proposals. The EBA has already started its work to develop some technical standards.

An industry representative stated that more time had been given in the past. Japan and Switzerland are up and running, and the UK is slightly lagging. Nobody knows what will happen in the US.

An industry representative noted that the output floor transition accounts for around 33% of the implications of implementing the final text. For many banks the other 66% will be due to the 2032 transitional period for reduced risk weights for unrated corporates and residential mortgages. Lots of elements will be material for banks. The key question is around the EBA technical standards and they will evolve.

An industry representative added that the Commission, Parliament, Council and the authorities have been clear that the implementation date will be 1 January 2025. Private companies had hoped that the date would be postponed, but banks are working hard to get there. Some technical standards are also outstanding.

A public representative stated that the European Parliament's view has always been to deliver Basel III quickly in order to have the new package implemented in time. One of the primary objectives was to have an agreement after the triologue, with enough time to implement the Basel recommendation in a timely manner. The second one was to have a European regulation that is as close to the Basel recommendation as possible.

A public representative added that there are some European specificities; Europe applies the same rules to every bank, which is different to other jurisdictions. That introduced a clear problem in the negotiation, as the

profile of banks and the diversity of Europe's banking system is relevant and its role is wider than in other jurisdictions. ESG was another relevant issue during the negotiation. More needs to be done in climate risk; stability needs to be increased to control banking activities to reduce that risk.

A public representative explained that political agreement had been reached at the end of June 2023. In recent months there have been many technical issues that needed to be fixed before the final deal. The ECON Committee voted for the package in December, and it is now at level two regulations and level two proposals. The EBA can work with the decision, with the vote taking place after the ECON meeting. Everything will be ready to support the package in plenary in March or April, but much work needs to be done.

The Chair agreed that it is clear that regulatory authorities and the industry have much more to do to ensure the full implementation of the reforms in practice.

2.2 Diversity of bank business models, their implication on SMEs lending and the application of the international standard required adaption in the EU

An official stated that the EU strikes the right balance with Parliament, Council and Commission, because it has a very heterogeneous landscape. Germany has many small and medium sized banks, as well as large banks. The EU applies the Basel standards to banks of every size, which is a huge difference compared to other parts of the world. It is important to have transitional regulations. For Germany it was important that the adaptations for specificities remain transitional, with a clear end date.

An industry representative recalled the first impact study by the EBA in 2019, which showed a 'horrific' 25% increase on average. Already in 2016 there had been resolutions by both the Council and the European Parliament. The first resolution has been around no significant increase on average in the European Union, and the second has been around recognition of EU specificities. The five 'pain points' that were at the core of the company's lobbying were: unrated corporates and how to deal with the rating shortage; trade finance; residential real estate; securitisations; and specificities around the Emissions Trading System (ETS). Good solutions were received on ETS, securitisations and trade finance. The other items are manageable within the transition period.

An industry representative noted that the implications for banks in Europe are dependent on the business model and the degree to which credit risk is being calculated by internal ratings based (IRB) models. There will be common equity tier 1 (CET1) requirements. There are certain areas where not much preparation can happen, such as in residential mortgages and unrated corporates. Using IRB models for that type of exposure will result in significant implications. The transitional periods help, but it is now dependent on how it is going to be implemented with the EBA technical standards. A vital technical standard on disclosures asks banks to disclose fully loaded figures, beyond the derogations, until 2032.

3. The current US proposal maintains a dual system which applies higher standards to the largest banks with tailored proposals for smaller institution. The proposal does not permit the modelling of credit risk and has raised industry concerns around the impact on an international a level playing field, SME financing and securitisation

The Chair highlighted the strong theme of a desire for overarching consistency in implementation from panellists.

An industry representative stated that the US is having a very vocal consultation period. Pressure on the US agencies at the start of 2023 was around the dual system in place between the globally systemically important banks (G-SIBs) versus the regional bank model. Since the GFC regional banks have not had the same attention and focus as the G SIBs. A recalibration was not done as part of the Basel Endgame proposal for the G-SIBs that had already had a stress capital buffer and a standardised floor introduced. Since 2008 the capital reserves of G SIBs have grown from 678 billion to 1.1 trillion, and their average tier one ratios have moved from 10.2% to 13.6%.

An industry representative explained that there is significant US opposition to the current proposal, for both level playing field concerns and the more fundamental principle of capital being priced and sized relative to the risk being taken. In the US proposal there is no modelling of credit risk RWA. Investment grade RWA levels can only be assessed where companies have publicly traded securities, which is a big problem for small and medium enterprises in the US as credit availability and pricing is worsened for a part of the economy that does not have many other options.

An industry representative added that operational risk is calibrated based on a business indicator component which only looks at the size of the revenues, which reintroduces a large differential between the G SIBs and the regional banks. The US does not have a problem with Basel market risk, but the market risk charging for Basel on the G-SIBs has already been incorporated under the stress capital buffer and the stress testing framework. There is a double counting and overlap between what would be proposed and what is already in place for the G-SIBs.

An industry representative added that there is a credit conversion factor being introduced for the unused portion of retail lines of credit, which will lead to an effective risk weighting for credit card loans of more than double what has been observed through quantitative modelling. Inflation Reduction Act (IRA) tax credits that are being introduced to help fund a carbon transition would have 250% to 400% risk weights assessed for US tax benefits in limited liability companies under the Basel III end game proposal.

3.1 The regulatory process raises concerns

An industry representative explained that the US has the Administrative Procedure Act (APA), which establishes clear procedural requirements that apply to all federal agency rulemaking, including the Basel III proposal. As per the Bank Policy Institute comment letter, the Basel III proposal violates both the procedural and substantive standards of the APA because it lacks a sufficient evidentiary basis, ignores evidence, fails to explain the methodology and assumptions, and improperly fails to disclose underlying data and analysis from the public.

3.2 US implementation dates may have significant impacts on international banking groups

An industry representative noted that the difference in implementation dates both does and does not impact their company, as it conducts business in a significant number of jurisdictions. Their company is used to operating under multiple different jurisdictions and tailoring requirements on all of its calculators for relevant jurisdictions, but it will not change a long-term business franchise decision based on something that is a transitory difference such as the EU-UK six-month differential. The question is whether structural differences emerge or not.

4. Global consistency challenges are being closely monitored by different jurisdictions to avoid unlevel playing field issues

The Chair summarised that panellists agreed that there is a great deal of progress and a long way to go, and that there is a great deal of consistency and faithfulness to the standards, though with some deviations. The UK has its own specificities that take into account the unique nature of the UK market.

A Central Bank official noted that the unrated corporates issue is a big issue in Japan. One of the more fundamental challenges for Japan is FRTB, whose implementation hinges on the assumption that other jurisdictions are doing the same thing, in particular how to deal with so-called non modellable risk factors. Discussing the existence of market data becomes much easier if all jurisdictions, including the US, also implements it.

An official explained that there are dangers if capital is not being put where the risk is. Basel III is a fundamental contribution to the stability of the financial market, but if it is not implemented consistently across the major jurisdictions then there will be no level playing field. There will also be a struggle for internationally active banks to comply with all the different standards, which will be hugely cost intensive. Switzerland has a fallback position, and in mid 2024 it will evaluate the implementation stage of its major competitors. Switzerland will closely monitor the Regulatory Consistency Assessment Programme (RCAP).

The Chair observed that, based on comments from panellists, from the EU perspective it seems like it is 'full

steam ahead', even if the US takes longer to resolve some of the discussions that have been mentioned.

A policymaker stated that conversations are ongoing with the US regulators in order to better understand where they are in the process and what the next steps may be. Discussions in the standard setting fora are sometimes complex. However, once standards are agreed, it is important for the level playing field and the credibility of the international processes that the rules are implemented by everyone. Transition periods are in place for topics such as low risk mortgages and unrated corporates to give banks more time to adapt. More generally, after an intense period of legislation, there is a justified and legitimate call for legal stability, predictability, and knowing the direction of travel.

A public representative added that the Basel recommendations need to be consistently implemented across jurisdictions. If the belief is that the regulations can reduce the risk of a future banking crisis then the competitiveness of EU banks will be better than others.

An industry representative was of the view that US G-SIBs are already capitalised in a manner that is compliant with Basel III capital level requirements. The US has taken a very different view on things like the RWA density compared to other jurisdictions.

An industry representative stated that more of a holistic view is needed around discrepancy of timelines. There are Pillar 1 and Pillar 2 capital requirements, supervisory requirements around the use of internal models, and implications on capital requirements. It is necessary to bring all stakeholders together and consider the risk return profile and the underlying capital levels needed to deem the system as financially sound and stable.

An official noted that much work with the regulation was focused on financial stability. It is time for a legislative pause and to give time for banks to implement all the regulation. It is unlikely that there will be upcoming new regulation as a result of the Basel Committee report on the recent banking crisis.