Implementing Basel III

Remarks by Pablo Hernández de Cos
Chair of the Basel Committee on Banking Supervision and Governor of the Bank of Spain

Panel at the European Economic and Social Committee public hearing on "The EU banking reform package"
8 February 2022

Opening remarks

Good afternoon, and thank you for inviting me to take part in this public hearing on the EU banking reform package.

I will be focusing my remarks today on the implementation of the outstanding Basel III reforms. I will first offer some reflections in my capacity as Chair of the Basel Committee and then offer some specific comments on the state of play in Europe in my capacity as Governor of the Bank of Spain.

By way of a brief overview, the Basel Committee is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing global financial stability. In pursuing its work, the Committee is anchored by rigorous empirical analysis, including a comprehensive evaluation work programme. Such an approach helps ensure that the Committee's approach is grounded as far as possible by impartial evidence.

Financial stability is a global public good. The cross-border spillovers of financial distress can result in under-investment in financial stability by individual jurisdictions and regions.[1] Given the global nature of the financial system, distress in one jurisdiction or region can easily spill over to other parts of the globe. We have seen numerous examples of such cross-border spillovers in previous financial crises. An open global financial system therefore requires a set of global minimum and consistent prudential standards. In our interconnected world, a failure to achieve this could result in regulatory fragmentation, regulatory arbitrage, an uneven playing field for internationally active banks, and increased risks to global financial stability.

Since its inception in 1974, Basel Committee members have demonstrated their strong commitment to cooperating on global financial stability issues, including by means of developing a global regulatory framework for internationally active banks. The latest version of this framework, known as Basel III, seeks to address the shortcomings in the banking system that were exposed by the Great Financial Crisis (GFC). The Basel III framework was finalised in 2017 and was endorsed by the G20 Leaders.

[1] See Hernández de Cos (2019).

Starting with my perspective as Chair of the Committee, I would like to make three broad points.

First, I think it is helpful to recall the rationale of these reforms and why they remain as important today as they were when they were finalised in 2017.[2]

While much has changed since 2017, the Covid-19 pandemic and other structural trends have only further underlined the importance of a resilient banking system. The Basel III reforms have played a central role in ensuring the banking system has remained operationally and financially resilient during the pandemic.[3] Unlike the experience of the GFC, banks have been able to continue supporting the real economy. Bank customers, whether they be depositors, borrowers or users of other banking services, have benefited greatly from the resilience of the banking system and will continue to do so. We should also recognise that public support measures have largely buttressed banks from losses to date. We should therefore not become complacent about the need to implement the outstanding Basel III reforms.

While the initial set of Basel III reforms fixed a number of fault lines in the pre-GFC regulatory framework, the way in which banks calculated risk-weighted assets (RWA) – the denominator of banks' risk-weighted capital ratios – remained largely unchanged. Yet the GFC painfully demonstrated the excessive degree of variability in banks' modelled capital requirement. For example, when banks were asked to model their credit risk capital requirements for the same hypothetical portfolio, the reported capital ratios varied by as much as 400 basis points.[4] Similarly worrying levels of variability could also be seen in other modelled risk categories, including market and counterparty credit risk.[5] And the GFC highlighted shortcomings with the operational risk framework, where banks' modelled capital requirements were insufficiently robust to cover losses stemming from misconduct and inadequate systems and controls.

This excessive degree of RWA variability threatened the credibility of banks' reported capital ratios. At the peak of the GFC, investors lost faith in banks' published ratios and placed more weight on other indicators of bank solvency.

The outstanding Basel III reforms seek to help restore credibility in the calculation of banks' RWA in four ways:

(i) First, they will enhance the robustness and risk sensitivity of the standardised approaches for credit risk, market risk and operational risk, which will facilitate the comparability of banks' capital ratios.

(ii) Second, they will constrain the use of internally modelled approaches by ensuring that modelled parameters are subject to greater safeguards and that advanced modelling approaches are not used for portfolios with limited historical data.

(iii) Third, the Basel III reforms will introduce a robust risk-sensitive output floor. The output floor provides a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approaches. This helps to maintain a level playing field between banks using internal models and those on the standardised approaches. It also supports the credibility and comparability of banks' risk-weighted calculations thanks to the accompanying public disclosure requirements,

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[2] See Hernández de Cos (2021) for a longer exposition of the points made in this section.

[3] See BCBS (2011, 2013a, 2014).

[4] See BCBS (2013c).

[5] See BCBS (2013b, 2015).

as banks will be required to publish their total RWA that constitute the denominator of their risk-weighted capital requirements, including with the output floor adjustment.

(iv) And fourth, the reforms will complement the risk-weighted framework with a finalised leverage ratio. The leverage ratio provides a safeguard against unsustainable levels of leverage and mitigates gaming and model risk across both internal models and standardised risk measurement approaches.

The gravity of the regulatory fault lines that Basel III seeks to address remains as important today as it was pre-pandemic. For example, a recent report by the European Banking Authority on banks' modelled capital requirements points to a "significant" level of capital dispersion "that needs to be monitored".[6] So it is critical that all Basel Committee jurisdictions implement the Basel III reforms in a full and consistent manner.

The second point I would like to address is the assertion that the Basel III reforms have not been adequately designed to reflect jurisdiction- or region-specific characteristics, and that their implementation will impede economic growth and banks' ability to tackle structural trends and challenges, such as the digitalisation of finance or climate-related financial risks. Such statements do not accurately reflect the rigorous process that the Committee followed, and do not serve the interests of a sustainable and inclusive economic recovery.

The Basel III reforms benefited from an extensive consultation process with a wide range of stakeholders. The Committee issued no fewer than 10 consultation papers as part of these reforms, with an accompanying consultation period that spanned the equivalent of almost three years. The finalised standards took on board many of the comments received from stakeholders and reflect the differences in views among our members. They include a range of national discretions to provide a degree of flexibility. They are a compromise by their very nature. A back-of-the-envelope estimate suggests that over 35 key adjustments were made to the reforms as they were finalised relative to the original proposals. Since I am speaking to a mostly European audience today, I should note that the majority of these adjustments were made to reflect the views of different European stakeholders.

The Basel III reforms were also guided by rigorous quantitative analyses. These studies clearly show that the Committee met the objective set by the Group of Governors and Heads of Supervision, and subsequently endorsed by G20 Leaders, of not significantly increasing overall capital requirements at the global level.[7] Under very conservative assumptions, these reforms are estimated to increase banks' Tier 1 capital requirements by only 2% if implemented immediately.[8] Of course, some "outlier" banks may face higher requirements, for example as a result of aggressive modelling practices. This is an intended outcome of our standards, which are precisely targeted at reducing excessive RWA variability. Even in those instances, the actual capital impact is likely to be much lower than is asserted by some stakeholders, not least because of the sufficiently long transitional arrangements: starting in 2023, the final elements of these reforms will be implemented by 2028, some 20 years since the GFC.

It is also increasingly clear that the outstanding Basel III reforms will complement the previous reforms in having a positive net impact on the economy. For example, a recent analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary,

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[6] EBA (2021).

[7] See BCBS (2016) and G20 (2016).

[8] See BCBS (2019).

whereas their benefits will help permanently strengthen the resilience of the economy to adverse shocks.[9] It also finds that potential deviations from the globally agreed Basel III reforms – for example, with regard to the output floor – would significantly dilute the benefits to the real economy. History has shown time and again that it is healthy and resilient banks that are best able to lend to the real economy and contribute to growth and jobs. To suggest therefore that implementing Basel III will somehow impede the ability for banks to meet these objectives and adapt to structural trends, including the digitalisation of finance and climate change, is not supported by empirical evidence.

Third, and this will be my final point as Basel Committee Chair, implementing Basel III in full and consistently is a powerful symbol of jurisdictions' ongoing commitment to multilateralism. Basel Committee members have repeatedly reiterated their expectation of this commitment over the years. It is now critical that all Basel Committee member jurisdictions translate this commitment into concrete action by implementing the standards fully and consistently.

I will now make a few remarks on the specific proposals currently being discussed in Europe in my capacity as Governor of the Bank of Spain. As you may know, the Basel Committee has a comprehensive programme – the Regulatory Consistency Assessment Programme (RCAP) – to assess the consistency of our members' implementation of Basel III after it is adopted domestically. As and when Basel III is implemented in Europe, the Committee will have the opportunity to conduct an RCAP peer review of its consistency. Until then, I will comment on the current state of play as Governor of a European national central bank.

My starting point is to reiterate the importance for the full and consistent implementation of all aspects of the Basel III framework, as set out in a joint letter by 24 central banks and supervisory authorities to the European Commission last September.[10]

I would like to take this opportunity to reflect on what this means in practice now that the European Commission has published its proposal.

First, it is critical to implement the full Basel III package in Europe, as its components are complementary in nature and are necessary to safeguard the resilience of the European banking system. In this respect, I appreciate that the Commission's proposal covers all the elements included in Basel III.

Second, preserving financial stability requires timely implementation of the reforms in Europe. The European Commission proposal already foresees a two-year delay compared with the globally agreed timeline. I would therefore urge all stakeholders to accelerate work in implementing Basel III in Europe, taking due account of the need to respect our European legislative process. Any further delays could result in the European banking system being insufficiently prepared to face future shocks and could even have undesirable knock-on effects on the implementation process in other jurisdictions.

Finally, consistency should be a key pillar of the implementation process in Europe. As I previously mentioned, Basel III incorporates enough flexibility through the use of national discretions. For example, the European Commission proposes to exercise the discretion to exclude banks' historical

[9] See Budnik et al (2021).

[10] The letter is accessible here.

losses when calculating operational risk capital requirements, an option already adopted by other jurisdictions and compliant with Basel III.

In contrast, pursuing approaches that go beyond the flexibility embedded in Basel III should be minimised. There are already some deviations from the initial Basel III standards in our legislation and the European Commission's proposal includes additional ones, including several in the credit risk framework. Such deviations would not be in the best interest of Europe, as they could undermine the credibility and robustness of our bank capital framework and could leave specific risk exposures under-capitalised. An example at this juncture of such a scenario is collateral valuation, as we are already identifying a build-up of systemic risk in real estate markets in different jurisdictions.

Another area of concern for me relates to the output floor, which is a key plank of Basel III to help reduce excessive variability in risk-weighted assets and restore the credibility of banks' capital ratios. While I welcome the "single stack" design in the European Commission's proposal, I note that the proposal also introduces a range of transitory adjustments when it comes to residential real estate, unrated corporates and derivative exposures. These adjustments should be avoided as, in my view, they present a deviation from Basel III, are unfounded from a prudential or financial stabilityperspective, and could trigger a "race to the bottom". I would emphasise that, even when considering arguments that call for these adjustments to facilitate implementation, any such deviations should be strictly temporary in nature and should not be extended further.

In conclusion, Europe has a unique opportunity to demonstrate its commitment to multilateralism and to globally agreed decisions. It is in our collective and global interest to move on towards implementing Basel III and to ensure that we focus our attention and resources towards some of the emerging risks and structural trends affecting the banking system, including the ongoing digitalisation of finance and climate-related financial risks. More than a decade after the GFC, we owe it to the citizens of Europe to demonstrate our commitment to global cooperation and strengthening the resilience of our banks.

Thank you.

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