

## Remarks at City Week Panel 2022

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### On Basel III

As a general starting point, I think it would be fair to say that the global banking system has largely weathered the pandemic without any major issues. Indeed, unlike the Great Financial Crisis 15 years ago, the banking system has been resilient.

This is in no small part thanks to the initial Basel III reforms, which were aimed at improving the quality and quantity of banks' capital and liquidity resources.

The Committee is evaluating whether the implemented Basel III reforms have functioned as intended during the pandemic. Our preliminary assessment indicates that the banking system would have faced greater stress during this period had these reforms not been adopted and in the absence of public support measures. Banks are now better capitalised and have stronger funding profiles than in 2007. This enhanced resilience, coupled with the large-scale public support measures, played a key role in safeguarding banks during the Covid-19 pandemic.

And importantly, unlike in the GFC, banks continued to lend to households and businesses. They now have the opportunity to play an important role towards contributing to a sustainable and inclusive economic recovery.

This is a further reminder that a prudent regulatory framework underpinned by well capitalised banks is key to securing financial stability, especially at a time when downside risks to the economic outlook are increasing.

We have also identified some areas in the Basel Framework – including the usability of capital and liquidity buffers and potential procyclical dynamics in the risk-based capital framework – that we will continue to evaluate this year. And we are also conducting a more comprehensive evaluation of the implemented Basel III standards drawing on the evidence from the past decade.

As ever, this work will be guided by empirical evidence and analyses. Given the imperative of focusing on implementation, the bar for making policy changes will, however, be high and any potential adjustments to the Basel framework should not affect those standards agreed but not yet implemented.

The full, timely and consistent implementation of the outstanding Basel III standards remains the priority. The 2017 reforms are designed to address excessive variability in banks' risk-weighted assets and the lack of comparability in banks' reported capital ratios, including an output floor standard for internationally active banks. The imperative for implementing these reforms remains high. 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".

Moreover, the past few months have reminded us that the transition from pandemic to endemic is likely to be a bumpy one. As I just noted, the economic outlook continues to be marred by uncertainty, not least because of recent geopolitical developments and rising inflationary pressure.

Such an environment further strengthens the case for Basel III implementation. An increasing number of empirical studies have concluded that the outstanding Basel III reforms will have a positive net impact on the economy. But these benefits arise only if the standards are implemented in full and in a manner that is consistent with what was agreed globally by the Basel Committee. This is a point that has been repeatedly reaffirmed by G20 Leaders and the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee. We can only truly achieve a global level playing field if all member jurisdictions implement Basel III consistently.

In this respect, the Basel framework provides some flexibility for jurisdictions through the inclusion of national discretions such as in the case of operational risk requirements, an option already adopted by some jurisdictions.

Speaking as the Governor of the Bank of Spain, it therefore concerns me to see the current discussions at the European Union level on implementing Basel III include proposed deviations from the globally agreed standards. As noted in the recent response by the European Central Bank to the European Commission, any such deviations would leave pockets of risks insufficiently addressed in the banking sector. In the specific case of the output floor, I welcome the approach adopted by the European Commission when it comes to the single stack approach adopted at the consolidated group level aligned with the design and the level of application of the Basel standards. However, the foreseen transitional arrangements for the output floor in that proposal imply a deviation from the Basel III framework that is unfounded from a financial stability perspective and which 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.

So, let me finish by highlighting that, at a time where the importance of global cooperation is once again at the forefront, implementing all aspects of Basel III in full and consistently is a powerful symbol of jurisdictions' ongoing commitment to multilateralism.

It is in our collective interest to implement the finalised Basel III reforms as soon as possible and lock in the benefits. This will enable us to focus our attention and resources towards emerging risks and structural trends affecting the banking system.

## On cryptoassets

When something in the financial system is growing very quickly and in largely unregulated space, it is important for central banks and regulators to assess the implications and risks associated with such developments. In the case of cryptoassets, the market has grown from about \$16 billion five years ago to nearly \$3 trillion last year. Meanwhile, the number of cryptoassets has roughly doubled. There are now nearly 6,000 cryptoassets.

In terms of the "core" of the financial system, banks' exposures to cryptoassets are relatively limited to date. But what matters isn't the current state of the industry but rather the potential for it to scale up rapidly and to pose risks to individual banks and overall financial stability. This is why we need a proactive and forward-looking approach to regulating cryptoassets.

This is all the more important as the risks from this growing market could impact the banking system and global financial stability through several channels. Banks' direct and indirect exposures to cryptoasset markets can arise in their capacity as lenders, issuers, providers of custody services or market-makers. More generally, banks and the financial system can be impacted by:

- "wealth effects", where changes in the value of cryptoassets might impact the wealth of investors, with subsequent implications for economic activity.
- "confidence effects", where developments in cryptoassets could impact investor confidence in cryptoasset markets and potentially the broader financial system; and
- the use of cryptoassets for payments, including so-called global stablecoins, could have potential systemic implications should there be disruptions to payment systems.

Given the global nature of the cryptoasset market and cross-border implications of these risks, these are clearly areas of relevance to global standard-setting bodies such as the Basel Committee. This is why we are in the process of developing global prudential standards to safeguard the banking system. As with all of our standards, these would provide a minimum global level playing field. Jurisdictions would be free to build upon them and apply more conservative requirements.

Following our initial consultation paper last summer, we are now finalising a second consultation paper, which we plan to publish this summer. We will then aim to finalise our treatment by the end of this year.

Given the cross-sectoral nature of many issues related to cryptoassets, we will also continue to coordinate closely with other global standard setting bodies and international forums.

## On climate-related financial risks

Climate-related financial risk is one of the key priorities of the Committee over the coming years. Financial risks from climate change are global in nature and therefore necessitate a cross-border response. A recent study estimates that G20 financial institutions have nearly \$22 trillion of exposures to carbon-intensive sectors, of which on-balance sheet bank loans account for 60%. It is therefore critical to ensure that climate-related financial risks are adequately captured in banks' risk management practices, disclosures, supervision and regulation.

Given the scale, scope and time horizon of these risks, the Committee is pursuing a holistic approach to ensure that banks and supervisors adequately measure, disclose and mitigate such risks. In 2022, we plan to finalise a set of global principles for the effective management and supervision of such risks, following our consultation last year. We hope to publish these in the next couple of months.

In addition, we are conducting a holistic "gap" analysis across the Basel framework – spanning the regulatory, supervisory and disclosure pillars – to assess whether there are any aspects that require additional global measures. I won't pre-empt the outcome of this discussion, which is very much a live and active one. I would say however that this is a complex and challenging issue. There is a clear risk for financial institutions and financial stability. But there are no easy answers.

Building on the two analytical reports the Committee published in April 2021, I would highlight three conceptual challenges.

First, climate change may result in financial losses that differ significantly from historical precedents. Therefore, historically calibrated models may understate climate-related financial risks, and addressing the risks associated with climate change might require greater reliance on future estimates/scenarios.

Second, there are issues associated with the time horizon over which climate-related financial risks will manifest themselves. There is also potential for market participants to "pull forward" certain risks. In terms of duration, it is possible that climate-related financial risks will result in more prolonged stress periods than those observed in the past.

And third, there remain incomplete data and methodological challenges associated with the measurement of the risks. It will take some time to address these issues, and they cannot be resolved in isolation by the Basel Committee.

As I said, these are complex issues that cannot be easily resolved from a conceptual standpoint. And these challenges arise irrespective of which tool we use (ie Pillars 1, 2 or 3).

Finally, this is clearly another area where close cooperation with other global bodies, including the International Sustainability Standards Board, will be key to ensure that we deliver a well coordinated response.