Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Crossing the Basel III implementation line

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Introduction

Good afternoon, and thank you for inviting me to speak at the Eurofi High-Level Virtual Seminar, in association with the Portuguese EU Council Presidency.

It is now well over a year since the start of the Covid-19 pandemic, which is first and foremost a health crisis, with a devastating impact on lives, livelihoods and our longer-term well-being. We have also seen the devastating economic impact resulting from this crisis. To give just one example: by the end of 2022, global GDP is forecast to be up to 4% lower than pre-pandemic projections (Graph 1).[2]

So recent positive health-related developments bring some much-needed rays of hope. These include those regarding vaccines and further advances in diagnostics and medical treatments. There is light at the end of the tunnel.

But there continues to be a high degree of uncertainty related to the outlook, and with it a range of downside risks. These range from the creeping emergence of new variants to bottlenecks in the production, distribution and authorisation of vaccines. Health-related restrictions may continue to be with us for some time, which in turn will continue to impact economic activity. Talk of sharp economic bouncebacks and a revival of the Roaring Twenties may therefore prove to be somewhat premature. Put differently, the tunnel may well lengthen, with the light at its end becoming dimmer.

What are the implications of this backdrop for the global banking system? And how best can banks be "part of the solution" in contributing to a sustainable economic recovery? I will try to provide some answers to these questions in my talk today, focusing primarily on the crucial importance of implementing the Basel III Framework in a full, timely and consistent manner.

[1] In relation to the content of this address, as a member of the Governing Council of the European Central Bank, I am required to observe the so-called "quiet period" preceding meetings at which monetary policy decisions are to be taken. Accordingly, my reflections are related to my role as BCBS Chair and should not be interpreted as indicating the monetary or economic outlook.

[2] OECD (2021).

The benefits of a resilient banking system are now clear

Covid-19 is the first system-wide stress test of the global banking system since the advent of Basel III. Much has been said about how the banking system has remained broadly resilient to date, and how banks have not been part of "the problem" in exacerbating the economic crisis.[3]

This is in no small part due to fact that banks entered the pandemic on a much more resilient footing than during the Great Financial Crisis (GFC), thanks to the initial set of Basel III reforms.[4] In addition, the ongoing cooperation among Basel Committee members during the Covid-19 crisis was key to ensuring a global, timely and comprehensive response by the Committee during the initial phase of the crisis to address some of the short-term financial stability issues. And the unprecedented range of fiscal and monetary measures taken by all jurisdictions to support the real economy have largely shielded banks to date from losses and the crystallisation of risks.

These initial Basel III reforms were focused primarily on enhancing the quality and quantity of loss-absorbing capital, introducing international standards to mitigate liquidity risk, and incorporating a macroprudential dimension to capture system-wide risks. They have clearly increased the safety and soundness of banks worldwide.[5] For example, banks' Common Equity Tier 1 (CET1) risk-weighted capital ratios have more than doubled over the past decade, reaching over 14% by the end of 2019 (Graph 2). Tier 1 leverage ratios stood at over 6% at the end of 2019, an increase of almost 80% since 2011. And banks' holdings of high-quality liquid assets grew by more than 50% during this period, totalling €10.7 trillion by the end of 2019.

Importantly, this enhanced resilience did not come at an expense to the real economy. Contrary to some of the assertions made by some stakeholders when the initial Basel III reforms were being developed, we did not see any sharp pullback in bank lending at the global level. In fact, banks' balance sheets grew by over 25% over the past decade (Graph 3).

During the Covid-19 crisis, the Basel Committee took several prompt measures to safeguard the resilience of the banking system, ensure that banks continue to lend to creditworthy households and businesses and provide sufficient operational capacity to authorities and banks. These include technical guidance on the prudential treatment of the risk-reducing measures taken by governments in many jurisdictions to ensure that they are reflected in banks' regulatory requirements. The Committee also reminded banks that expected credit loss accounting frameworks should not be applied mechanistically in order to avoid excessively procyclical outcomes. We also reiterated and elaborated our supervisory guidance on the role of the Basel III capital and liquidity buffers to absorb shocks and maintain lending to the real economy. And in order to ensure that both regulators and banks have sufficient resources in place to address the short-term financial stability priorities related to Covid-19, the Committee deferred the implementation timeline of the outstanding Basel standards by one year from 1 January 2022 to 2023.

Together with the extraordinary support measures taken by public authorities across jurisdictions to contain the effects of the pandemic, the Basel III reforms and the Committee's Covid-19 measures have helped ensure that bank lending remained resilient during the initial phase of the pandemic: bank lending increased in the first half of last year, a far cry from the stark deleveraging that occurred during the GFC (Graph 4).

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[3] Hernández de Cos (2020).

[4] BCBS (2011, 2013a, 2014).

[5] See eg Borio et al (2020) for a primer on post-GFC regulatory reforms.

We have also seen the broader and tangible benefits from having well capitalised banking systems. For example, jurisdictions with banks that had the largest capital buffers experienced a less severe impact on their expected GDP growth, as measured by the IMF's growth-at-risk (GaR) framework.[6] In a similar vein, better-capitalised banks increased their lending during the pandemic relative to their peers.[7] And the uptake of public support measures, such as loan guarantee programmes, was higher for better-capitalised banks.[8]

These facts support the growing empirical literature pointing to the net benefits of higher capital and liquidity requirements.[9] A reminder that it is strong and healthy banks that are able to support the real economy and lend to households and businesses.

Covid-19 has also further underlined the importance of global cooperation to safeguard the financial stability of banks. The cross-border spillovers of financial distress can result in an under-investment in financial stability by individual jurisdictions.[10] An open global financial system therefore requires global prudential standards and ongoing supervisory cooperation.[11] Unlike with global pandemics, self-isolation is not an option for effective policymaking and supervision.[12]

Despite all these positive developments, we are far from declaring, "mission accomplished" when it comes to the safety and soundness of the global banking system. There continues to be no shortage of risks to the banking system as the pandemic continues to unfold. As I discussed in an earlier speech, it is a question of when, not if, bank losses will start to crystallise.[13] The potential permanent economic "scarring" from the crisis, alongside rising debt levels, could increase the longer-term structural fragilities of banks' balance sheets. Moreover, we cannot understate the stabilising effect of the extraordinary public support measures on the banking system during the current crisis.[14] But such measures will eventually be unwound, leaving the banking system to rely on its own prudential safeguards.

Against this backdrop, banks and supervisors must continue to vigilantly monitor, assess and mitigate emerging risks as we go through the next phases of the crisis, and ensure that banks contribute to the subsequent recovery in a sustainable way. This is why the Committee has set up a structured approach to monitoring of the resilience of the global banking system as the Covid-19 pandemic continues to unfold, which is a key part of our current work priorities.

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[6] Galán (2020). GaR links macro-financial conditions to the probability distribution of future real GDP growth.

[7] Hardy (2021).

[8] Bank of Spain mimeo.

[9] BCBS (2019).

[10] Eichengreen (2006).

[11] Hernández de Cos (2019).

[12] Rogers (2020).

[13] Hernández de Cos (2020).

[14] As an illustration of the significance of these measures, recent stress test results by the IMF suggest that, under a severe adverse macroeconomic scenario, more than 90 percent of banks by assets across 29 systemically important jurisdictions would remain above statutory minimum capital levels through 2022. These results reflect the impact of the extraordinary monetary and fiscal policy support and important bank-specific mitigation policies. Without such policies, the IMF estimates that the proportion of capital-deficient bank assets would have roughly doubled. See IMF (2020) for more.

Implementing Basel III: a little less conversation, a little more action, please

In addition to monitoring current risks and vulnerabilities, we must ensure that we adopt an increasingly forward-looking supervisory approach by identifying, assessing and mitigating emerging risks and structural trends impacting the global banking system. Some of these risks and trends – including the digitalisation of finance, climate-related financial risks, and banks' business models – were already identified before the pandemic. Covid-19 has further underlined the importance of addressing them.

Yet an important prerequisite is the need to lock-in the financial stability benefits of the outstanding Basel III reforms by implementing them in a full, timely and consistent manner. Doing so would ensure that the regulatory fault lines of the global banking system – the gravity of which remain as important today as it was pre-pandemic – are adequately fixed. This is why a key priority for the Committee over the coming years is the implementation of previously agreed reforms.

Let me provide a brief recap of the nature of these outstanding reforms, which were finalised in 2017.[15] 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 (RWAs) – 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 requirements. For example, when banks were asked to model their credit risk capital requirements for the same hypothetical portfolio, the reported capital ratios varied by 400 basis points (Graph 5). Similarly worrying levels of variability could also be seen in other modelled risk categories, including market and counterparty credit risk.[16] 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 (Graph 6). Whether due to a lack of robustness in banks' models or an excessive degree of discretion in determining key regulatory inputs, the shortcomings in the RWA framework underlined the need for a complete overhaul.

The outstanding Basel III reforms seek to help restore the credibility in the calculation of banks' RWAs 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. For example, the Basel II standardised approach assigns a flat risk weight to all residential mortgages. In the revised standardised approach, mortgage risk weights depend on the loan-to-value ratio of the mortgage. The revised standardised approaches also reduce mechanistic reliance on external credit ratings by requiring banks to conduct sufficient due diligence and by developing granular non-ratings-based approaches.

(ii) Second, they will constrain the use of internally modelled approaches. The GFC highlighted a number of shortcomings related to the use of the internal ratings-based (IRB) approaches to credit risk, including excessive complexity, lack of comparability and lack of robustness in modelling certain asset classes and key risk parameters. Accordingly, the use of the most "advanced" IRB approach has been removed for certain asset classes,

[15] BCBS (2017).

[16] BCBS (2013b, 2015).

and "input floors" have been put in place for certain risk metrics to ensure a minimum level of conservatism. In a similar vein, Basel III removes the use of internal model approaches for credit valuation adjustment (CVA) risk, as CVA is a complex risk that cannot be modelled in a robust and prudent manner. Finally, Basel III streamlined the operational risk framework, replacing the internally modelled approach and existing standardised approaches with a single risk-sensitive standardised approach to be used by all banks. These changes are aimed at overcoming two major flaws in the operational risk framework. First, capital requirements for operational risk proved insufficient to cover operational risk losses incurred by some banks. Second, the nature of these losses – covering events such as misconduct and inadequate systems and controls – highlighted the difficulty associated with using internal models to estimate capital requirements for operational risk;

(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, 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.[17]

(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.

These reforms benefited from an extensive consultation process with a wide range of stakeholders. As you know, the Committee actively encourages and seeks input from stakeholders when developing our standards. Indeed, this approach was recently described as "one of the most procedurally sophisticated" processes.[18]

Accordingly, 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 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 its objective of not significantly increasing overall capital requirements at the global level. Under very conservative assumptions, these reforms are estimated to increase banks' Tier 1 capital requirements by only 2% if implemented immediately.[19] 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,

[17] BCBS (2018).

[18] Viterbo (2019).

[19] BCBS (2019).

not least because of the sufficiently long transitional arrangements: starting in 2023, the final elements of these reforms will be implemented by 2028, fully 20 years since the GFC.

And it is increasingly clear that the outstanding Basel III reforms will complement the previous ones in having a positive net impact on the economy. For example, a forthcoming analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary, whereas their benefits will help permanently strengthen the resilience of the economy to adverse shocks.[20] 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.

Conclusion

Covid-19 has underscored how a functioning banking system is one that is resilient and capable of absorbing shocks instead of amplifying them. Yet the importance of addressing the remaining structural flaws and frailties in the global banking system remains as high today as it was pre-pandemic. These fault-lines could be brutally exposed once again in future financial crises. And they would remain unaddressed if some jurisdictions do not implement all aspects of the Basel III framework.

It is therefore in our collective and global interest to move on towards implementing Basel III. Combating infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. The Covid-19 pandemic will not end until everyone is safe. Similarly, the global benefits of Basel III will not be achieved unless all Basel Committee jurisdictions implement the outstanding reforms in a full, timely and consistent manner, as repeatedly agreed by G20 Leaders and the Group of Governors and Heads of Supervision.[21] Failure to do so could potentially trigger a harmful "race to the bottom" in bank prudential standards, which would ultimately threaten global financial stability. More than a decade after the GFC, we owe it to the citizens across our jurisdictions to demonstrate our commitment to global cooperation and strengthening the resilience of our banks.

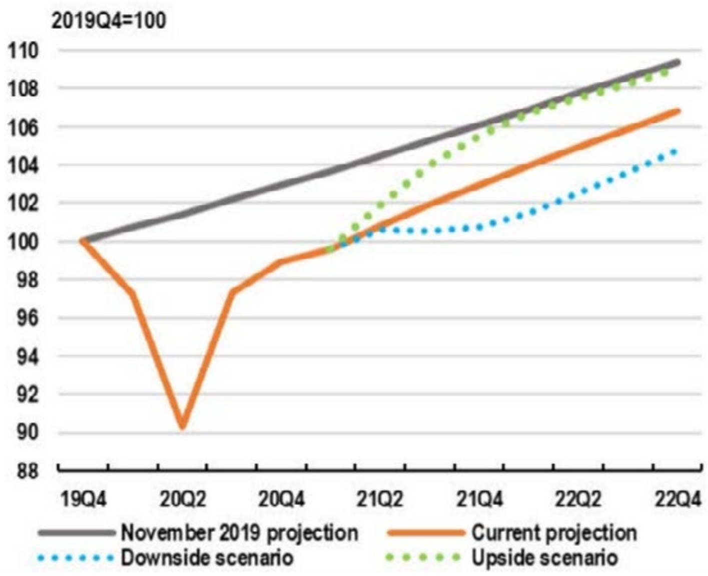
Looking ahead, we must cross the Basel III finish line and devote our attention and resources to emerging risks and trends impacting the global banking system, including the ongoing digitalisation of finance and climate-related financial risks. Indeed, these are some of the main elements of our work programme for the coming year, which we will be publishing shortly. Yet delays or inconsistencies in the implementation of Basel III would undermine our ability to move forward with equipping banks and supervisors with the necessary tools to meet these future challenges. So my final message to you is simple: a little less conversation, a little more Basel III implementation action, please!

[20] ECB (2021).

[21] BCBS (2020a).

Graphs

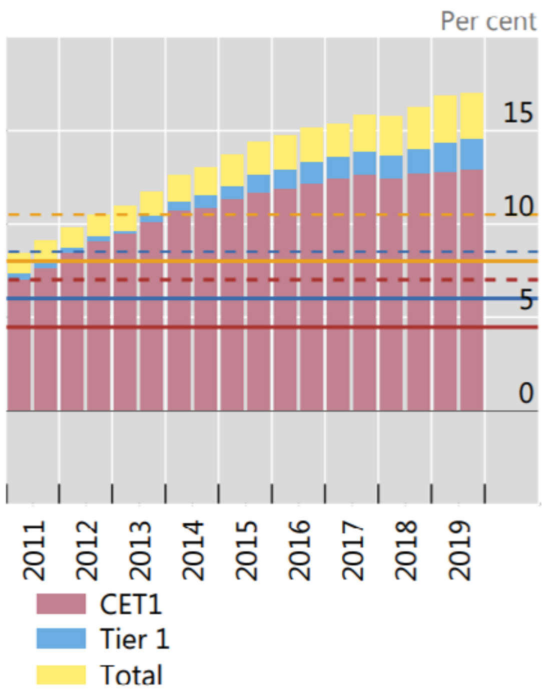
Graph 1: World GDP index[1]



Source: OECD (2021).

[1] The November 2019 OECD Economic Outlook projections are extended into 2022 using the November 2019 estimates of the potential output growth rate for each economy in 2021.

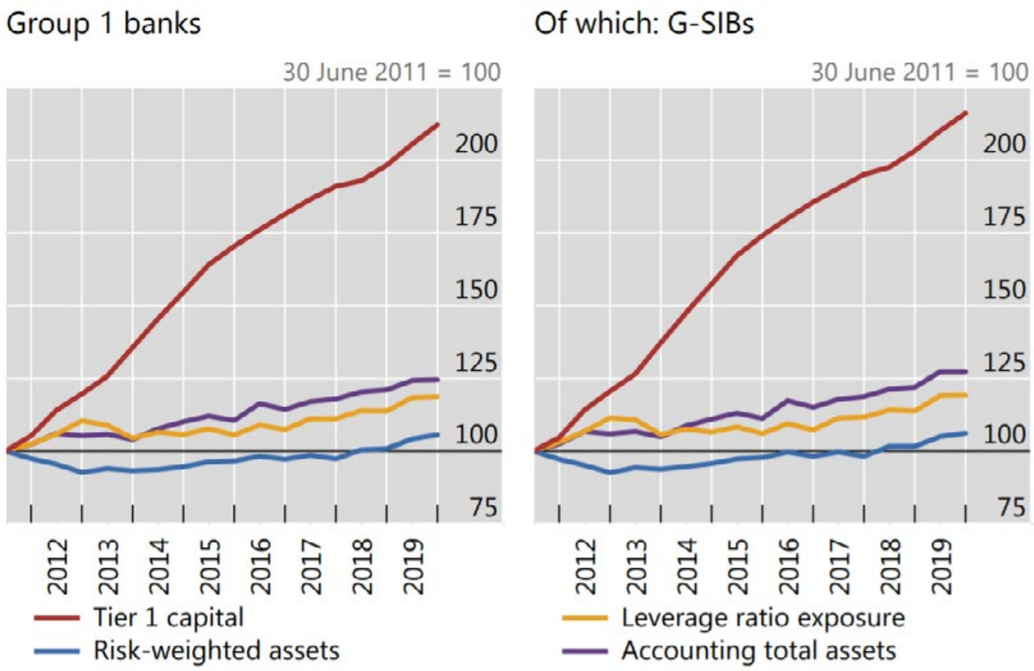
Graph 2: Evolution of banks' risk-weighted capital ratios[1]



Source: BCBS (2020b).

[1] For a consistent sample of 105 large internationally active banks. The solid lines depict the relevant minima; the dotted lines the minima plus the capital conservation buffer.

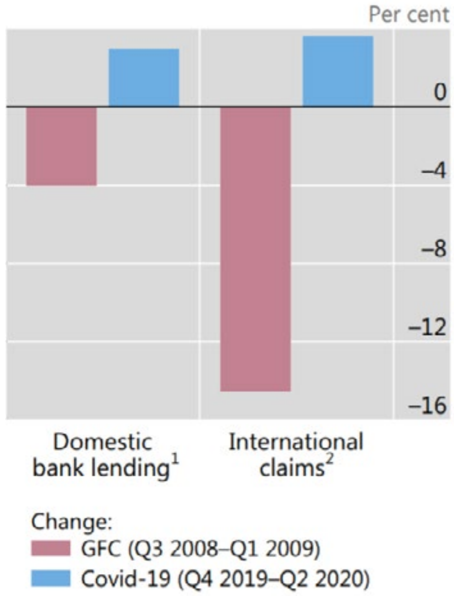
Graph 3: Evolution of key regulatory and balance sheet variables[1]



Source: BCBS (2020b).

[1] For a consistent sample of 105 large internationally active banks. Tier 1 capital, RWA and leverage ratio exposure assume full implementation of Basel III. Data points from H1 2010 to H2 2012 use the original definition of the leverage ratio. Data points from H1 2013 to H1 2017 use the definition of the leverage ratio set out in the 2014 version of the framework. Note that the data points for H1 2013 use an approximation for the initial definition of the Basel III leverage ratio exposure where gross instead of adjusted gross securities financing transaction values are used. Data points from H2 2017 onwards use the final definition of the leverage ratio to the extent data are available.

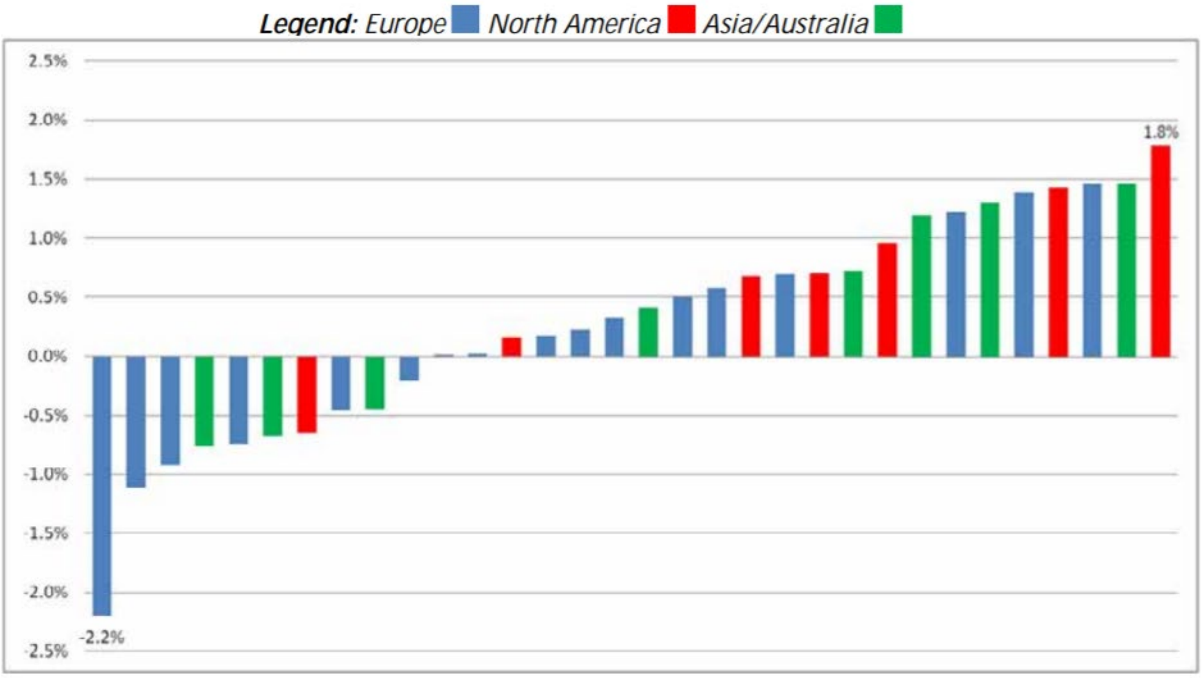
Graph 4: Bank lending during the GFC and Covid-19



Sources: Datastream; SNL; BIS; BIS calculations.

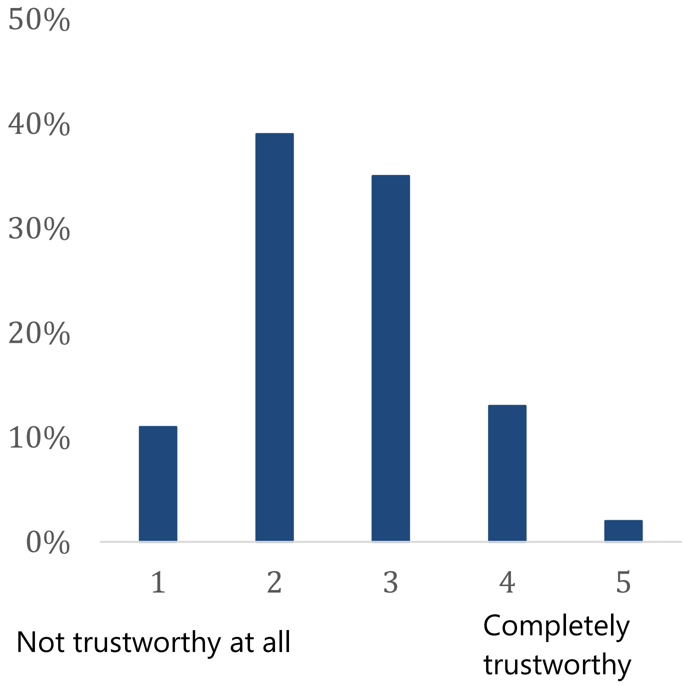
[1] Bank credit to the private non-financial sector (based on 44 reporting countries). [2] Immediate counterparty basis, for all reporting countries, all counterparty sectors and all maturities.

Graph 5: Difference in reported capital ratios for hypothetical portfolio[1]



Source: BCBS (2013c).
[1] Graph shows the change from a hypothetical 10% capital ratio if individual bank risk weights from the hypothetical portfolio exercise are adjusted to the median from the sample. Each bar represents one bank. The chart is based on the assumption that variations observed at each bank for the hypothetical portfolios are representative for the entire sovereign, bank and corporate portfolios of the bank and are adjusted accordingly. No other adjustments are made to RWA or capital.

Graph 6: Responses to question, "How much do you trust risk weightings?"[1]



Source: Barclays Capital (2012).
[1] Survey of 130 Asian, European and US equity investors, representing 100 institutions with approximately $6 trillion of equities under management.

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