

Basel III implementation in the European Union

Introductory remarks by Pablo Hernández de Cos

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Eurofi panel on Basel III implementation in the EU
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Check against delivery

Good morning and welcome to this panel on implementing Basel III in the EU.

When I was asked to chair this panel (in my capacity as Chair of the Basel Committee), I must confess that I had somewhat mixed feelings.

On the one hand, I was pleased to see that Eurofi was organising this one-hour panel to discuss what is a crucially important topic. As you know, following the Great Financial Crisis (GFC), the Basel Committee undertook a range of reforms to address material regulatory fault lines in the banking system.

The benefits of the initial set of reforms – which were aimed at addressing the unsustainable levels of leverage in the banking system, insufficient high-quality capital, excessive maturity transformation and lack of a macroprudential overlay – were clear to all of us during this pandemic.¹ The global banking system has remained broadly resilient to date, and, unlike during the GFC, banks have not exacerbated the economic crisis by sharply cutting back lending. The initial Basel III reforms, alongside an unprecedented range of public support measures, are the main explanations for this outcome.²

In many ways, Covid-19 has provided clear and tangible evidence of the benefits to society in having a well-capitalised banking system. We saw that jurisdictions with banks that had the largest capital buffers experienced a less severe impact on their expected GDP growth and better-capitalised banks increased their lending more during the pandemic relative to their peers.³

Yet the job of safeguarding global financial stability is far from finished. The outstanding Basel III reforms, which were finalised in 2017, are aimed at addressing significant fault lines in the global banking system. Addressing these fault lines remains as important today as it was pre-pandemic. Indeed, the primary objective of these reforms is to restore credibility in the risk-weighted capital framework. This is to be achieved by reducing excessive variability in banks' modelled capital requirements and developing robust risk-sensitive standardised approaches which would also serve as the basis of the output floor.

¹ For a summary of the Basel III reforms, see C Borio, M Farag and N Tarashev (2020): "Post-crisis international financial regulatory reforms: a primer", *BIS Working Papers*, no 859, April.

² Basel Committee on Banking Supervision (2021): "Early lessons from the Covid-19 pandemic on the Basel reforms", July.

³ P Hernández de Cos (2021): "Crossing the Basel III implementation line", speech given at the Eurofi High-level Virtual Seminar, 15 April.

Recall how at the peak of the GFC investors lost faith in banks' published ratios and placed more weight on other indicators of bank solvency. 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 risk-weighted asset (RWA) framework underlined the need for a complete overhaul.

Let me just give one example to underline how these fault lines continue to remain a major concern today. In 2013, the Committee's first report on the variability of banks' risk-weighted assets highlighted a worrying degree of variation.⁴ 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. Fast-forward to 2021 – eight years later – and despite repeated claims by some stakeholders that banks have already "fixed" this problem, the latest report by the European Banking Authority on banks' modelled capital requirements points to a "significant" level of capital dispersion "that needs to be monitored".⁵

Importantly, these Basel III reforms are not an exercise to increase overall capital requirements at a global level. But equally, to successfully meet our primary objective, "outlier" banks, such as those with particularly aggressive modelling techniques, will rightly face higher requirements.

Given the "exogenous" nature of the Covid-19 shock, these vulnerabilities were not tested during this pandemic. However, it is clear that, if left unaddressed, they will expose material shortcomings in the banking system in future financial crises. So I am pleased that we will have the opportunity this morning to discuss the implementation of these reforms in the EU.

On the other hand, I remain concerned about the potential to focus the discussion on whether or how to implement Basel III in the EU in the current juncture! These reforms were finalised in 2017, with a globally agreed (revised) implementation date of 1 January 2023. G20 Leaders have repeatedly called for their full, timely and consistent implementation. Now is therefore the time for action.

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 recent analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary, whereas their benefits will help to permanently strengthen the resilience of the economy to adverse shocks.⁶ 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.

Importantly, the reforms also benefited from an extensive consultation process with a wide range of stakeholders. Indeed, a recent academic study described the Committee's consultation approach as "one of the most procedurally sophisticated" processes among policymaking bodies.⁷ The Committee published no fewer than 10 consultation papers as part of these reforms, with an accompanying consultation period that spanned the equivalent of almost three years!

So the finalised standards agreed at the global level are already a compromise by their very nature, and reflect the different views of Committee members and external stakeholders. Over 35

⁴ Basel Committee on Banking Supervision (BCBS) (2013): *Regulatory consistency assessment programme (RCAP) – analysis of risk-weighted assets for market risk*, 31 January.

⁵ European Banking Authority (2021): *EBA report result from the 2020 market risk benchmarking exercise*, EBA Papers, no 5, March.

⁶ K Budnik, I Dimitrov, J Gross, M Lampe and M Volk (2021): "Macroeconomic impact of Basel III finalisation on the euro area", *European Central Bank Macropprudential Bulletin*, issue 14, July.

⁷ Viterbo, A (2019): "The European Union in the transnational financial regulatory arena: the case of the Basel Committee on Banking Supervision", *Journal of International Economic Law*, vol 1, no 24, June.

key adjustments were made to the reforms during this period, with the majority of these reflecting the views of different European stakeholders.

Financial stability is a global public good. It knows no geographic boundaries – the adage that “no one is safe until everyone is safe” applies as much to the pandemic as it does to safeguarding global financial stability. This is why the Committee designed and calibrated Basel III at a global level, and incorporated enough flexibility through national discretions within the framework. Approaching these reforms from a different perspective – for example by giving undue attention to the impact on individual banks, jurisdictions or regions – risks missing the forest for the trees.

To be clear: the domestic and democratic transposition of global standards is a very important process and one that should be fully respected. But the focus should now primarily be on the “action” side of things, which means demonstrating how the EU’s commitment to multilateralism and to globally agreed decisions endorsed by the Group of Governors and Heads of Supervision, and to which G20 Leaders have repeatedly committed to implementing in a full, timely and consistent manner.

So I hope that our panel discussion today and the active participation of the audience will provide a constructive discussion on these important issues, building on the broad landscape that I have just set out.