Implementing Basel III

*The EU began the process of transposing the final parts of Basel III into law with the publication of legislative proposals in October 2021. **José Manuel Campa**, chairperson of the European Banking Authority, explains why timely and accurate implementation of the capital standards is so important*

IQ: In October 2021, the European Commission (EC) published the proposed text of the third Capital Requirements Regulation (CRR III), which will transpose the final Basel III standards into EU rules. Once finalised, the European Banking Authority (EBA) will develop regulatory technical standards (RTS) to implement the rules. Which areas do you think will be most critical and what challenges might arise?

José Manuel Campa (JMC): The publication of the EC's proposal is a major milestone that allows us to move forward with the adoption and implementation of the final parts of Basel III in the EU. It's been a long time in the making. By the time it is fully implemented, it will be more than 20 years after the financial crisis, so it's important we move forward. The critical components of this last part of Basel III are the Fundamental Review of the Trading Book (FRTB) and, more broadly, the risk sensitivity of the capital models that banks use. It is important the framework is risk sensitive, which was achieved through the Basel III agreement, but it's also important that the use of internal models does not result in unwarranted decreases in capital requirements, which is why the output floor is such a crucial part of the overall package. Following the EC proposal, the process now continues with European co-legislators and it's important to make sure we stay loyal to the Basel standards with timely implementation of the reforms.

IQ: Will it be possible for banks to secure capital model approval from their supervisors by January 1, 2025, while the RTS are still being finalised?

JMC: We are doing our best to provide banks and supervisors with the framework to secure model approval in a timely way, and this is obviously an area in which supervisors need to work with banks to make sure the process is smooth. We delivered the first phase of the RTS for the internal model approach two years ago and these are still pending approval from the EC, but I think the existence of the RTS should provide a good basis for banks to keep moving forward with implementation of the new internal model approach and start the approval process with their

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supervisors. Banks must approach their supervisors well in advance because it takes time for them to grant approval – they need to provide a comprehensive overview of the model, a good indication of where they're going and time for supervisors to properly assess them.

IQ: The EC has proposed that the standards should apply from January 1, 2025, two years later than the Basel Committee on Banking Supervision timeline. Do you think other jurisdictions should adopt the same timeline for Basel III implementation to ensure global consistency?

JMC: We have always argued for timely and faithful implementation of Basel III, so the fact this is delayed is not positive, but I think it's more important that there is clarity and certainty on the process going forward. That's why I welcome the proposal that was put forward in October. The EU has a democratic decision-making process and it takes time – it would have been better to have implemented sooner rather than later, but it's also very important that there is consistent implementation globally. The EU has been the first to put forward a proposal, but the UK and the US have a faster rule-making process.

IQ: In a speech at ISDA's Annual General Meeting last year, you said it is important to ensure the EU implements Basel III in full and without material deviation from global standards. The EC's proposal for CRR III deviates from Basel III in some areas, including credit valuation adjustment (CVA) and the standardised approach to counterparty credit risk calculation in the output floor. What is your view on these deviations?

JMC: I would say there are two basic principles that should guide this process: the first is to remain faithful to the Basel standards; and the second is that any deviations should be justified by risk-sensitivity issues. In specific areas where there are deviations, the EC has made adjustments to square the difficult equilibrium between having a reform that is loyal to Basel III while, at the same time, not creating a significant increase in overall capital requirements.

The crucial point is that these exemptions or deviations in the proposal must remain temporary, and there should be no opportunity in the process of finalising the legislation to make them permanent. This applies to some of the exemptions and prohibitions in the calculation of the output floor. The EC did not want to open the debate on the CVA exemption again, but we do need clarity on the way the exemption is being applied because we have observed that it may not have been applied consistently across all banks in the EU. We very much welcome the proposed disclosure requirements, which will provide transparency to investors on how the exemption is being used by banks, creating a more level playing field.

IQ: Is there a danger that too many deviations, even if they're linked to risk sensitivity issues, might lead to a very unlevel playing field?

JMC: Absolutely, and that's why it was so important for us that Basel III preserved the risk sensitivity of the models. Basel III makes the standardised models more risk sensitive, and it therefore makes the rationale for keeping those exemptions less valid. But, as a result, it made the quantitative impact of those exemptions less significant because the standardised approach has become more risk sensitive. I hope →

→ this will result in a robust, well-calibrated framework that is flexible enough to adapt to the idiosyncrasies of any particular market or jurisdiction, although some local adjustments may be warranted in specific cases.

IQ: Basel III introduces an output floor, which sets a lower limit on capital requirements when banks use internal models. The EC has proposed a 'single stack' approach that would apply the output floor at the consolidated group level. However, some member states have suggested the output floor should apply at the level of individual legal entities. What do you think is the best way forward?

JMC: I think the EC deserves a lot of credit for maintaining the single-stack approach, because some of the proposals for a parallel stack approach were not consistent with the letter and philosophy of Basel III. This would have impaired the credibility of Europe's commitment to faithful implementation of Basel III. The fact the EC chose to apply the output floor to groups at the consolidated level is fully consistent with Basel, so this is a good step forward that will help to foster the single market and the banking union.

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IQ: The EBA has been a strong proponent of benchmarking as a means of increasing standardisation and reducing variability of capital requirements across banks. Given all the changes to the capital framework that will now be implemented and the increased role of standardised approaches, how important will benchmarking be in the future?

JMC: Benchmarking is really a critical tool in understanding and reducing unwarranted variability in capital requirements among banks. I think benchmarking will continue to play an important role, particularly in the transition phase as the FRTB standardised approach is implemented. Benchmarking is also a good way to give supervisors early signals of possible outliers, so it will allow banks to have better backtesting and to benchmark themselves relative to other players in the market. For us, benchmarking is one of several important tools that are needed as part of disclosure and transparency requirements. The goal here is not to make all banks identical, but to avoid excessive variability. When you have a lot of variability, you need to identify and understand why this is happening and this is where benchmarking becomes so important.

IQ: Under the CRR III proposal, the EBA has to decide whether environmental, social and governance (ESG) risk should be incorporated into bank pillar-one requirements by 2023, two years earlier than the original 2025 deadline. How will the EBA go about this, and does the earlier deadline create any challenges?

JMC: The new deadline clearly puts additional pressure on us to deliver on time. We're currently working on a discussion paper so we can get feedback from stakeholders, and we will publish the final report by 2023. The key focus is to be clear on how best to ensure there's a robust risk-based and evidence-based approach to any kind of prudential recommendations that may affect capital requirements. The focus at this stage will be on environmental risk rather than social risk, which will come later. We put a lot of emphasis on disclosure, risk governance and risk measurement. It could be that environmental risks are already embedded in banks' risk measurement, but they may not be properly captured in some cases, so this is what we need to identify.

IQ: There has been discussion of a green supporting factor in the regulatory capital framework, which would grant capital relief to incentivise banks to finance projects that support the green transition. In your view, should ESG be incorporated into the prudential capital framework, or is it already sufficiently captured as part of banks' internal capital adequacy assessment processes?

JMC: I think it's absolutely right that ESG should be incorporated into the assessment of prudential capital requirements because it's a salient risk and has characteristics that are likely to be different from the traditional risk factors that have been measured. Banks need to properly measure, account and provision for those risks to which they are exposed, so we must make sure ESG risks are properly managed across their portfolios.

Using the prudential framework to incentivise certain policy behaviours would, in my view, be a mistake. I'm very keen on facilitating the transition to a more sustainable economy, but we must avoid any situation that could generate financial instability in the interim. For this reason, I don't think a green supporting factor is a good policy tool – there are other ways that banks and supervisors can actively support the green transition.

For instance, disclosures are very important for enhancing risk measurement, helping the financial sector to be better equipped to assess environmental risks. Disclosures also push counterparties to ask their banks to provide information on how those risks are being measured, managed and mitigated, which will help to facilitate the transition. With enhanced disclosures and better risk management, the financial sector can really be a catalyst in facilitating the transition – but not through the inappropriate measurement of risks.

IQ: Europe has led the way in developing a regulatory framework to incorporate ESG into risk management and business operations. How do you see this agenda evolving, and is it possible to achieve a globally coordinated approach?

JMC: The climate challenge is global and, as a basic policy principle, you need to have policy prescriptions that are adequate to the size of the problem or market that you're managing. If it's a global problem, then you need global solutions. So, in that sense, I view the agenda positively because I see the sensitivity towards ESG issues and risks globally. Europe is ahead of other regions in addressing this, but I don't think that should be used as an argument for us to slow down because the problem itself is not slowing down. We should continue to push this agenda as far and as fast as possible, and this will hopefully also push other jurisdictions forward in the process.

There is a lot of activity going on around the world. While it might seem uncoordinated, it would be much worse if there was no action. Ultimately, this is an area in which we don't yet have a well-established supervisory toolbox, so we need to develop this. It would be good if we could have a harmonised taxonomy and methodology for measuring risk, clear policy prescriptions and a single global body that can manage this. We're not there yet, but the International Financial Reporting Standards Foundation has said it will move forward with standards for non-financial disclosures and sustainability, and the Basel Committee is actively working on better assessment of ESG risks. We need to continue pushing as much as possible on this front.

IQ: There is increasing scrutiny of banks' exposure to crypto assets, both at the regional and Basel Committee levels. What steps are needed to integrate this risk effectively into the prudential framework?

JMC: The EBA has been an early actor in raising concerns about these new instruments and the impact they might have on the financial system. There is a lack of regulation on how crypto assets should be traded and whether they should be considered payment mechanisms or assets that would be subject to the Markets in Financial Instruments Directive. The vast majority fall somewhere in between.

Our first objective is to warn consumers of the risks that are involved in these unregulated assets, whether because of the inherent volatility or the lack of regulation and institutional protection. The second objective is to track the way banks are marketing these assets to their customers and buying them onto their balance sheets. Our assessment is that the risk has increased as the prevalence of these assets has developed. They are unregulated assets, so consumers need to be aware of the risks if they want to engage. The presence of these products on bank balance sheets remains very small and is not really cause for concern at this stage, but it's an area we need to watch closely.

When it comes to prudential capital treatment, the goal should be that everyone has a real understanding of what the risks are in these types of assets and that banks properly manage their risks. We don't want a prudential system that penalises banks for participating in crypto just because we don't want them in this market. We want them to be able to do a proper risk assessment and, for that, we need a proper regulatory regime. IQ

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