'This newsletter is translated from the Japanese edition distributed on October 27th.
Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The curious strength of emerging economies, etc.

Global Risk Watch Vol.31
6 November 2017

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2. Overview of Development in Financial Regulations (Trends & Topics)

 # The "last few meters" towards an agreement; the Basel III reforms (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Final agreement on the Basel III reforms has again been postponed. BCBS members had concluded their discussions late last year on the "denominator" part of Basel III reform including measurement methods for operational and credit risk, and the final draft appears to be ready. The only issue left open is so-called "output floor (capital floor)." While the Basel Committee of Banking Supervision (BCBS) held a meeting in Basel on October 4th and 5th, they released no announcement on capital floor. Media coverage reported that negotiations had continued during the International Monetary Fund (IMF) annual meeting in Washington D.C. from October 13th to 15th. According to the reports, France raised an objection to a compromise proposal of a 72.5% capital floor. In the speech at Institute of International Finance (IIF) annual membership meeting in October, Mr. William Coen, BCBS Secretary General, used a metaphor of a marathon to describe Basel III reform, saying the process is within the "last few meters" of the finish line. He also stated that the final decision is in the hands of the Group of Central Bank Governors and Heads of Supervision (GHOS), the governing body of the BCBS. Based on this circumstantial evidence, an agreement on capital floor standards seems no longer to be a technical discussion, but rather a political one. Given that the new FRB Vice Chair Quarles was still acclimating to his new role at the time of the meeting, and a phase-in of output floor remains as an option for the final agreement, those last few meters in a marathon will likely be run at the BCBS and GHOS meetings in December.

An appropriate level for capital floor relies on the recognition of the gap in characteristics between the standardized and internal methods. The BCBS will require banks subject to international standards to apply both of these methods to calculate their risk assets. Generally speaking, standardized approaches are superior in comparability and transparency since they utilize the same, simplified calculation for different banks. At the same time however, they produce more conservative results with higher risk assets, and are less sensitive to fluctuations of risk profile. On the other hand, internal methods provide higher risk sensitivity by applying parameters based on historical data thereby enabling more sophisticated risk measurement. Nonetheless, since methods vary for respective banks, it is more difficult to compare results and ensure transparency.

At an early stage of the Basel III reform discussions, more focus was placed on the elimination of arbitrary tendencies of the internal models and a return to the standardized approaches. In the Basel III reform, calculation by standardized methods will be a mandatory requirement, and it will be required to treat a certain proportion of risk calculated by standardized measurement as a minimum level for capital charge - this is what we call output floor. The BCBS consultation paper in July 2016 proposed 60 to 90% floor, but regulators continued negotiations for the following two years. Advocates of the standardized method demanded high floor while supporters of the internal models pushed for lower ones.

From a pragmatic perspective, floor standards depend on the gap between the risk levels by standardized and internal models. In reality, the standardized method recognizes higher risk assets for some banks than others, depending on the components of their finanical asset portfolio. The standardized approach designates a higher risk weight on certain financial instruments as a result of the Basel III reforms. If a bank owns more of these products, they are considered to bear the higher risks of their assets, thus are subject to more stringent capital requirements. The debate has shifted away from a focus on methodology and towards the creation of a fair environment for different banking systems by installing capital floor standards. Purportedly there was initial distance between the US regulators, who had called for more rigorous capital requirements with higher floor, and the French and other European regulators who preferred lower floor. Later on, upon inauguration of the Trump administration and particularly the resignation of FRB Governor Tarullo who is known for his rigid banking supervision, the U.S. has transitioned away from excessively severe banking regulation. The US is softening its stance on the capital floor standards as well. In France, their portfolio structures indicate higher risk according to the standardized methods and helps to explain their call for floor to be set at 70% or below.

These discussions reflect the regulators' common understanding of the need for a “level playing field” in international regulation. Creating a fair and sound competitive environment for BCBS member states and their banking systems is one of the missions of global financial regulation and its policymakers. Debates around capital floor may appear to be a clash of each country's particular agenda, but ultimately they contribute to this shared goal of establishing an equal footing. However, the EU has shown a recent tendency to move away from international standards based on the Basel regulation. The Capital Requirements Regulation (CRR) reform bill proposes to reduce capital requirements by the fundamental review of the trading book (FRTB). Banks in the EU would be subject to alleviated 65% of capital charge by international standards for three years following the FRTB implementation. Historically, banks in the U.S. have been subject to stricter domestic standards than the Basel regulations. This is changing under the Trump government in order to secure a level playing field for American banks. FRB Vice Chair Quarles in charge of banking supervision (assuming the post on October 10th) is presumably supportive of aligning the US with the international standards.

A convergence of rules is not the only way to secure a level playing field; it acts also as a valid option to set out regulation fitted to financial markets and practices in respective countries. A good example of this is the interest rate risk in the banking book, standardized under the Pillar 2 framework of the Basel accords. It is vital to distinguish and properly use both rule-based and principle-based approaches to maintain a level playing field. Similarly, the least desirable outcome is when a divergence of rule-based regulations becomes commonplace.