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Global Risk Watch Newsletter

U.S. tax cut – what it means for the economy, etc.

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

 # The real race begins now: the final agreement on the Basel III reform (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

The Basel III has finally come to an agreement; on December 7th, the Group of Central Bank Governors and Heads of Supervision (GHOS) has endorsed the Basel III reform. The Basel Committee on Banking Supervision (BCBS) has published the final document of the reform, which calls for implementation in 2022, and sets the long debated capital floor at 72.5%. It is a landmark event ending the significant uncertainties in international financial regulation, to fundamentally revise calculation methods for risk-weighted assets (RWA) (which serves as a basis to calculate capital requirements) and to establish international standards for banks' capital levels. Several critical discussion points during the global consultation process delayed the agreement by one year. Nonetheless, the authorities and the industry that have contributed to and completed this "long marathon" of the Basel III reform deserve solid respect.

The contents of the final agreement are deemed fairly reasonable. Based on the new RWA calculation methods, the BCBS estimates that the required capital for internationally active banks will decrease by 0.5%, and increase by 3.8% for other banks on overage. This result is consistent with the G20's stance not to "further significantly increase overall capital requirements across the sector". Moreover, the new RWA methods sufficiently reflect industry opinions. At an earlier stage of the reform discussion, the authorities were supporting a reform draft utilizing the standardized approach for its applicability and comparability, shifting away from the Basel II promoting internal models. After numerous discussions, the final document respects the input from the sector to focus on internal models for sophisticated and risk-sensitive calculation, and partially adopts internal models as well as risk-sensitive standardized methods. For instance, the public consultation document on credit risk had proposed to withdraw the internal ratings-based (IRB) approach for RWA calculation, and consolidate to the standardized approach (SA) for large corporations. In the end, the final document allows for the fundamental internal rating based approach (FIRB). In regards to operational risk, the advanced measurement approach (AMA) is withdrawn, but the new SA adopts risk-sensitive methods that account for banks' business indicators (i.e. profits) and internal losses. The new implementation date is set as 2022, and the transition period for the capital floor is extended to 2027, which should provide ample time for banks. Including these time spans, the final agreement should also be welcomed by financial institutions.

However, the real race is only about to begin in order to implement this new international regulation, and have private entities comply with it. There is a possibility for delay in implementation, and a gap among countries for implementation period, which can undermine a level playing field in the banking sector. The new implementation date is already delayed by two years to 2022 from originally intended 2020, and the relief measures will be applicable for the capital floor during the transition period from 2022 to 2027. Further, during this period, authorities in respective countries are entitled to apply the +25% upper limit to the RWA at their own discretion. The prolonged debate on the capital floor was allegedly due to European regulators, concerned of soaring capital requirements, advocating for lower floors. The relief measure during transition probably reflects this opinion. The draft EU Capital Requirement Directive (CRD) had proposed to delay the Basel III implementation in Europe, and continue the relief measure for a specific period of time (i.e. FRTB).

For private financial institutions, the true work to comply with the Basel III reform is on the horizon. Largely, the reform materializes transition from complex internal models to a simpler approach. Nonetheless, it does not mean the compliance burden on private entities is ignorable. For instance, the credit risk SA method to calculate RWA for mortgage loans newly adopts a Loan-to-Value ratio (LTV) as a risk driver. Particularly at Japanese banks, LTV tends not to be included in a database as a risk measurement indicator. Looking at operational risk, the Basic Indicator Approach (BIA) (which calculates RWA based on gross profits) and the Standardized Approach (TSA) will be abolished and integrated into a new SA which includes internal losses as a factor. For financial institutions that have applied BIA and TSA thus far, data collection and aggregation on internal losses will be a critical challenge. Additionally, the Basel III reform on market risk (FRTB) requires a much more intricate risk calculation method than the current one, which poses significant burden on the system. As discussed above, required capital did not grow dramatically for the overall banking sector on average, but, according to the BCBS estimates, its impact greatly varies from one bank to another. Banks need to again conduct analysis on the impact on their capital and take appropriate measures.