

Regulatory News Alert

Finalization of the Basel III post-crisis regulatory reforms

8 December 2017

After nearly a year of stalled negotiations, the Basel Committee on Banking Supervision (BCBS) has announced that **a deal has been reached on the 'finalization' of Basel 3 (often referred to as "Basel 4")**.

On 7 December 2017, the BCBS's Governors and Heads of Supervision (GHOS) governing body appears to have bridged the last remaining gap between regulators – particularly between the US and Europe – on the extent to which banks can use internal models to determine their capital requirements.

The final agreement reached is to calibrate the standardized output floor at 72.5 percent and phase its implementation over five years between 2022 and 2027. Other elements of the agreement (incl. SA Credit Risk and IRB constraints) are foreseen to apply from January 2022.

Read the [BCBS press release](#).

Overall, the package of final standards agreed (available in full on the BCBS website) include:

- Revised standardized approach for credit risk
- Constraints on the use of IRB approaches
- Framework for operational risk
- Calibration of standardized output floors
- Revised CVA framework
- A leverage ratio buffer framework for G-SIBs

The BCBS has agreed to **formally delay the implementation of the Fundamental Review of the Trading Book (FRTB) to January 2022** (from 2019) in light of implementation difficulties and delays in most jurisdictions.

The BCBS also announced that it has completed its review of the regulatory treatment of sovereign risk. The Committee, however, could not reach a consensus regarding the next steps and has consequently decided not to consult on any changes for the moment.

This marks a critical milestone in the finalization of the post-crisis regulatory framework, but much still remains to be done. The timely and faithful transposition of Basel 3 into national/EU law will be where attention turns to next, and something that we expect to be a lengthy and complex process.

Five things to remember about Basel III

This agreement will give the banking industry more clarity about the full impact of the BCBS's capital package. It is, however, far from the last word.

A lot still has to happen before these standards are finalised and implemented, and these steps may yet present banks with more uncertainty and complexity than they had bargained for.

Five factors, in particular, are important to remember in the aftermath of the Basel III agreement:

1. **The factors underlying the final deal:** most attention has focused on the 72.5% calibration of standardised floors, as this was the most controversial part of the final stretch of BCBS negotiations. But the precise impact of this floor will depend on two other elements which have been much less discussed – where the BCBS has come out on the revised standardised approach for credit risk (in particular how risk-sensitive it is) and how conservative it has been in the constraints it imposes on the use of internal model approaches. Indeed, it appears that the agreement on the 72.5% calibration for floors was facilitated by a parallel decision to reduce materially the risk weights for mortgages and other lending under the new standardised approach. This is likely to be of significant benefit to many European banks relative to the BCBS's original proposal. The detail of the BCBS's final standards will need close scrutiny and assessment in the coming weeks before the overall impact of the standardised floor can be understood. In addition, the decision to impose a leverage ratio buffer for Global Systemically Important Banks (G-SIBs) of 50% of their existing risk-weighted G-SIB buffer is also expected to be capital constraining for a number of firms.
2. **An extended implementation period:** although the start date for most of the new standards is 1 January 2022, the BCBS has chosen to bring the standardised output floors gradually into force through a five year phased implementation period (50% in 2022 rising almost linearly to reach 72.5% in 2027). This should give banks more time to adjust to any increases in capital requirements by the new approaches. This transition may, however, be less useful if the market pushes banks, particularly those perceived to have shortfalls under the framework, to get there much more quickly than the regulations require of them.
3. **Commitments to implementation:** recent years have seen a growing list of instances where governments, legislators and regulators have been more willing to amend international regulatory standards before implementing them than they were in the immediate aftermath of the financial crisis. BCBS leaders have made a series of strong statements this year underlining the importance they place on a coordinated and consistent implementation of these new standards. Nevertheless concerns persist and regulatory fragmentation may continue to get worse, not better.

If so, this will give rise to significant operational, technological and even strategic repercussions for banks. For a more in-depth analysis of the implications of regulatory fragmentation see our Centre for Regulatory Strategy paper *Dealing with Divergence: A strategic approach to growing complexity in global banking rules*.

4. **The intentions of EU policymakers:** The implementation of this framework in the European Union is almost certain to require new legislation. It is important to note that the banking package presently being negotiated in Brussels – the 5th Capital Requirements Directive and 2nd Regulation (CRD V/CRR II) – does not cover what the BCBS has just issued. Implementation will inevitably require a lengthy and complex political process that could be further delayed by the June 2019 European Parliament elections and the inauguration of a new European Commission several months later. Throughout this, there will be many opportunities for EU legislators to suggest amendments to reflect the specificities of EU banking business models or practices. We expect to see European governments and Members of the European Parliament give important signals in the coming weeks about their approach to transposing these new standards into EU law.
5. **Things still left unfinished:** despite this being billed as the ‘finalisation’ of the Basel framework, several elements of it remain subject to changes being made at the international level. The formal decision to delay the implementation of the Fundamental Review of the Trading Book (FRTB) from 2019 to 2022 reflected widespread delays already announced in most jurisdictions, but ongoing BCBS-level work next year on several aspects of the FRTB which have proven most difficult, particularly the P&L attribution test, could still have a material effect on banks with significant trading activities. Also, the treatment of sovereign risk on bank balance sheets, on which the BCBS chose not to consult, will continue to linger as a long-outstanding reform initiative that regulators in many countries would like to see the BCBS or the EU move to address.

The path ahead

The BCBS has now passed the baton on to its members to translate these new standards into law, and for regulators, in turn, to specify how they intend to implement them in practice.

Banks need to give these new standards careful consideration, particularly to understand the impact that they will have on capital adequacy and the sustainability of products and business lines. In particular, they should pay close attention to whether regulators in their key jurisdictions look likely to meet the BCBS’s 1 January 2022 target for the entry into force of this framework. The uncertainty and complexity, particularly for internationally active banks, arising from the work that regulators still have to do on the implementation of Basel III will be one of the most important regulatory challenges they will face in the coming years. This isn’t over yet...

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