

Concluding remarks by Andrea Enria,
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Basel III ‘Are we done now?’



Dear Colleagues, Ladies and Gentlemen,

It is a pleasure and an honour, for me, to address this distinguished audience and close the insightful discussions and contributions we have carefully listened to in the course of today. I am very thankful to the Institute for Law and Finance for having organised this timely event and for providing me with the opportunity to share with you some reflections on the finalisation of Basel III.

Let me say upfront that I believe the package agreed in December is a major achievement. The international regulatory community faced three key challenges. First, it was essential to remove regulatory uncertainty and bring the reform process to a close. The industry had rightly expressed serious concerns on the difficulty to perform effective capital planning in the absence of a complete regulatory framework, more than ten years after the start of the financial crisis. Second, the credibility of international standards had to be restored, addressing the issue of excessive variability of risk weighted assets (RWAs) calculated via internal models. To make this task more difficult, the Basel Committee had to strike a difficult balance between the need to maintain sufficient risk sensitivity, an important priority for jurisdictions widely relying on bank internal models, and the quest to ensure a global level playing field, a significant concern for those jurisdictions that decided not to allow the use of models-based approaches. Third, it was necessary to reaffirm the commitment to the implementation of the full reform package in all G20 jurisdictions, resisting pressures to drop or significantly water down some key elements of the Basel Committee’s rulebook. The crisis has damaged trust amongst regulators and convergence around stronger international standards was a key ingredient to restore the institutional set-up supporting cross-border banking business. I believe the December agreement ticks all the three boxes.

Colleagues and market representatives in this audience, with whom I have in different settings discussed the reform, know that I have repeatedly engaged for an agreement. At different stages of the debate I flagged some concerns on the proposals being put forward by the Basel Committee. The EBA has been amongst the first to identify and document with extensive empirical analyses the excessive variability in RWAs. We have actively promoted new rules and supervisory guidance to harmonise practices and re-establish the credibility of the framework. We supported the introduction of constraints to the use internal models, especially in areas where they had a dismal track record. But we also warned against the risk of throwing away the baby with the bathwater, by significantly reducing the risk sensitivity of the framework. This is especially important to note, as the debate has been overly focused on the need to avoid a significant overall increase in capital requirements. To me, what mattered most was to prevent that the constraints to the use of internal models generated an inadequate redistribution of capital requirements, with unwarranted increases in the charges for low risk business and implicit incentives to shift towards riskier activities. I did not mind an increase in overall capital requirements, if there was a good, risk-based justification for it. Composition mattered more than level, in the matter at hand.

The significant changes introduced following the public consultation allayed my concerns.

In the area of **credit risk**, the agreed restrictions on the scope of loss-given default (LGD) estimation for low-default portfolios reflect evidence that LGD estimation and wholesale portfolios – as opposed to probability of default (PD) estimation and retail portfolios – are the most important targets when it comes to RWA variability within credit risk. Also, the introduction of moderately calibrated input floors should help keep model risk and arbitrage practices at bay.

Operational risk is among the areas where – learning from the crisis and the recent empirical evidence – a regime shift was in my view most warranted, triggering a capital requirement increase, where needed. The Advanced Measurement Approach lent itself to far too opaque modelling choices and too heterogeneous model outcomes, in certain cases leading to undercapitalisation against the multiple and severe operational risk episodes that can materialise. The existence of several different standardised approaches did not promote comparability either. Against this backdrop, the replacement of all existing methods by the newly developed one, should substantially simplify the framework. However, maintaining risk sensitivity for operational risk is not an easy task. The rule design process has clearly shown this. It will be in my view essential to carefully test the newly proposed approach and, in particular, to understand the implications of the discretion that the Basel agreement introduces in relation to the historical loss component of the requirement - a choice that we will have to make at the EU level. It would be important to maintain some regulatory incentives for bank management to set in place internal mechanisms to effectively monitor and allocate capital for operational risk.

The decision to ban modelling for credit value adjustment (CVA) risk (**CVA-IMA**), in my view, is less straightforward, as it decreases risk sensitivity of capital requirements in this area. Back in 2015, the EBA warned legislators and other stakeholders about potential outcomes of excessive CVA risk, also in relation to the system of exemptions that apply in the EU, and started an ongoing monitoring

of CVA risk. Our preferred route would have been to gradually eliminate those exemptions while re-calibrating the existing capital requirements framework.

As to the **aggregate output floor**, together with several other European members, the EBA expressed some scepticism, arguing that the leverage ratio represents a sufficient top-down constraint on the outliers of the risk weighted assets calculation. Moreover, after extensive analysis of the problem of RWAs variability, our conclusion was that a bottom-up repair process, targeting specific areas where problems had been identified and focusing on harmonised definitions to enhance transparency and comparability, was preferable to a blunt output floor. In other words, to address the variability of modelling outcomes, we would have preferred to be digging at the roots instead of hacking at the leaves, if I may say so. However, we understand that this was an important component of the package for other authorities that rely mainly on the standardised approach. In light of the need to reconcile different views around the Basel table on the role of internal models in regulation, I believe that the final calibration of the output floor strikes a good balance.

The **standardised approach for credit risk**, which will drive most of the output floor constraining power, becomes a more risk-sensitive backstop. This is important not only because it makes the output floor backstop more responsive to risk, but also for the European population of smaller and less complex banks to which, in the EU, we traditionally extend the application of the Basel standards. There are several reasons to be satisfied about what the reform does in this area. While broadly remaining capital-neutral, **the reform of the standardised approach introduces enhanced risk differentiation and granularity** in areas such as exposures secured by real estate, specialised lending exposures, exposures to small and medium enterprises (SMEs), unrated exposures to corporates and institutions, retail exposures, covered bond exposures, as well as for equity exposures. In addition, you will have recognised yourselves that in some of these areas the new standardised approach moves closer to the European regulatory tradition.

As I mentioned, there are aspects of the debate on the finalisation of Basel III on which we collectively will have to reflect. I firmly believe in the value of impact assessments to inform the choices of regulators and support an open public debate with all stakeholders on proposed reforms. Still, I am concerned when the whole debate is biased by an excessive focus on quantitative impact. We should remind ourselves that regulation aims at changing behaviour. Hence, quantitative impact assessments can provide useful input to discuss whether the behavioural effect will move in the right direction or could have unwarranted effects. Instead, the whole debate has been driven by a widely overestimated calculation of the capital impact from the industry, coupled with a rather simplistic syllogism equating higher requirements to lower lending and growth. The whole issue of ensuring that capital charges are correctly measuring risks and that variability across institutions remains within reasonable ranges never appeared in the discussions. Also from the regulators' side, excessive emphasis was put on the 'no significant increase' objective. Some opaqueness in the Basel process, especially when the initial proposals started being revised without any public disclosure, has probably not helped supporting a better technical engagement with stakeholders.

Today's very insightful discussions have extensively covered the importance of the agreement, its implications in terms of risk capture, investors' behaviour and economic impact at the regional

level. Having the honour to close this event, I feel obliged to address the core question of our conference programme: *‘are we done now?’* I will deceive you, although hopefully in a constructive way. The short answer to that question is ‘not really’. As for the longer answer, a few more considerations are probably needed.

Undoubtedly, the standards agreed by the Basel Committee now provide a good yardstick for long-term capital planning for international banks. Particularly in this case I consider of the utmost importance that all G20 jurisdictions ensure a scrupulous adherence to the Basel Committee’s rules text, at least for banks directly competing in international banking markets.

But any rulemaking exercise is inevitably followed by an **equally important and equally challenging implementation effort**. From a European perspective, the way forward is, I would say, threefold. In the first place, thorough analyses will be needed to ensure the international standards are transposed in accordance with the principle of **proportionality**, taking into account the compliance burden for smaller and less sophisticated local banks and considering the appropriateness of the impact on specialised business models. Secondly, we will need to complement the newly agreed framework with two equally important toolkits to address and monitor undue variability and potential arbitrage in the risk weighted assets calculation. I am referring to, respectively, the **bottom-up repair of modelling practices** and the **benchmarking analysis** of internal models. Lastly, we will need to make sure enhanced **transparency** vis-à-vis the markets accompany the implementation of the newly agreed rules.

As regards the implementation of the standards, in the EU we have traditionally extended the Basel framework to all our institutions, not only to the larger and more internationally active ones, introducing deviations only where justified by sound empirical evidence. The Single Rulebook, built on the basis of this approach towards international standards, provided the EU financial system with an unprecedented set of harmonised rules as well as an essential condition of level playing field among players. The principle should not change this time: a rigorous and empirically-grounded implementation strategy will be the key determinant of a successful reform.

As for past components of the Basel reform package, the EBA will conduct its assessment covering the implications of international standards on small and medium-sized banks, banks with simple or specialised business models as well as on lending to the real economy and to small and medium-sized enterprises.

Let me elaborate on the work we have done and are currently doing on the Fundamental Review of the Trading Book (FRTB), as this is a chapter of the Basel framework that has recently attracted a good deal of discussion, and is a component on which our thinking is quite advanced.

Back in November 2016, recognising the compliance burden that certain elements of the new standards may imply for small and less complex trading book businesses, we have advised the Commission on a system of proportionality thresholds, whereby institutions with the smallest trading books may derogate market risk requirements and apply instead the credit risk framework, while institutions with a mid-tier trading book may keep applying a potentially recalibrated version

of the current standardised approach for market risk (the Basel 2.5 approach), instead of the standardised approach reformed by the FRTB. The Commission has taken on-board this approach in the formulation of its legislative proposal. Last December, we launched a public discussion on technical although very relevant implementation aspects of the FRTB, among which the composition of the Profit & Loss (P&L) used for the P&L attribution tests and the methodology to compute capital requirements on non-modellable risk factors.

As the Basel Committee decided to align the implementation of the FRTB to the timeline of the December 2017 package, acknowledging the need to further reflect on the technical implementation as well as the relative calibration, I have encouraged my staff to share with our Basel colleagues the technical options we have developed in the context of the EBA's work, as well as the evidence we are gathering around our proposals, not only on implementation issues, but also on relative calibrations and proportionality. Overall, we believe there is merit in fine-tuning the relative distance between the newly introduced approaches – so as to target the initially envisaged modelling premium - while maintaining a less sophisticated standardised alternative. Such alternative could be the already existing (Basel 2.5) methodology, recalibrated to achieve levels of capital charge comparable with the ones of the new approaches.

Impact assessment analysis will have to cover other important chapters of the December 2017 package. Certainly, it will be crucial, from my perspective, to understand the risk-sensitivity implications of exercising the national discretion that the framework allows on the historical loss component of the operational risk requirement, particularly in light of the wide range of business models that characterises the EU banking market. Also, we will have to look into aspects of implementation of the aggregate output floor and assess its impact on specialised business models, with particular focus on those that carry out their activities on the lower-tail of the risk distribution.

The second element of what, I believe, should be the agenda on the way forward is the bottom-up repair of modelling practices, as opposed to portfolio risk-driven variability, practice-based variability should be the target of supervisory action. Back in 2015, the EBA launched a public discussion – and subsequently a roadmap – on the repair of IRB modelling. This led us not only to take stock of a very wide range of modelling practices – against which we proposed harmonised solutions – but also to fill the gaps that arise when regulatory provisions are not sufficiently clear or detailed.

The good news is that the project is almost accomplished. With the publication of the guidelines on the estimation of PD and LGD parameters, last November, the estimation of loss-given-default in conditions of economic downturn remains the last item to be accomplished. As per our tradition, the findings of our stock-take exercises are public: the guidelines on the parameters estimation have been accompanied by a report on IRB modelling practices that illustrates the great level of detail according to which 102 institutions from 22 Member States have been surveyed in relation to their modelling practices. We gave European institutions time to prepare for the application of the harmonised toolkit and we look forward to seeing that framework fully operational under the newly agreed credit risk standards.

The second complementary toolkit in our agenda is the benchmarking analysis. In order to monitor on an ongoing basis the variability of RWAs, and identify those institutions that are true outliers, we will need to develop at the global level a systematic and consistent benchmarking framework. While the reform was being designed, much discussion on undue RWA variability focussed on either the relative distance between internally-modelled and standardised requirement, which is the backbone of the output floor proposal, or on the simple distribution of aggregate RWA densities. The former approach assumes that standardised metrics may represent an absolute measure of risk, disregarding that within each of the regulatory buckets the actual performance of local portfolios or local business models may be very heterogeneous. The mere aggregate RWA density metric does not offer any reference point and is notoriously driven by the joint action of portfolio risk, modelling practices and supervisory/regulatory segmentation.

In this context, benchmarking analysis offers a more comprehensive set of analytical possibilities and allows to take an ‘identify and investigate’ type of approach, which is necessary to understand the true drivers of identified outlier positions. Let me only mention, on the basis of the EBA experience, two dimensions along which the benchmarking analysis supplements the monitoring of RWA densities. First, for the so-called ‘low default portfolios’, due to their wholesale nature, it was possible to ask banks to measure RWAs on sets of common obligors. In broad terms, this means looking at RWA distributions by controlling portfolio risk. Second, for the so-called ‘high default portfolios’ – which are retail and hence more local in nature – a backtesting approach was taken, comparing model estimates with realised risk. Going forward, benchmarking may also be used to test the performance and convergence of specific sub-components of the IRB regulatory toolkit, which go beyond the PD, LGD or RWA estimation outcomes.

The EBA has an established benchmarking tradition that is enshrined in the law and, each year, is carried out through the publication of dedicated binding standards. Our experience is already shared with colleagues from other jurisdictions within technical groups of the Basel Committee. I encourage the Basel Committee to attach high priority to this type of work in its future agenda.

Finally, let me turn to the topic of disclosure, which I see as another of the priorities as we move into the implementation phase. The compound set of regulatory changes that will become applicable in 2022 require both banks and supervisors to revisit the way risk is represented, both in terms of reporting requirements and requirements of disclosure towards the markets. At the EBA, work on these aspects is ongoing; the aim is to be able to implement these changes in a timely and smooth manner, so as to facilitate the implementation of the new rules. We have discussed today the implications of this reform for investors. With the completion of the rule design phase, one of the duties we have vis-à-vis investors is to make sure the enhanced risk capture of the framework becomes fully accessible to them. Market discipline, exercised via Pillar III disclosure, is a component of the Basel regime we cannot and should not undermine, in any way or form. In this regard, allow me to take this opportunity to voice one concern I have. The reform package includes transitional provisions and national discretions, on several fronts. I believe that, irrespective of the transitional path and of national choices on the optional components, disclosure should cover the fully-fledged Basel framework. We not only have to put investors in a position to exercise their due-

diligence, but also we should avoid that incomplete disclosure translates into reputational problems and investors' decreased trust.

Conclusions

International standards are a common good for regulators and industry alike. When they lose credibility, it is not only the reputation of regulators that suffers: in the absence of reliable metrics funding markets may enter into a freeze, with good and bad banks suffering alike. This has happened when the flaws of the regulatory definition of capital were exposed at the beginning of the crisis, as innovative instruments failed to provide the expected loss-absorbency and continued paying coupons while governments were forced to put in place hefty public support packages. Similarly, as banks perceived to have similar portfolios posting significantly different RWAs and bank managers started talking of 'risk weight optimisation', public confidence in the reliability of internal models was damaged. The Basel Committee has now delivered on both fronts, putting the regulatory framework supporting international banking on a much stronger footing.

The ball is now in the court of the authorities in charge of implementing the last chapter of the reform. In the EU, the forthcoming renewal of the European Parliament and Commission in 2019 make the timeline particularly challenging, due to the pause in legislative activity. The EBA stands ready to assist and conduct the preparatory technical work as soon as possible, with a view to ensuring a timely application of the international standards in 2022.

Today's discussions provided all of us with a lot of food for thought on the challenges for regulators and banks. Of this we should all be grateful to the organisers and, especially, to all speakers and panellists.