Basel III and beyond

Regulatory insight

December 2016

For your next step
In the aftermath of the UK’s vote to leave the EU, it would be easy to forget that financial regulation continues to evolve at a global, European, and UK level.

The Capital Markets Union (CMU) agenda was slowed by the post-Referendum departure of UK EU Commissioner Lord Hill. However Valdis Dombrovskis, Lord Hill’s replacement as Commissioner for Financial Services, Financial Stability & CMU has reiterated the importance of a return to the growth agenda for Europe.

As the fall-out from the financial crisis subsides, tension is growing between those who would like to push on with financial reform and those who are keen to make sure banks are able to assist in growing the economy. Although Mark Carney, Chairman of the Financial Stability Board and Governor of the Bank of England, and others have said that authorities are focused on not significantly increasing capital requirements further, there is a nervousness about how the outstanding regulatory agenda will impact banks’ ability to help facilitate economic growth.

It is this tension which is bringing the European Commission (EC), and others, into conflict with the Basel Committee on Banking Supervision (BCBS).

**BASEL ACCORDS**

The BCBS has progressively introduced a number of accords with the aim of strengthening the stability of international banking:

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<tr>
<th>BASEL I</th>
<th>BASEL II</th>
<th>BASEL III</th>
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<td>Published: 1988</td>
<td>Published: 2004/2006</td>
<td>Published: 2010</td>
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- Based on the recognition of the overriding need for a multinational accord to strengthen the stability of international banking
- Focused almost entirely on the amount of capital banks should be obliged to hold

- A new capital adequacy framework was first proposed in June 1999 and eventually released in June 2004
- As well as capital requirements, it included supervisory oversight and effective use of disclosure
- The financial crisis intervened before Basel II was fully implemented

- Seeks to address vulnerabilities displayed during the financial crisis
- Comprises a comprehensive set of reform measures developed to:
  - improve the banking sector’s ability to absorb shocks arising from financial and economic stress
  - improve risk management and governance
  - strengthen banks’ transparency and disclosures
The BCBS:

• Does not possess any formal supranational authority
• Makes decisions that do not have legal force
• Has no enforcement authority

Consequently, it relies on its members, the central banks and other financial regulatory authorities, to implement the standards it introduces. This means that UK banks are impacted by BCBS standards both directly through any implementation the UK enacts as a BCBS member, but also, for the time being, via any implementation through EU law.

Most of Basel III has already passed into European legislation through the EU’s Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV (CRD IV) although this work is not yet fully implemented.

Some BCBS standards are yet to be completed and some are yet to be transferred into European Legislation. In the following pages, we look at recent developments and at what is still expected to be introduced in the field of financial regulation.

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**BIS MEMBER CENTRAL BANKS**

The BIS’s capital is held by central banks only. Sixty central banks and monetary authorities are currently members of the BIS and have rights of voting and representation at General Meetings:

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<th>Country</th>
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<td>Bank of Algeria</td>
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<tr>
<td>Central Bank of Argentina</td>
<td>National Bank of the Republic of Macedonia</td>
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<td>Reserve Bank of Australia</td>
<td>Central Bank of Malaysia</td>
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<td>Central Bank of the Republic of Austria</td>
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<td>National Bank of Belgium</td>
<td>Netherlands Bank</td>
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<td>Central Bank of Bosnia and Herzegovina</td>
<td>Reserve Bank of New Zealand</td>
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<td>Central Bank of Brazil</td>
<td>Central Bank of Norway</td>
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<td>Bulgarian National Bank</td>
<td>Central Reserve Bank of Peru</td>
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<td>Bank of Canada</td>
<td>Bangko Sentral ng Pilipinas</td>
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<td>Central Bank of Chile</td>
<td>(Philippines)</td>
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<td>People’s Bank of China</td>
<td>National Bank of Poland</td>
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<td>Bank of the Republic (Colombia)</td>
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<td>Croatian National Bank</td>
<td>National Bank of Romania</td>
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<td>Czech National Bank</td>
<td>Central Bank of the Russian Federation</td>
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<td>Danmarks Nationalbank (Denmark)</td>
<td>Saudi Arabian Monetary Agency</td>
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<td>Bank of Estonia</td>
<td>National Bank of Serbia</td>
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<td>European Central Bank</td>
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<td>Deutsche Bundesbank (Germany)</td>
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<td>Bank of Greece</td>
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<td>Hong Kong Monetary Authority</td>
<td>Sveriges Riksbank (Sweden)</td>
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<td>Magyar Nemzeti Bank (Hungary)</td>
<td>Swiss National Bank</td>
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<td>Bank Indonesia</td>
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<td>Central Bank of Ireland</td>
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<td>Bank of Israel</td>
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<td>Bank of Italy</td>
<td>Bank of England</td>
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<td>Bank of Japan</td>
<td>Board of Governors of the Federal Reserve</td>
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<td>Bank of Korea</td>
<td>Reserve System (United States)</td>
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<td>Bank of Latvia</td>
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On 24th November the European Commission released proposals which would seek to complete much of this work.

The proposals amend CRR and CRD IV which were the original means of bringing much of Basel III into legislation.

They also propose changes to the:

- Bank Recovery and Resolution Directive (BRRD)
- Single Resolution Mechanism Regulation (SRM)

Nevertheless, these proposals need to go through the normal EU procedure of being considered by the European Parliament and European Council before the rules are concluded, and this can be a lengthy process.

Changes to the CRR and CRD IV to complete Basel III will include:

- **Leverage Ratio** – a binding leverage ratio of 3% has been proposed. (A binding leverage ratio is already in force in the UK via the Prudential Regulation Authority (PRA) in the UK)
- **Net Stable Funding Ratio** – one of a pair of measures (along with the Liquidity Coverage Ratio) brought in by Basel III to address difficulties and vulnerabilities caused by ‘weak’ funding practices in the run-up to the financial crisis.

There are additional work streams which have been completed since Basel III, that have not yet been implemented by the EU, and which were also highlighted in the recent European Commission announcement. These include:

- **Standardised Approach on Counterparty Credit Risk (SA-CCR)**. This is the BCBS’s standard for a comprehensive non-modelled approach for measuring counterparty credit risk with:
  - Over-the-counter (OTC) derivatives
  - Exchange traded derivatives
  - Long-settlement transactions

SA-CCR was completed in 2014 and is recognised as an area where the European Commission is particularly sensitive to ‘proportionality’ i.e. the measures which are being required of banks should be proportional to the desired objective – one of the overarching themes of the Commission.

SA-CCR will increase the amount of capital required for institutions active in capital and financial markets and be punitive for those institutions which don’t qualify to use the

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What remains to be done?
Internal Model Method (IMM), unless a capital floor is introduced.

- **Fundamental Review of the Trading Book (FRTB)** – The BCBS work on FRTB seeks to:
  - clarify the modelling of trades
  - define a better boundary within an institution between the ‘trading book’ and the ‘banking book’
  - discourage internal arbitraging

The BCBS’s standard addressing FRTB was published in January 2016 as Minimum Capital Requirements for Market Risk and again has the potential to increase the amount of capital banks are required to hold. It is potentially more punitive on banks which either:

- have a large trading book
- use lots of advanced modelling techniques – an approach which is being discouraged

- **Total Loss Absorbing Capacity (TLAC)**

In November 2015, the Financial Stability Board (G20 level organisation) published a standard for Global Systemically Important Banks (G-SIBs) on loss absorbing and recapitalisation capacity in resolution, which set a minimum standard for TLAC. This calls for banks to maintain a minimum amount of equity plus debt which is ‘bail-in’ able – i.e. debt which is subordinate to more senior debt and in effect becomes equity in the event of the wind-down of the bank.

The EC’s proposal to update the BRRD seeks to align the calculation and amount of Minimum Requirement for own funds and Eligible Liabilities (MREL) and that of TLAC. The specific terms of MREL instruments are determined by a bank’s local competent authority – in the UK’s case the PRA.

### NOT BASEL IV

To be clear, Basel IV doesn’t officially exist, it is a term which has been used to describe a range of measures or amendments which are anticipated in the field of financial services regulation.

Further topics which are either in progress or potentially being considered, either as a further iteration of the Basel standards or additional EU regulations include:

- **Standardised approach for credit risk** – aimed at:
  - reducing variation in the amount of capital held by banks against credit risk
  - revising the ‘capital floor’ to make sure that the amount of capital across the banking system does not fall below a certain level

This is still ongoing at Basel level. Much of this work revolves around what models banks are allowed to use – which risks can be assessed and what parameters should be used. It also covers whether they are using ‘Standardised’ or ‘Internal Ratings Based’ approaches – either advanced internal ratings based (A-IRB) or foundation internal ratings based (F-IRB). This standard is likely to have most impact on those banks which have been using more advanced modelling techniques to date.

- **Operational risk** – The BCBS’ proposed methodology went out for consultation in March 2016. This is not expected to be finalised by the end of 2016 and is a contentious area, with some domestic regulators indicating that they would be resistant to a modelled approach for determining the amount of capital banks are obliged to hold to cover operational risk.

- **Sovereign risk** – Still work-in-progress and not expected to be finalised until 2017 or 2018.

- **Investment firms** – The Commission is expected to design a framework for the prudential regulation of investment firms by the end of 2017 or early 2018.

- **Covered bonds** – The Commission has been working on harmonisation around covered bonds and the possible adoption of some common definitions – part of the CMU agenda.

- **Broader reviews of BRRD, Single Supervisory Mechanism (SSM), and macro-prudential frameworks** – Several other reviews are in the pipeline.

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1Article: BoE’s Carney says some global bank capital reforms will be cut (Reuters, 25 October 2016)
Sources of further information

**EU Banking Reform: Strong Banks to Support Growth and Restore Confidence** (European Commission, 23 November 2016)

**Basel Committee on Banking Supervision – Overview** (Bank for International Settlements)

**The European Commission**

**Bank of England**

**Basel Committee on Banking Supervision Reforms – Basel III** (A good Overview of the key Components by the Bank for International Settlements)


**Finalising Basel III Introductory Remarks by William Coen, Secretary General of the Basel Committee, at the Meeting with the European Parliament’s Committee on Economic and Monetary Affairs (ECON Committee)** (Bank for International Settlements)

**Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement** (Bank for International Settlements)

**European Commission Better Regulation Guidelines**

**BoE’s Carney says some Global Bank Capital Reforms will be cut** (Reuters, 25 October 2016)

**Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution** (FSB, 9 November 2015)

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