The Basel Capital Compromise For Banks: Better Buffers, Elusive Comparability

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Key Takeaways

- Banks around the world have held up well during COVID-19, demonstrating the effectiveness of Basel rules for increased capital over the past 10 years; CET1 about doubled for the world's 100 largest banks over that time.
- The Basel Committee's focus now is completing what's already been agreed, yet we believe uniform implementation of the rules will be difficult to achieve.
- To future-proof banks, supervisors' attention is shifting toward other types of risks, such as environmental.
- We expect limited appetite from standard setters globally for another hike in capital requirements in the next two to three years out of concerns about business model sustainability.

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Mission (partly) accomplished. The Basel Committee reforms of the past 10 years have boosted capital at banks around the world. S&P Global Ratings believes this was its most important objective, and its achievement was no small feat. That gave banks the strength to pass their first global test: the COVID-19 pandemic.

The Committee's other objective of improving the comparability of regulatory capital metrics appears more difficult to meet. We believe the final standards, finished but delayed, will help over time. The decision to delay their implementation by a year to January 2023, due to the pandemic, was fully justified. But the risk of uneven application of the standards is one of several reasons why we believe investors will have to live with partial comparability of regulatory metrics.

The Basel Committee also has its eye on updating regulatory standards to include environmental and digital risks. Given the current lack of standardization in data, methodologies, and disclosure, as well as evolving national and regional initiatives, we believe the Basel Committee can play a crucial role in harmonizing climate-related regulatory efforts and enhancing market transparency.

COVID-19 Demonstrates The Enduring Role Of Public Support

The regulatory agenda of the past 10 years--spearheaded by the Basel Committee on Bank Supervision--has transformed banks globally by requiring them to shore up capital and liquidity. This we believe is the main reason why banks have been able to withstand the pandemic's economic impact to date. We estimate, for instance, that the capital base of the largest banks about doubled over that period. According to the Bank for International Settlements, between June 30, 2011, and Dec. 31, 2019, the Common Equity Tier 1 (CET1) capital base of the largest 100 banks increased 99%, or around €1.9 trillion. This comes on top of a large reduction in a number of banks' riskier exposures during that period.

At the same time, banks have weathered COVID-19 shocks because of systemic support. Part of that was indirect, through various fiscal and other measures their corporate and household customers received. Part of it was direct--to encourage banks to continue supporting and lending to customers--and in the form of liquidity or credit guarantees, as well as relief from minimum regulatory capital and liquidity requirements.

This support highlights that regulation isn't a substitute for the occasional need for systemic or potentially more-targeted financial aid, whatever its form. To support the economies where they operate, banks take on risk in their job of maturity transformation-- borrowing money on shorter timeframes to lend out on longer timeframes--and operate with a smaller proportion of equity than most nonfinancial corporates. Regulations can tweak the extent to which banks can play these maturity transformation and credit creation roles, balancing the economic benefit against the likelihood of banks needing support in certain stress scenarios. That said, we believe COVID-19 was an unusual shock. As such, it does not represent a reliable blueprint about how public authorities will handle future stress scenarios.

Regulators Show That They Can Flex Appropriately

Banks' operational leeway benefited immensely from the temporary relaxation of a number of prudential rules (see box 1). As a result, they could focus on their No. 1 priority: providing critical services to the real economy. The short-term impact has been positive as the authorities' actions helped banks maneuver through the worst part of the downturn, in line with the original intentions of the regulations (see "Bank Regulatory Buffers Face Their First Usability Test," published June 11, 2020).

Examples Of Prudential Capital Measures In Response To COVID-19

- One-year delay to the implementation of the latest revisions to the Basel III capital rules ("Basel IV") (global).
- Transitional arrangements for expected credit loss accounting (global).
- Greater flexibility in classification of and risk-weighting applied to forborne loans and lending under public support/guarantee schemes (global).
- Relaxation of counter-cyclical buffers (BOE, ECB, HKMA, etc.).
- Relaxation of rules pertaining to buffer breaches that could automatically lead to reduced or eliminated dividends (Fed).
- Relaxation of systemic risk buffers (Bank of Russia, Bank of the Netherlands, Finnish FSA, etc.).
- Temporary relaxation of Pillar 2 guidance (EU).
- Modified calculation of leverage ratio (FED, ECB, JFSA, FINMA etc.).
- Reduction in capital conservation buffers (Banco Central do Brasil, Bank of Russia, South African Reserve Bank).
- Waiver of requirement to recognize unrealized losses on sovereign bonds (EU).

Source: S&P Global Ratings: "Bank Regulatory Buffers Face Their First Usability Test," June 11, 2020.

It is still too early to predict whether some of these changes could become permanent. If so, a long period of lower capital and liquidity targets, less transparency in recognizing bad debt, or delays in setting aside adequate provisions for loans could weaken banks' balance sheets and erode investor confidence. This is not our base case scenario, but one we continue to monitor.

This period of regulatory relaxation is raising questions about the usability of regulatory capital buffers. Despite the massive economic shock from the pandemic, no major bank dipped into its regulatory capital buffers. We believe regulators might revisit two aspects of these buffers once the COVID-19 crisis is over:

Countercyclical capital buffer (CCyB) requirements, which individual jurisdictions can revise over time, were effective in some cases. In those jurisdictions that had imposed CCyBs before the outbreak of the pandemic, regulators reacted quickly to reduce these requirements, thereby releasing regulatory capital for banks' use. Unfortunately, one important aspect limited its use: The CCyB requirements at the onset of the pandemic were set at 0% in many jurisdictions (for example, Australia, Germany, Japan, and the U.S.), and were less than 1% in most.

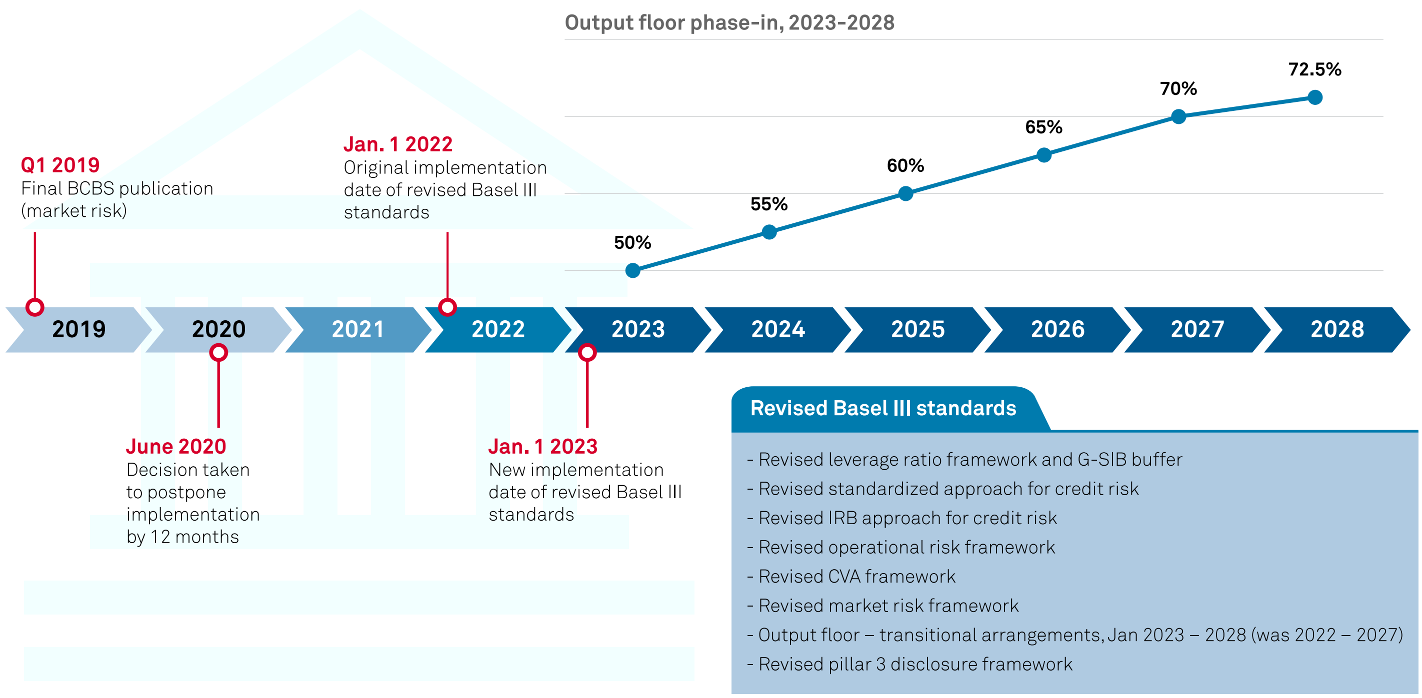
The other (fixed) buffer requirements (for example, capital conservation and systemic buffers) can trigger automatic payment restrictions on ordinary dividends or hybrid interest payments. A number of banks appeared reluctant to consider using these buffers because of concerns about a possible negative market reaction.

Learning from this experience, we believe that regulators may explore the option of reducing some of the fixed buffer requirements and compensate with potentially larger (variable) countercyclical buffers in good times.

Even And Timely Implementation Of What's Already Been Agreed Is Far From Guaranteed

The Basel Committee is focusing on ensuring even and timely completion of already agreed standards. (For a summary, see "The Basel Capital Compromise For Banks: Less Impact Than Meets The Eye," published on Dec. 8, 2017, and chart 1.)

Basel III Implementation Postponed Until 2023



BCBS--Basel Committee on Banking Supervision. G-SIB--Global systemically important banks. IRB--Internal ratings-based approach. CVA--Credit valuation adjustment. Source: S&P Global Ratings.

This task is crucial but won't be easy. Because these globally agreed standards need to be passed into local legislation, we believe local policies might be adopted that might lead to divergence. There are several reasons:

Complacency: Banks have been resilient so far to the COVID-19 shock, so policymakers may not believe stricter rules are necessary.

An emphasis on business model viability: Bank profitability in many regions appears to be a greater source of concern—including for standard setters--in an era of low-for-longer interest rates.

Banks as a conduit for policy: The resilience of banks has allowed authorities to view them as a conduit for economic and monetary policies to lessen the immediate economic damage from coronavirus lockdowns. Some authorities may continue to prioritize domestic short-term policy goals over long-term bank resilience and global coordination.

Lower Reported Capital Ratios Don't Automatically Mean Capital Shortfalls

The completion of Basel III will increase regulatory risk-weighted assets and reduce reported regulatory capital metrics in certain jurisdictions, such as Europe and Japan. That's because the output floor and restrictions of model-based approaches would raise overall risk-weighted assets of many banks in these regions, which use internal models.

Some market participants equate higher risk-weighted assets with capital shortfalls, so argue that more conservative standards would therefore again lead to a meaningful increase in overall capital requirements. We agree that the banking system is adequately capitalized. But we disagree that lower regulatory ratios would necessarily lead to the need for some banks to increase capital substantially. As we stated in our Dec. 8, 2107, report "The Basel Capital Compromise For Banks: Less Impact Than Meets The Eye," we see four reasons why banks subject to higher risk-weighted assets due to the revisions may not need to substantially raise their regulatory capital:

1. Implementation will be gradual. According to the latest Basel recommendations, most revisions will be implemented only from January 2023, with the output floor gradually phased in over five years.

2. Management is taking remedial action. We continue to expect bank managers to take a number of actions to reduce the regulatory capital impact, for instance, as European banks have done in the past several years. As a result, the minimum capital requirements for a sample of close to 100 EU banks would increase 18.5% based on end-2019 data, down from 24.1% based on June 2018 data, according to a study by the European Banking Authority assuming full implementation of the final Basel III standards.

3. Banks may lower their own high capital targets. Most banks' capital policies already considered the likely impact of upcoming standards. As a result, many banks have high capital targets and large management buffers above overall requirements. This should allow banks in some cases to either reduce their buffer or even lower minimum target levels.

4. Regulators may adjust their approach. National or regional regulators may change their stance and adapt regulatory minimums assigned to individual banks. A panoply of regulatory tools have led to capital buffer requirements well in excess of Pillar 1 minimums. In particular, capital stress tests have become one of the main tools to assess capital adequacy in the U.K. and the U.S., and are increasingly driving assessments in other markets. We expect that some regional regulators may choose to reduce Pillar 2 requirements to offset some of the Pillar 1 increases for specific banks.

Regulatory Capital Metrics Will Become More Comparable--To A Degree

We fully agree with the need to reduce variability in the calculation of risk-weighted assets between banks and regions and believe that ongoing initiatives (see Appendix) are addressing this. In particular, the output floor will help reduce the variability between banks that use the standardized approach and those using internal models. For banks that use internal models, the output floor and restrictions on the use of certain approaches will help reduce the risk of excessive variability in the calibration of models.

The lack of comparability is one of the factors that prompted us to introduce our risk-adjusted capital (RAC) framework in 2009. While the revised standards represent a big step toward greater comparability, we expect that inconsistencies will remain. This continues to underpin our use of the RAC ratio as the foundation of our capital and earnings analysis under our bank rating methodology. While we recognize the improvements in how regulatory ratios are calculated, they still don't support a ranking of banks' capitalization. Some banks, for instance, have higher regulatory ratios but weaker underlying capitalization.

We believe the comparability of risk-sensitive regulatory metrics--for example, CET1 and Tier 1 ratios--will remain somewhat elusive, for a number of reasons, including:

Protracted implementation. The final revisions to Basel III standards will only start to be implemented from 2023, and the output floors will be gradually phased in over a five-year period.

Regional nuances. For similar exposures, some regions where banks are active users of internal models will still benefit from lower risk weights than banks using standardized risk weights, although the output floor and restrictions to the use of internal models will reduce this benefit. Regulations in the U.S., for instance, already force banks using internal models to calculate their requirements based on the standardized approach and to apply the higher of model-based and standardized approaches.

Risk of uneven implementation. A jurisdiction like the EU, for example, is already assessed as "materially non-compliant" for its implementation of current Basel III rules, reflecting jurisdictional particularities in its implementation of the global standards, such as haircuts on the capital requirements for exposures to small and midsize enterprises, and exemptions for credit valuation adjustment calculations. Discussions about possible haircuts for "green" exposures (but in our view not necessarily less risky from a credit perspective) could exacerbate these disparities. As an illustration, according to the EBA study mentioned earlier, pro forma Tier 1 capital requirements (assuming unchanged Pillar 2 requirements) would increase 18.5% based on full implementation of Basel III standards, but only about 13% after considering certain existing and possible specificities in the implementation of the standards in EU law. The EU is not alone in having adapted and adjusted some of the existing standards into local legislation, and we believe this will remain the case when the time comes to pass the revised standards into law.

Possibility of a prolonged or renewed temporary relaxation in rules. The COVID-19 shock has justified the coordinated relaxation of a number of rules across the globe. A question mark remains about the speed of the "return to normal" for some rules but also about whether local regulators now feel empowered to take similar actions in the event of the next crisis, including regional crises.

Sovereign exposures are not part of the final Basel III standards, and some elements are still subject to national discretion. It appears that finding a globally acceptable compromise was not possible in this area. As a result, banks in various countries follow different rules, and in many cases, domestic and regional sovereign exposures do not attract any capital requirement.

Environmental Risks To The Fore

Financial authorities are increasingly aware and concerned about the potential impact of environmental risks, especially climate change, on financial stability. The Basel Committee's recent reports ("Climate-related risk drivers and their transmission channels" and "Climate-related financial risks – measurement methodologies") provide preliminary thoughts about its commitment to identify gaps in the current Basel framework where climate-related financial risks may not be sufficiently addressed. On a positive side, it suggests that traditional risk categories (for example, credit, market, liquidity, operational, and reputational) can adequately capture the impact of environmental risks on banks' creditworthiness. That said, the Basel Committee notes that both banks and supervisors have so far predominantly focused on assessing the drivers of environmental risk through the lens of credit risk analysis, and to a lesser extent through other types of risk (such as reputational risk, business modeling, legal risk, and strategic positioning). Methodologies for measuring environmental risks are several, all presenting pros and cons.

The key challenges identified in the main measurement approaches are:

- The trade-off between risk differentiation and comparability, with the need to balance the desired level of risk granularity and the goal to compare and aggregate banks' exposures.
- The availability of data and information and differences in accounting principles and/or reporting schemes across jurisdictions.
- The translation of climate risk drivers into financial risk parameters in a forward-looking manner.

On the latter, we view positively some supervisors' recent efforts to include climate-related risk and scenarios in stress tests. Indeed, unlike backward-looking analysis based on previous data, forward-looking analysis--such as scenario analysis and stress tests--better indicates banks' vulnerabilities and, therefore, how they may need to adjust their strategies and risk management. This is because environmental risks and opportunities are constantly evolving, and it is difficult to predict what scenarios banks will have to face in the long term.

The French Prudential Supervision and Resolution Authority concluded one of the first climate stress tests in April 2021. This pilot analysis provides a forward-looking view of the risks and vulnerabilities facing the French financial system (banking and insurance groups) over a long-term horizon, based on several alternative scenarios. Although the overall exposure of French banks and insurers to climate risks was assessed as "moderate," the exercise brought to light methodological difficulties and the absence of certain key data to assess unequivocally the vulnerability to environmental risks. The Bank of England (BoE) and European Central Bank will follow, including environmental risks among the variables used in their stress tests to apply to the banks they supervise. For example, the BoE will shortly launch its Climate Biennial Exploratory Scenario to explore the financial risks posed by climate change to the business models of banks and other market participants.

Given the broad challenges in measuring and addressing environmental risks, we consider it unlikely that there will be large increases in capital requirements related these risks or opportunities in the foreseeable future. That said, evidence of differences in the vulnerability of banks might lead to different Pillar 2 requirements and could influence banks' strategies over time.

Appendix: A Summary Of The Latest Revisions To Basel III Capital Rules

For a detailed discussion about the changes, see "The Basel Capital Compromise For Banks: Less Impact Than Meets The Eye," published on Dec. 8, 2017.

The revisions introduce three main types of regulatory changes:

- Output floors: The outcome is a floor of 72.5%, compared with the initially proposed range of 60%-90%. The floor is calculated on aggregated risk weighted assets (RWAs), meaning that for a bank using internal models for certain exposures, the aggregate RWAs can't fall below 72.5% of aggregate RWAs computed under the standardized approaches across all asset classes and risk types.
- Restrictions to use of IRB approaches for credit risk (see table 1); restrictions as well in the parameters (e.g. probability of default floor) used to calibrate internal credit models; for operational risk, replacement of the current four approach by one single standardized approach.
- Review of standardized approaches for credit and operational risks, and for CVA risk.

Other key features include:

- A long implementation horizon: The standards will be effective as of January 2023, apart from the output floor, which, at the local regulator's discretion, can be phased in between January 2023 (50%) and January 2027 (72.5%). In addition, national regulators can opt to cap the increase in a bank's total RWAs resulting from the output floor at 25% during the phase-in period. The implementation of the FRTB standards is postponed until January 2023.
- Leverage ratio: Globally systemic banks will have to meet a surcharge above the 3% minimum leverage ratio requirement. The buffer will be set at 50% of the entity's risk-capital systemic buffer.
- Sovereign exposures: No decision was reached, with little visibility on the likely outcome of past consultations.

Table 1

Revisions To Available Credit Risk Approaches

Exposure class	Methods available under the new standards	Change in available methods compared with existing standards
Banks and other financial institutions	SA or F-IRB	A-IRB removed
Corporates with total revenues > €500 mil.	SA or F-IRB	A-IRB removed
Other corporates	SA, F-IRB or A-IRB	No change
Specialized lending	SA, supervisory slotting, F-IRB or A-IRB	No change
Retail	SA or A-IRB	No change
Equity	SA	All IRB approaches removed

F-IRB: Foundation internal ratings-based; A-IRB: Advanced internal ratings-based; SA: Standardized approach. Source: BCBS.

Related Research

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Bank Regulatory Buffers Face Their First Usability Test, June 11, 2020
- Nordic Banks' Capitalization Should Remain Stable Despite Revised Basel III Standards, Jan. 24, 2018
- The Basel Capital Compromise For Banks: Less Impact Than Meets The Eye, Dec. 8, 2017
- Basel III Regulations Spark Innovation As Project Finance Banks Try To Stay In The Game, Jan. 31, 2017

This report does not constitute a rating action.

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