Convergence in the prudential regulation of banks – what is missing?[1]

Executive summary

Regulatory divergence, or differences in how jurisdictions apply Basel III and other global banking standards, is a significant source of market fragmentation. For banks that operate in several jurisdictions, such variations create an uneven playing field and may hinder market entry, reduce efficiency and impede global risk-sharing among a broader array of market participants.

Global standard setters, such as the Basel Committee on Banking Supervision (BCBS), promote a level playing field for internationally active banks. A full, timely and consistent application of the Basel III framework bolsters the stability of national and global financial systems and promotes the comparability of prudential metrics across jurisdictions. Nevertheless, country-specific rules may still be justified as a means of strengthening the resilience of the domestic economy.

Following the 2007–09 Great Financial Crisis, the BCBS and the Financial Stability Board (FSB) have adopted programmes to assess how their members have implemented the post-crisis reforms. Such initiatives have helped to align domestic regulations with the agreed reforms across jurisdictions. However, these studies have also found some inconsistencies in implementation, including differences in when and how international standards were adopted.

Under Japan's presidency of the G20 in 2019, the FSB investigated whether regulatory policies and supervisory practices have led to market fragmentation and considered tools to address the issue. The FSB report outlined ways of mitigating the negative effects of market fragmentation from a market efficiency and financial stability perspective. It recommended taking into account the fragmentary effects of regulation during the standard-setting process and the implementation monitoring programmes of standard setters. It also suggested that authorities should enhance communication and information-sharing between themselves.

This paper leverages off the FSB's report and identifies specific sources of regulatory divergence in the banking sector. The findings are based upon a synthesis of earlier publications of the Financial Stability Institute that identified the methods that authorities use to implement international standards and to develop policies in areas for which no sufficiently prescriptive guidance exists.

An overarching observation is that the full, timely and consistent application of Basel III is a necessary but not sufficient condition in harmonising the prudential oversight of internationally active banks. While variations in Basel III implementation may increase the scope for market fragmentation, there are fundamental causes of regulatory divergence that warrant further scrutiny.

Domestic regulations, even when assessed as compliant with Basel standards, may still lead to different prudential outcomes across jurisdictions. This can be attributed to at least three factors: (i) varying practices in asset valuations that may impact the measurement of banks' regulatory capital; (ii) differences in the scope of application of Pillar 1 across jurisdictions; and (iii) distinct implementations or interpretations of Pillar 2 provisions that may lead to differing requirements.

[1] Rodrigo Coelho (rodrigo.coelho@bis.org), Fernando Restoy (fernando.restoy@bis.org) and Raihan Zamil (raihan.zamil@bis.org), Bank for International Settlements.

The authors are grateful to Mohamed El-Khalil, Costas Stephanou, Bryan Stirewalt, Greg Sutton and Fernando Vargas for helpful comments. We are also grateful to Jimmy Shek for valuable research support and for Esther Künzi for administrative support.

Differences in how banks calculate regulatory capital are a key source of regulatory divergence. Regulatory capital (subject to certain adjustments) is based on the difference between the value of a bank's assets and liabilities. As liabilities are mostly held at amortised cost, asset valuations materially impact a bank's reported capital figure. As banks are highly leveraged, even small changes in asset values can have a disproportionate effect on capital. Thus, heterogeneous asset valuation practices may materially affect the consistency of bank solvency assessments across jurisdictions, as the regulatory capital figure is the starting point for assessing compliance with Pillars 1 and 2 of the Basel framework.

The valuation of loans drives the reported capital number of banks. The loan valuation process impacts earnings and common equity Tier 1 (CET1), via loan loss provisioning. The magnitude of provisions is affected by how banks measure losses on non-performing exposures (NPEs), for which there is no single accounting or prudential standard. In addition, the introduction of expected loss (EL) provisioning significantly expands the scope for judgment and dependency on internal models. Furthermore, some authorities have implemented country-specific prudential backstops to accounting provisions, which can also undermine the comparability of reported regulatory capital across jurisdictions.

Other hard-to-value assets can also affect a bank's capital figure. Accounting rules require certain assets to be measured at fair value (FV), with the unrealised gains or losses impacting CET1 capital. Some assets measured at FV, such as Level 2 and 3 assets, are not traded in an active market, necessitating modelling assumptions. The assumption dependent nature of these valuations can lead to varied practices.

Differences in the scope of application of Pillar 1 may lead to additional sources of regulatory fragmentation. Variations in Pillar 1 requirements stem from differences in the timing and substance of the implementation of international standards. The lack of a uniformly agreed definition for an internationally active bank is another cause of discrepancy, as is the adoption of country-specific rules for banks not subject to the Basel framework.

As for Pillar 2, it is a principles-based standard that is intended to accommodate a range of approaches, which, in turn, can lead to varied prudential outcomes. Jurisdictions require a diverse set of banks to submit a self-assessment of their own capital adequacy, setting the context for the supervisory review process. Authorities also apply various approaches to determine capital add-ons and stress-testing exercises, including where the add-ons, if applied, belong in a bank's capital hierarchy. Finally, supervisory expectations for liquidity add-ons are not specified in Pillar 2.

It is neither feasible nor desirable to eliminate all regulatory discrepancies across jurisdictions. The Basel framework consists of minimum standards that should be applied, at least, to internationally active banks, and jurisdictions are free – indeed, encouraged – to apply higher standards if warranted for their banking systems (ie gold-plating). The standards can, therefore, co-exist with domestic rules aimed at adjusting the prudential regime to the specificities of their national financial systems.

There could, however, be benefits in achieving more consistent practices across jurisdictions. On the first source of discrepancies, there is scope to reduce divergent practices in the measurement of NPEs, Level 2/3 assets and performing loans under EL provisioning. One potential way of addressing such variability is through the design of prudential backstops. On the second and third sources of discrepancies – different scope of application of the Basel framework and the implementation and interpretation of Pillar 2 requirements – there is room to analyse which areas may be most prone to different outcomes and whether these are justified to accommodate national specificities.

There are a variety of instruments that can be used to address unwarranted regulatory fragmentation. The BCBS evaluates the implementation of its standards in all member jurisdictions, and it has already issued guidance on elements of the prudential regime where significant discrepancies exist. Additional policy work may be considered in areas where excessive heterogeneity remains, such as those relating to the measurement of NPEs and other hard-to-value assets that are consequential in the calculation of regulatory capital. Further guidance on the scope of application of the Basel framework and greater clarity on certain features of Pillar 2 can also promote more regulatory convergence.