Sabine Lautenschläger: Basel III – sense and sensitivity

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the Institute for Law and Finance Conference on Basel III, Frankfurt am Main, 29 January 2018.

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It is done: Basel III has been finalised.

I admit that it was a long journey, but in my view, it was worth the wait: Basel III will help to make banking safer. It is crucial, though, that Basel III is properly implemented – in Europe and around the world. It must not be watered down.

Basel III marks the end of the post-crisis reforms; regulatory certainty has been restored. The banks know what awaits them; they can be confident about the regulatory framework, and can plan ahead and support the real economy.

But does Basel III deliver what was promised? Does it, on the one hand, create rules which are sufficiently risk-sensitive to set the right incentives for banks? And does it, on the other hand, create rules which are simple enough to decrease model risk?

Banks are not enchanted by Basel III. Many of them claim that it throws risk sensitivity overboard and penalises low risk exposures. Are these claims justified?

Well, we have not thrown risk sensitivity overboard. And why would we? Risk sensitivity helps align capital requirements with actual levels of risk and supports an efficient capital allocation. It prevents arbitrage and risk shifting. And risk-sensitive rules promote sound risk management.

But we all know how challenging it is to measure and model risks. Much depends on the quality of the models; much depends on the data and the assumptions that feed into those models; and much depends on supervisors' capacity to act. If there are errors along the way, banks might end up undercapitalised and vulnerable. This, in turn, might lead markets to question the reliability of risk-based capital requirements in general, which would undermine trust in banks more generally.

Therefore we need to balance risk sensitivity with some safeguards. And this is exactly what we aim to do with Basel III. It preserves risk sensitivity. It retains internal models for most asset classes. And it enhances the risk sensitivity of the standardised approaches. But at the same time, Basel III adds a few safeguards.

First, I think we can all agree that it makes no sense to allow for more complex risk-sensitive capital requirements if risks cannot be measured and modelled. Basel III therefore aligns the degree of risk sensitivity with the extent to which it is possible to measure and model risks.

Second, there are some more conservative haircuts on collateral and some input floors. These input floors lie beneath the parameters for "probability of default" and "loss given default". And there will be floors beneath the "exposure at default" calculation as well. These floors work bottom-up; they will keep banks from feeding their internal models with excessively low inputs. This serves as a safeguard as it prevents capital requirements from being set too low.

And, yes, these input floors make the rules a bit less risk-sensitive. But we need to look at this in absolute terms – for residential mortgages, the input floor increases from three basis points to five basis points. Five basis points correspond to a once-in-2,000 years default rate! Is such a floor really too conservative? At global level, the bottom-up reforms see small increases in capital for exposures to other banks, large corporates and equity investments. This is somewhat offset by a reduction in risk weights for loans to small and medium-sized enterprises.

Third, there is the hotly debated output floor. It ensures that risk-weighted assets calculated with internal models do not fall too far below those calculated with standardised approaches. “Too far below” means they must reach at least 72.5%. Does that kill risk sensitivity? No, it does not. Obviously, there is still room for banks to apply individual risk weights and to benefit from lower capital requirements for classic, low-risk banking business.

And more than that: the effective floor might even be lower than 72.5%. This is due to the fact that many banks apply the standardised approaches to at least some exposures. This implies that, depending on the share of assets still under the standardised approach, the effective floor for them could be lower than 72.5%.

At the same time, Basel III makes the standardised approaches themselves more risk-sensitive. Let me give you just one example: residential mortgages. Under Basel II, the standardised approach assigned the same risk weight to almost all such mortgages. But in Basel III, the risk weights of residential mortgages depend on the loan-to-value ratios. The output floor is thus set in relation to a benchmark, which itself has become more risk-sensitive. And let us not forget that, in some cases, the standardised approaches have become less costly in terms of capital. At global level, the capital requirements from standardised approaches have been reduced by about 2% on average. Mortgages and corporate lending make up the majority of these reductions.

So, Basel III does keep risk sensitivity on board. It acknowledges, though, that there are limits to internal models. It provides safeguards to restore trust in risk-based capital requirements.

Does this mean that Basel III is the perfect standard – the philosopher’s stone of banking regulation?

Well, Basel III is a global standard, and across the world, financial sectors differ greatly. Just think of real estate financing and how differently it is treated in Europe compared with the United States. Thus, a global standard cannot suit everyone perfectly. The key is to find an acceptable compromise; the alternative would be to have no global standard, and that would definitely be worse. The output floor in particular is one such compromise.

What impact will the final Basel III package have on banks – and on their business models and their capital?

The rules are not neutral. The bottom-up safeguards in Basel III, including the input floors, will impact on risk weights in some business areas. Certain retail credit card exposures are one example. The top-down output floor affects overall capital requirements, depending on the overall portfolio composition of a bank. For example, our analysis suggests that the difference between internal ratings-based and standardised risk weights tends to be relatively large in certain segments of real-estate markets where historical loss rates are exceptionally low. The output floor tends to be more binding for banks which are heavily engaged in these markets.

Overall, it is hard to predict how business models will evolve. This depends not only on regulation, but also on many other factors, including the future path of profitability in different business areas, the pricing power of banks and, eventually, how banks will adapt their business models.

Now what about additional capital requirements? What about the banks’ claim that the burden might be too heavy for them?

Well, there are two things to bear in mind.

First, there will be a long transition period. This is at the heart of the overall compromise which paved the way for finalising Basel III. This transition period runs right through to 2027. It gives banks and legislators time to implement all the changes introduced by Basel III.

Second, the European Banking Authority estimates that, for EU banks, the final Basel III package will lead to an aggregate Tier 1 capital shortfall of €34.4 billion. Is that a lot? In 2016, the largest banks in the euro area earned €50 billion – net, after taxes, and in a difficult environment. Also, the capital shortfall refers to the end of the transition period, which is nine years away. Most banks should be able to earn their way out of potential shortfalls.

To sum up, Basel III preserves risk sensitivity in a sensible way. At the same time, banks will be able to handle its impact and, in the long run, they too will benefit from a more stable banking system.

Thank you for your attention.