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STOCKTAKING AND OUTLOOK ON SELECTED ASPECTS OF THE GLOBAL AND EUROPEAN PRUDENTIAL FRAMEWORK

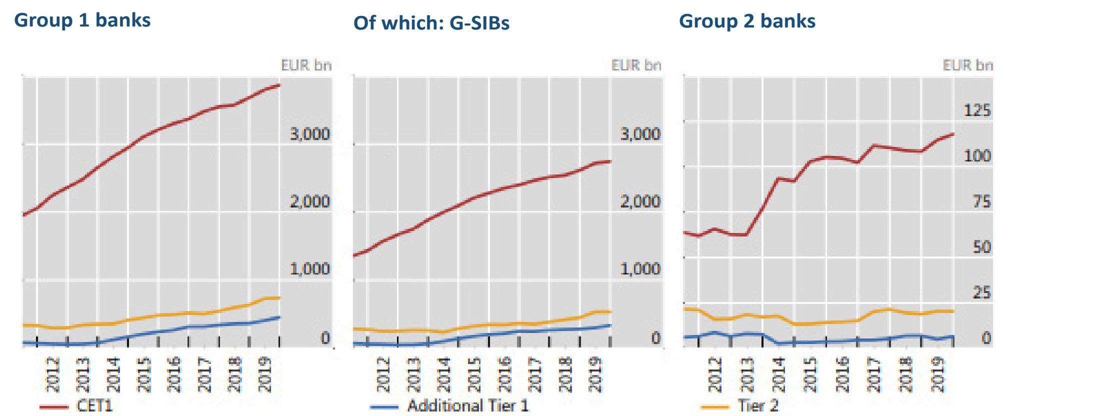
Introduction

The global financial system and its regulatory landscape have changed dramatically since 2008. The global financial crisis had various causes such as flawed corporate governance and consumer protection frameworks as well as high-risk financial instruments. In response, central banks, regulators and policymakers introduced new requirements aiming to increase the resilience and stability of the financial system. On the side of the banks large institutions have significantly improved their capital ratios compared to pre-crisis levels and are subject to recovery and resolution plans to allow authorities to take early coordinated action or to ensure an orderly resolution process in the event of failure. They have also strengthened their corporate governance and organisational cultures. These combined efforts result in a situation where banks are in much better shape today and contribute to a safer financial system, especially during episodes of stress. This statement from a Discussion Paper published by the Swiss Finance Council (SFC) in March 2019[1] still holds true despite the severe economic shock caused by the COVID-19 pandemic.

The Financial Stability Board (FSB) similarly argues that the pandemic is the first major test of the global financial system since the G20 reforms were put in place following the financial crisis of 2008. Thus far the global financial system has weathered the pandemic thanks to the swift, determined and bold international policy response. At the same time the FSB indicates that the functioning of capital and liquidity buffers may warrant further consideration and that some concerns about excessive financial system procyclicality.[2]

Furthermore, the Basel Committee for Banking Supervision (BCBS) states that, since the adoption of Basel III, a significant improvement in the overall resilience of banks has taken place, leading to an average Common Equity Tier 1 (CET1) of around 13% compared with 7% in 2011[3], which is confirmed by the level of capital in absolute terms (see Figure 1). The level of CET1 in the Banking Union reached a higher average of 15.6% at the end of 2020 and the Liquidity Coverage Ratio, which was introduced as one of the responses to the 2008 financial crisis, reached its highest level to date at the end of 2020 (see Figure 2).

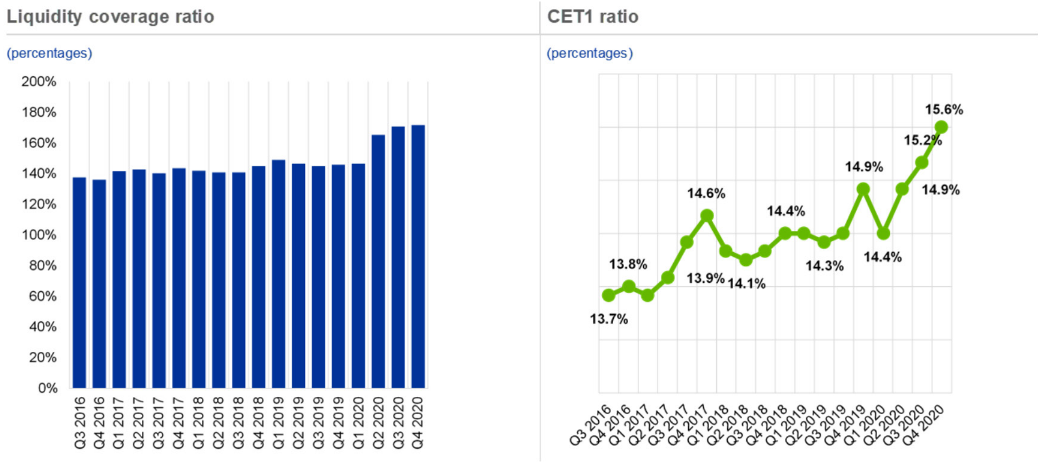
Figure 1: Level of Capital*
Consistent sample of banks, exchange rates as of the current reporting date



** The graph shows the fully phased-in initial Basel III framework for the data points up to and including the end of 2018 and the actual framework in place at the reporting date for all data points thereafter.*

Source: Basel III Monitoring Report December 2020 (December 2019 data).

Figure 2: Capital and Liquidity Ratios



Source: ECB banking statistics, Statistical Data Warehouse. Enhanced outlook and emerging risk in the banking union.

However, the high number of on-the-run ad hoc regulatory interventions that were necessary during the early stages of the pandemic suggest there are lessons to be learnt and room to refine the regulatory framework. This Issue Note takes stock of the current global and European prudential framework. Additionally, we will discuss related policy developments in some selected areas and make suggestions for improvements in the spirit of regulatory efficiency and financial stability.

Areas of Stocktaking

Although the banking sector remained resilient throughout the pandemic, the current situation reveals some structural shortfalls in the regulatory framework. Consequently, there is no reason for complacency and efforts to make the global and European financial system more efficient and more resilient must continue. The BCBS has recently announced that it will be devoting a substantive part of its agenda over the next few years to carefully evaluating the impact and effectiveness of its post-crisis reforms. The work will be grounded in rigorous empirical analysis.[4] The SFC welcomes this focus. However, a backward-looking assessment might not deliver a true picture and may lead to wrong conclusions if jurisdictions are implementing the final Basel III reforms divergently, be it in terms of timing or in terms of content.

From a global perspective we will discuss procyclicality and the usability of capital buffers to act in a countercyclical manner, as they appear to be the most prominent examples of possible improvements for internationally active banks. As for the European prudential framework, the completion of the Banking Union and solving the related home-host issues remain crucial. A truly integrated Banking Union, coupled with an effective, competitive Capital Markets Union, would increase competition and eliminate unnecessary costs in the interest of consumers and investors. Besides, banks would have new business opportunities and new incentives for cross-border mergers. In addition to taking stock of the framework that currently applies in the EU, the Issue Note will also look at the latest developments regarding the prudential treatment of third country banks in the EU.

Global Level

The BCBS recently identified procyclicality and the useability of capital buffers as a matter of concern. According to its report published in July 2021, the two main sources of procyclicality are capital impact from credit loss provisioning, and capital impact for banks' market activities, especially market risk and credit valuation adjustment. On the capital buffer framework, the report concludes that it has not yet been clearly tested, given that most banks maintained significant capital headroom above their regulatory minimum requirements. Moreover, extraordinary public support granted during the COVID-19 pandemic has had a mitigating impact. It is therefore too early to draw lessons on the cyclicality of the framework and on the usability of capital buffers, but clearer evidence may emerge, if further losses materialise as support measures are unwound and banks' capital ratios fall closer to their buffers.[5]

Procyclicality

Over the past decade, the global regulatory and accounting framework was generally transformed into a more risk-sensitive and market-oriented model as banks, which choose to use internal models, calculate their operational risk, credit risk and market risk in a highly risk-sensitive manner, reflecting the underlying risk characteristics. The risk-sensitive nature of Risk Weighted Assets (RWA) has, however, become an issue for specific asset classes and led to substantial RWA inflation due to market volatility, in particular in the market risk area (e.g. stressed Value at Risk treatment in some jurisdictions). The same holds true for the accounting framework, which has gradually moved to a mark-to-market approach and introduced new rules on Expected Credit Losses (ECL) with the International Financial Reporting Standard 9 (IFRS 9). IFRS 9 and US Generally Accepted Accounting Principles (GAAP) mark a paradigm shift from incurred loss to expected loss but differ in the moment at which expected losses are recognised. While US GAAP requires the recognition of lifetime losses at origination or purchase of an asset, IFRS 9 only demands to account for the expected losses in the next twelve months as long as the asset does not show a significant increase in risk. In contrast to US GAAP, IFRS 9 triggers the recognition of the ECL for the remaining lifetime only once such significant increase in risk occurs.

Accordingly, IFRS 9 presents a substantial degree of procyclicality. Even if financial institutions had the ability to accurately forecast future losses, ECL may only be provisioned up to a maximum of twelve months. Consequently, financial institutions will take a hit at a moment when a contractionary phase of the credit or business cycle has already started.[6]

The combination of a risk-sensitive prudential framework with a mark-to-market and forward-looking accounting framework leads to higher procyclicality, requiring banks, based on their internal model calculations, to hold more capital in times of higher risks and economic downturns. We support the established fundamentals of a risk-sensitive framework and do not contest an increase in RWAs as a consequence of economically difficult situations. Risk-sensitivity is and should continue to constitute the basis of prudential capital requirement calculations, translating the economic reality into banks' balance sheets. However, some of the procyclical effects may be overemphasised and trigger unintended consequences. Identifying and correcting them in the RWA calculation without weakening the global financial stability should be the focus of current discussions.

RECOMMENDATIONS

We appreciate that global standard-setters are in the process of assessing lessons learnt from the COVID-19 pandemic and are conducting a thorough stocktaking exercise regarding the procyclicality of the current regime so that any negative effects on banks' intermediation activities can be mitigated. In our view it is crucial to find the right balance between minimising procyclicality whilst also retaining risk-sensitivity. Areas to take a closer look at should include:

- a review of the procyclicality in market risk;
- how to address procyclical effects of credit risk (e.g. accelerated credit drawdowns and deterioration of credit quality) in the accounting and regulatory frameworks;
- how to address the impact on leverage exposure of stress points observed during the crisis – e.g. central bank deposits, government bonds.

Capital Buffers

While global regulators continued to encourage banks to use capital buffers to absorb losses, extend credit to the real economy and avoid excessive deleveraging, a combination of supervisory, regulatory and market-related concerns undermined banks' willingness to use the freed-up capital buffers in order to provide additional lending to the real economy. Capital buffers – with the exception of the countercyclical buffer – are intended to cover macroprudential and systemic risk and to protect against losses.[7] One of the reasons why banks are not using the buffers (with the exemption of the countercyclical buffer) may be that they are considered part of the stack of minimum required regulatory capital. Commonly they are deemed more as a line of defence against losses than an instrument to provide additional lending to the real economy during an economic downturn. Moreover, the market is using the capital ratio of a bank as a determining element for its valuation and credit rating, which themselves impact the banks' funding costs and capacity. Consequently, banks usually do not operate at the minimum of the total capital requirements but work with a more usable "management capital buffer" in addition to the required regulatory minimum.

The complexity, the stacking order and partial overlaps of the buffer framework make it difficult to make a clear distinction between buffers that are there to absorb losses and buffers that act countercyclically during an economic downturn. While the overall calibration of the combined buffer requirement appears appropriate, we encourage policy makers to engage in a discussion about the role of buffers and a possible redesign of the buffer stack to increase their countercyclical usability.

These arguments are supported by Kerstin af Jochnik, Supervisory Board Member of the European Central Bank (ECB), who argued in November 2020, that banks fear negative market reactions as well as rating downgrades. In terms of a possible solution to this problem, she suggested rebalancing the countercyclical and the structural elements of the capital stack.[8]

In its report on the early lessons from the COVID-19 pandemic, the BCBS argues in a similar way by stating that market stigma, uncertainty about the future, uncertainty about supervisory expectations or responses and other factors such as the potential breaching of the Leverage Ratio or the Total Loss Absorbing Capacity (TLAC) are the main reasons for constrained buffer usability.[9]

RECOMMENDATIONS

We invite global regulators to continue their analysis of the purpose and design of the buffer framework. Such an exercise should assess/address the following:

- if the practical application of the buffers has revealed some overlaps (especially where different national authorities are in charge of deciding on the buffers);
- while we deem the overall calibration of the buffer framework as appropriate (combined buffer requirement), policy makers should engage in a discussion about calibration and stacking order of the individual buffers;
- making the buffer framework better targeted to act in a countercyclical manner would argue for a relative recalibration between a stronger countercyclical buffer and a more risk-adjusted combination of other loss-absorbing buffers, keeping total capital requirements unchanged.

EU Level

Completing the Banking Union

The establishment of a Single Supervisory Mechanism (SSM) and a Single Resolution Board (SRB) is a success for financial stability, efficient supervision and an important step towards a Banking Union. However, the Banking Union is still incomplete and important topics that would foster private cross-border risk sharing and address fragmentation across its members remain subject to controversial discussions. Not much progress has been made since the topic attracted the highest political attention in the 2015 Five Presidents Report.[10]

Currently, four main topics rank on the agenda of the Banking Union discussions: i) the review of the crisis management framework whose main aim is to extend the resolution regime to a broader range of banks, ii) the review of the prudential treatment of sovereign exposures which currently carry a 0% risk weight, in order to break the vicious circle between banks and sovereigns, iii) the setting up of the European Deposit Guarantee Scheme (EDIS) and iv) a solution to the home-host issues to enable European cross-border banks to manage liquidity, capital and loss absorption in a fungible manner at group level, which we will discuss in more detail below.

Avoiding Market Fragmentation and National Ring-Fencing

Fragmentation can impair financial stability by reducing market liquidity and trapping resources which could otherwise be mobilised across borders in domestic markets, and, in extreme scenarios, can make a bank more brittle and prone to failure. If this trend becomes entrenched, efforts made in the past ten years to establish a stable and sound global financial system could be eroded.

Ensuring an Optimal Allocation of Capital and Liquidity in Cross-Border Banking Groups

The issues outlined on a global level can be observed within the EU as well. Furthermore, they are aggravated by ring-fencing, market fragmentation and a lack of completion of the Banking Union. This has been acknowledged by the Chair of the SSM, Andrea Enria, who said the EU legislation, that heavily restricts the free flow of capital and liquidity for banks operating across national borders within the EU, is a missed opportunity in terms of establishing a truly single market.[11] The ECB also notes that long-term and structural costs, as capital allocation and liquidity efficiency, can only be optimised in the absence of restrictions in this regard.[12]

In certain circumstances ring-fencing can undermine financial stability when resources are trapped and cannot be deployed in a fungible manner to support group affiliates. If such practices become pervasive, the likelihood of failure can increase fivefold or even fifteenfold compared to an integrated bank where internal capital is fully mobile.[13] Local ring-fencing of resources to build up buffers might be a rational decision for an individual jurisdiction, but it increases risks in the overall system as there is less flexibility within banking groups to address issues using resources cross-border and to allocate capital and liquidity where it is most needed. This concern is shared by the ECB in its 2020 Financial Stability and Integration Review, which states that ring-fencing of capital and liquidity can make a bank less resilient to shocks.[14]

The SFC shares these views and moreover observes that such ring-fencing practices are an obstacle to the pooling of resources where they produce the best outcome and channel funding to clients and sectors most in need. They also amplify the costs of a crisis and hinder a bank's ability to continue to extend funding to the real economy.

As a solution, the SFC supports an implementation of capital and liquidity requirements in a way that does not block capital locally but rather allows for sufficient fungibility of resources at group level to appropriately allocate capital where it is most needed. To address these challenges and avoid an escalation of the issue, we call for a closer dialogue between authorities and the industry, supported by a further formalisation of cooperation agreements. For example, the ECB has recently proposed that the European Commission should legislate "small scale amendments" to encourage banks to use existing intra-group liquidity waivers. Such arrangements would be reinforced by contractual arrangements confirmed by legal opinions, and a similar approach could be taken for capital waivers.[15]

Optimal Allocation of Loss Absorption Capacity

One of the main global answers to the 2008 financial crisis was the introduction of a bank resolution regime that enables significant banks to fail without causing systemic stability issues and using taxpayers' money. Resolution authorities were set up, which started drawing up individual resolution plans for banks. A core element of successful bank resolution funded by investors without the need for taxpayer support is the requirement that banks must hold sufficient TLAC in the form of capital and unsecured debt instruments to enable their resolution. Banking groups that will be resolved through one single entity (Single Point of Entry (SPE)) must downstream loss absorption capacity to their subsidiaries and ensure that they are resolved or liquidated only in coordination with the entire banking group. This differentiates such groups from where a Multiple Point of Entry (MPE) strategy is applied and where each individual entity is resolvable and consequently must issue loss absorption capacity by itself.[16]

In the first half of 2020, the FSB conducted a follow-up stocktaking exercise to review the technical implementation of the TLAC Standard with a particular focus on approaches in home and host jurisdictions towards TLAC resources. It states that while the availability of adequate loss-absorbing capacity is a prerequisite for resolvability and a credible resolution strategy, the appropriate calibration of requirements for pre-positioned resources needs to strike a balance between certainty for host jurisdictions and flexibility to deploy unallocated resources where needed within a group in times of stress.[17]

Similarly, the Chair of the Single Resolution Board, Elke König, has shown concern in relation to this issue by arguing that excessive ring-fencing of capital at subsidiary level leads to fragmentation of financial resources, which as such can cause situations where insufficient resources are available at group level to support stressed subsidiaries.[18] In a recent speech, König made a similar comment by stating that the high levels of pre-positioned Minimum Requirement for Own Funds and Eligible Liabilities (MREL) and TLAC in subsidiaries can clearly be a concern.[19]

Key jurisdictions decided however, to implement the internal TLAC provisions in a spirit of national ring-fencing, setting by law a fixed amount for internal TLAC equivalent to 90% of the standalone TLAC requirement. Such an approach is not only economically inefficient, it also promotes jurisdictional trapping of financial resources, which counters the aim of ensuring the highest level of global financial stability and which in turn benefits all jurisdictions.

The SFC believes that the implementation of the final steps of the Basel III framework into EU law, which reopens core EU prudential legislation, presents a good opportunity to review the current EU Internal TLAC provisions along the lines expressed by the FSB and the Chair of the SRB.

Prudential Treatment of Third Country Banks under EU Legislation

Third Country Branches

We recognise that the EU, unlike the US or the UK, does not have a consolidated picture of the activities of foreign banks that operate across the bloc in a mixture of subsidiaries and third country branches. In addition, a recent report[20] of the European Banking Authority (EBA) talks about the heterogeneity as regards to supervision and regulation for third country branches given different Member States have different rules and approaches.

To avoid regulatory inconsistency, we support the harmonisation of the regulatory treatment of third country branches across the EU. However, given branches offer numerous advantages to facilitate the openness of the EU financial market and offer efficient answers to the financing needs of wholesale clients and businesses locally, we strongly support preserving the benefits of wholesale branches.

For instance, third country branches should not attract full levels of capital and liquidity as foreseen in the Capital Requirements Regulation/Credit Requirements Directive (CRR/CRD), which would not take into consideration that the third country branch is the same legal entity as the third country parent institution, and subject to the third country's equivalent or (in the Swiss case) higher capital requirements in comparison to the ones set out in the EU. Furthermore, as previously highlighted, ring-fencing of capital and liquidity exacerbates fragmentation, increases failure risk (via misallocation and lack of fungibility), and increases costs to the provision of financing to the real economy at a critical juncture in the economic cycle. We do not agree that there should be a fixed asset threshold at which third country branches conducting wholesale business would have to be automatically converted into subsidiaries. Other jurisdictions have supervisory discretion to require this conversion for branches, and it is appropriate for the EU also to have this power, but the trigger for conversion should not be automatic above any predetermined thresholds.

Instead, EU authorities should take into account a range of criteria on a case-by-case basis. For example, the supervisor should take into account 1) the equivalence of prudential standards in the third country, 2) the level of cooperation with the third country home supervisor, and 3) the credibility and robustness of the recovery and resolution plan. Finally, the bar for any potential subsidiarisation should be set high and be used as a last resort option only. In our view, the solution is to ensure effective reporting and information sharing both between the third country bank and the host national competent authority (NCA) of the EU branch, and information sharing between EU NCAs (including when there is no single SSM supervisor). This should leverage existing Memoranda of Understanding (MoUs) between NCAs, such as the MoUs that are now in place between the UK Prudential Regulation Authority, the UK Financial Conduct Authority and the EBA. It is also important to ensure that requests for information from the host supervisor are proportionate, not duplicative and avoid requiring the firm to provide information that it considers sensitive or confidential.

If the EU takes an approach to third country branches that is stricter than in other jurisdictions, the result will be greater fragmentation, with less and more costly financing to the real economy. In summary, we think appropriate solutions should consist of a more harmonised branch prudential treatment, and enhanced mechanisms for firm-wide EU risk management and reporting.

Centralised Booking Models

Any change to the regulatory treatment of third country banks in the EU should be mindful of the efficiency and stability benefits of centralised risk management and centralised booking models. Whether through use of branches or via back to back/remote booking model approaches, global banks typically aim to aggregate risk in a location with access to the greatest source of liquidity for an underlying product, as well as allowing access to appropriate expertise and specialism. Centralised models allow for internal netting of market risk exposures, increase capital efficiency and therefore improve liquidity provision to clients. In addition, they limit the number of external hedging transactions, which reduce external interconnectedness and thus the risk of contagion in a crisis. Moreover, remote booking can be more convenient for clients as it allows them to transact with the same legal entity, regardless of where a trade is originated. Centralised booking hubs are equally important in a 'business as usual' context as they are in winding down a global bank's trading books under an SPE scenario, which is currently applied to most global banks. This ensures minimal disruption to clients, counterparties and financial markets during the recovery and resolution process.

Large Exposure Limits – Intra-Group Exemptions

Current EU legislation permits competent authorities to exclude exposures incurred by an institution to its parent undertaking and other subsidiaries of the banking group from large exposure limits, in so far as those undertakings are covered by consolidated supervision. This exemption also applies to third country banking groups where a subsidiary is based in the EU.[21]

Currently, the ECB supervision provides a general application of such an exemption. A recent consultation on national options and discretions points to a possible future change in the regime. Under the proposed new ECB guidance, the ECB supervision would – in case of the parent undertaking being headquartered in a third country – grant the exclusion from large exposure limits only on a case-by-case basis. Such an approach would challenge the above mentioned benefits of centralised booking hubs as well as centralised group risk management. In the spirit of a true single rulebook within the EU, the SFC would instead argue in favour of integrating a general intra-group exemption into the EU's prudential legislation.

RECOMMENDATIONS

- Divergent political views about if and how to introduce EDIS should not prevent policy makers and supervisors from developing the supervisory cooperation and information sharing structures needed to resolve home-host issues successfully. EU cross-border banks should be able to steer their liquidity, capital and loss absorption in the same manner as inside a single jurisdiction. The institutional, systemic and prudential safeguards today are significantly higher than before the 2008 financial crisis and a global model for resolving cross-border banks has been implemented. This provides additional safeguards to host authorities and should be reflected in the provisions governing home-host relationships by removing the possibility for national ring-fencing practices.
- Allocation of loss absorption capacity within cross-border banking groups should be such that it ensures the highest degree of financial stability and that resources can be quickly deployed where they are needed the most. For this reason, the FSB TLAC Term Sheet sets out that resolution authorities agree to set internal TLAC in a range of 75%-90%. This approach is widely supported by resolution authorities, but not reflected in EU legislation until now. Appropriate changes could be made in the framework of the final Basel III implementation.
- There should be more harmonisation in the regulatory treatment of third country branches, for example in authorisation, EU-level reporting and information sharing requirements. This would ensure the EU authorities have a consolidated "dashboard" of the activities of third country banks across their subsidiaries and EU branches and would harmonise heterogeneity of supervisory approaches. At the same time, the capital, liquidity and structural efficiencies of wholesale branching should be maintained to the benefit of the EU financial market and real economy. Third country banks in the EU should not be required to hold ring-fenced subsidiary-like levels of capital and liquidity locally within the EU. All EU supervisors should maintain and enhance close supervisory dialogues with third country home authorities. Subsidiarisation should be a last resort option and only deployed if there are concerns about supervisability following a case-by-case assessment.
- Centralised booking models are an important element of centralised risk management and contribute to financial stability not only in a going-concern context, but also by ensuring efficient recovery and resolution under an SPE scenario. Today, resolution authorities have in a large majority of cases opted to apply an SPE scenario to global banks. Consequently, future EU/Banking Union legislation should not per se challenge centralised booking models, but rather aim to facilitate discretionary intervention if deemed necessary to support EU/global financial stability.
- In the spirit of a true single rule book across the EU and in order to foster efficient centralised risk management, cross-border intra-group exemptions for large exposure limits, including for third country groups, should be made available within the EU prudential legislation without giving discretion to NCAs.

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