What is going on in Basel?

Nigel Jenkinson
Monetary and Capital Markets Department, IMF

2018 Seminar for Senior Bank Supervisors from Emerging Economies
A lot has been accomplished
The sweeping reform agenda produced significant success

“A decade on, this [reform] programme has largely been achieved. The financial system is safer, simpler, and fairer”

-Mark Carney
Chair, Financial Stability Board

April 20 2017
The financial system is stronger
Substantial progress on G20 policy objectives: cf. GFSR special chapter ten years on
Where are we in the regulatory process?

Agenda

- Finalizing Basel III
- Implementation & other recent activities
- Challenges and risks
Finalization of banks reforms
A long awaited agreement

- Addressing RWA inconsistencies
- New credit risk framework
- New operational risk framework
- Leverage ratio buffer
Pillar 1
Charges

Credit risk

Market risk

Operational risk

Internal Models

FIRB
AIRB

Revised
Dec 2017

Under review
Mar 2018

Eliminated
Jan 2016

Standardized

Cred.
Standardized

Revised
Dec 2017

Under review
Mar 2018

New Approach
TSA/ASA

Changing landscape
Basel II completely overhauled
Finalization of Basel III
Focus on risk weight assets

\[ \text{CAR} = \frac{K}{\text{RWA}} \]

Basel III (2010)

Basel III (2017)
Excessive risk weight variation
Undermine trust on capital ratios

Chart 1: Impact of Risk Weight variation on capital ratios

Legend: Europe □ North America ▢ Asia/Australia ▢

Change from 10% capital ratio if individual bank risk weights from the HPE are adjusted to the median from the sample. Each bar represents one bank. The chart is based on the assumption that variations observed at each bank for the hypothetical portfolios are representative for the entire sovereign, bank, and corporate portfolios of the bank and are adjusted accordingly. No other adjustments are made to RWA or capital.

Source: BCBS 2016 – Analysis of risk weighted assets for credit risk in the banking book
Credit risk
Credit risk review

Standard Approach

Reducing Mechanistic Reliance on Credit Ratings

More risk factors (e.g. LTV)

Enhanced Granularity

Internal Models Approach

Reduced Complexity

Some options removed

New restrictions
Credit risk review

New Credit Risk Standardized Framework

- Residential mortgages: risk weight depend on the loan-to-value
- SMEs: New risk weight (85%)
- Banks and Corporates: more granular treatment for unrated exposures.
- Retail exposures: distinction between revolving facilities and transactors)
- Off-balance sheet items: CCFs more granular and conservative
- Currency mismatches: 1.5 multiplier for retail and mortgages exposures
Internal models review
New floors based on standardized approaches

Banks will no longer be able to "turn off" the systems that produce the standardised data.

Floor: 72.5% of A

Additional capital
Operational risk
Operational risk weaknesses

Substantial flaws being addressed

- Low risk sensitivity
- Counterintuitive results

- Too complex
- No common practice

- Incorporates internal data in a simple and standard way
Operational risk weaknesses
Substantial flaws being addressed

- Operational losses below average reduce the capital charge.
- Operational losses above average increase the capital charge.
Market risk
Market risk review
Fine tuning underway

• Fundamental review of the trading book
  – Substantial increase in capital requirements
  – Address boundary issue (avoid arbitrage)
  – Better capture risks
  – More complex
• New standardized framework became more complex
  – Sensitivity based method, which requires sound pricing models
  – Basel Committee developing simplified alternative
    • Public consultation published in March /2018
    • Based on a recalibration of Basel II
    • Proposed scaling factors vary between 1.25 and 3.5
  – Expects to finalize revisions around the end of the year
Leverage ratio
• Ensure incentives for central clearing
  – Ongoing debate if exposures represented by initial margin and default funds’ contributions might curb access of clients to central clearing (to be put to consultation)
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<thead>
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<tr>
<td>Revised Standardised Approach Credit Risk</td>
<td>1 January 2022</td>
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<td>Revised IRB framework</td>
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<td>Revised Operational Risk Framework</td>
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<td>Revised Market Risk Framework</td>
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<td>Leverage Ratio</td>
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<td>Existing exposure definition: GSIB buffer:</td>
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<td>Revised exposure definition:</td>
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<td></td>
<td>1 January 2022</td>
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<td>Output Floor</td>
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<td>50%</td>
</tr>
<tr>
<td>1 January 2023</td>
<td>55%</td>
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<tr>
<td>1 January 2024</td>
<td>60%</td>
</tr>
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<td>65%</td>
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<td>1 January 2026</td>
<td>70%</td>
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<td>1 January 2027</td>
<td>72.5%</td>
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Basel Committee is changing its focus

Progress allows the Basel Committee to focus on supervision and implementation of reforms

- Implementation monitoring
- Supervision guidance
- Fine tuning Basel III
- Finalizing the reforms
- In the pipeline
<table>
<thead>
<tr>
<th>Date</th>
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<tbody>
<tr>
<td>27 Sep 2018</td>
<td>Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel NSFR regulations - Kingdom of Saudi Arabia</td>
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<td>Implementation of Basel standards</td>
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<td>Range of practices in implementing the countercyclical capital buffer policy</td>
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<td>Twelfth progress report on adoption of the Basel regulatory framework</td>
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<td>Frequently asked questions on the Basel III standardised approach for measuring counterparty credit risk exposures</td>
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<td>Frequently asked questions on market risk capital requirements</td>
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<td>19 Sep 2017</td>
<td>Basel III definition of capital - Frequently asked questions</td>
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<td>08 Jun 2017</td>
<td>Basel III - The Liquidity Coverage Ratio: frequently asked questions</td>
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<td>Frequently asked questions on changes to lease accounting</td>
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<td>24 Feb 2017</td>
<td>Basel III - The Net Stable Funding Ratio: frequently asked questions</td>
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<tr>
<td>26 Jan 2017</td>
<td>Frequently asked questions on market risk capital requirements</td>
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# Basel Committee sound practices and guidelines (2017-2018)

Important supervision guidance have been developed

<table>
<thead>
<tr>
<th>Date</th>
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<tr>
<td>17 Oct 2018</td>
<td><strong>Stress testing</strong> principles</td>
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<td><strong>Criteria for identifying simple, transparent and comparable short-term securitisations</strong></td>
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<td>Sound Practices: implications of fintech developments for banks and bank supervisors</td>
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<td>20 Dec 2017</td>
<td>Supervisory and bank <strong>stress testing</strong>: range of practices</td>
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<td><strong>Identification and management of step-in risk</strong></td>
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<td>Sound management of risks related to money laundering and financing of terrorism: revisions to correspondent banking annex</td>
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<td><strong>Prudential treatment of problem assets</strong> - definitions of non-performing exposures and forbearance</td>
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<td>30 Aug 2018</td>
<td><strong>Pillar 3 disclosure requirements - regulatory treatment of accounting provisions</strong></td>
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<td><strong>Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement</strong></td>
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<td><strong>Treatment of extraordinary monetary policy operations in the Net Stable Funding Ratio</strong></td>
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<td><strong>Capital treatment for simple, transparent and comparable short-term securitisations</strong></td>
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<td><strong>Risk weight for Asian Infrastructure Investment Bank</strong></td>
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<td><strong>Regulatory treatment of accounting provisions - interim approach and transitional arrangements</strong></td>
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<td><strong>Pillar 3 disclosure requirements - consolidated and enhanced framework</strong></td>
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<td>Incentives to <strong>centrally clear over-the-counter (OTC) derivatives</strong> - A post-implementation evaluation of the effects of the G20 financial regulatory reforms</td>
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<td>Revisions to the minimum <strong>capital requirements for market risk</strong></td>
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<td><strong>Pillar 3</strong> disclosure requirements - updated framework</td>
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Challenges and risks

No time for complacency

- Implementation delays and risk of rollback
- Risk landscape
- Sovereign – bank nexus
- Proportionality
- FSAP Findings – supervision weaknesses
- Conglomerates supervision
- Fintech
- Cyber risk
- Regulatory arbitrage
Not all elements of reform agenda finalized yet

Implementation challenges

... roll-back pressures are increasing

In addition some gaps remain:

- Sovereign risk; lack of consensus
- Proportionality framework
- Accounting; no convergence of IFRS and US GAAP
Risks to Financial Sector Health

Increasing leverage and changing financial landscape

ABS market: Outstanding volume ($ tn/bn)

Non-financial private sector Credit to GDP (Percent)

Global fund industry size ($ tn)

US and European Leveraged Loan issuance by leverage multiples (Percent of issuance)

Sources: SIFMA, China Securitization Analytics

Source: S&P Leveraged Commentary and Data

Sources: BIS BIS, Nomura Analytics

Advanced economies

China

Emerging market economies (excluding China)
## Sovereign – Bank nexus

Banks hold large exposures to sovereigns

Banks sovereign exposures in percent of total assets

<table>
<thead>
<tr>
<th>Year</th>
<th>Mean exposure</th>
<th>Median exposure</th>
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<tr>
<td></td>
<td>All</td>
<td>AE's</td>
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<tr>
<td>1999</td>
<td>8.1</td>
<td>6.4</td>
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<td>2000</td>
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<tr>
<td>2001</td>
<td>8.2</td>
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<td>2002</td>
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<td>2003</td>
<td>8.5</td>
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<td>2011</td>
<td>9.3</td>
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<td>2014</td>
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<tr>
<td>2005-14</td>
<td>9.1</td>
<td>7.8</td>
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</table>
Nexus operate through multiple channels

IMF Departmental paper: Managing the sovereign – bank nexus
Proportionality
How EMDEs can benefit the most from international standards?

- Basel III
- TLAC
- ...

- Risks to financial stability?
- Areas for simplification?
- How to avoid arbitrage?
- Appropriate threshold for differentiation?
- National consideration or international guidelines?
Proportionality
How EMDEs can benefit the most from international standards?

• Adjustments for size, complexity, market development, supervisory capacity,…
• Not about a new standard
• Not less conservative
• Allow convergence to international standards as market/ institutions evolve
FSAP Findings – Banking Supervision
Basel Core Principles Assessments 2013-2017 (37 assessments)
Banking supervision: Independence and resourcing
The main issue across sectors

Independence
- Operational
- Budget

Legal protection of staff

Resources
- Number of staff
- Qualifications of staff

Principle 2: Independence, accountability, resourcing, and legal protection for supervisors
(All BCP assessments since 2012)

Published BCP assessments in 2016-2017
Banking Supervision: Governance and conduct
Framework improved but challenges (across sectors) remain

Regulatory framework
• Governance (incl. remuneration), risk management and conduct regulations

Independence and quality of oversight functions

Supervisory intensity and focus

Principle 14: Corporate governance
(All BCP assessments since 2012)

Published assessments in 2016-2017
Conglomerates Framework needs strengthening

Financial Holding Company

Bank

Insurer

Invest

Asset Manager

Investment Funds

Invest

Risky / Illiquid Assets

Policyholders

Derivatives
Non Investment Grade Bonds
Real Estates

Principle 12: Consolidated supervision
(All BCP assessments since 2012)

Principle 20: Related parties
(All BCP assessments since 2012)
Fintech
Changing the financial landscape

Changing landscape
- New players
- New products
- Changing business models of incumbents
- Cross-border nature
- Artificial Intelligence
- Machine learning
- Data security
- Operational resilience

⇒ Challenging for regulators
⇒ Need for agile and proactive approach
What is the appropriate framework to best foster the possibilities provided by fintech?

EXECUTIVE SUMMARY

Rapid advances in financial technology are transforming the economic and financial landscape, offering wide-ranging opportunities while raising potential risks. Fintech can support potential growth and poverty reduction by strengthening financial development, inclusion, and efficiency—but it may pose risks to consumers and investors and, more broadly, to financial stability and integrity.

National authorities are keen to foster fintech’s potential benefits and to mitigate its possible risks. Many international and regional groupings are now examining various aspects of fintech, in line with their respective mandates. There have been calls for greater international cooperation and guidance about how to address emerging issues, with some also cautioning against premature policy responses.

In response to these calls from member countries, the IMF and the World Bank staff have developed the Bali Fintech Agenda, summarized in Annex I of this paper. The Agenda brings together and advances key issues for policymakers and the international community to consider as individual countries formulate their policy approaches. It distills these considerations into 12 elements arising from the experiences of member countries.1

Bali Agenda - Some Key Considerations

- **Promise of Fintech**
  - Reaping the benefits (financial inclusion, efficiency etc.) requires preparation (institutional capacity, outreach to stakeholders, cross agency cooperation)

- **Competition**
  - Open, free and contestable markets for level playing field. Foster standardization, interoperability and access to key infrastructures.

- **Monitoring**
  - Improvements and extension in the reach of monitoring framework, including ongoing dialogue with stakeholders.

- **Regulation**

- **Infrastructure**
  - Robust data and financial infrastructure. Resilient to cyber attacks and other disruptions.

- **International Cooperation**
  - Essential to ensure effective policy responses and limit risks. Share experience and best practices.
Cyber risks
Ensuring resilience to a rising trend

Ever-evolving and growing risk
• Assume breach concept
• Focus on detection, response, and recovery

Effective supervision is key
• International harmonization and cooperation needed

Cyber risk TA framework
• Based on evolving international standards and frameworks
Looking forward

CONTINUING CHALLENGES
Independence and resources
Governance and conduct
Conglomerate supervision
Sovereign-bank nexus
Proportionality

INTERNATIONAL HARMONIZATION AND COORDINATION
Emerging risks are cross border
Decrease regulatory arbitrage opportunities

AREAS IMPROVING
Bank capital and liquidity
Derivatives clearing

NEW CHALLENGES
Fintech
Cyber-risk
Financial innovation and regulatory arbitrage
Thank you!