Commission consultation on Basel III implementation – HMT response

1.1 We welcome the Commission's work to commence thinking about implementation of these important reforms, and thank the Commission for the opportunity to formally comment.

1.2 In answering the questionnaire, we have left the more granular analytical questions to our counterparts in Competent Authorities and relevant industry parties/groups.

GENERAL QUESTIONS

Question a) What are your views on the impact of the revisions on financial stability?

1.3 The UK believes firmly in the importance of harmonised international standards as a key measure to support financial stability. As the UK prepares to leave the EU, it remains committed to international standards for the financial industry, of which Basel III is a key component.

1.4 The UK Government strongly supports the language agreed by Finance Ministers & Central Bank Governors at the G20 Summit in Buenos Aires, Argentina on 19-20 March 2018.

> "The global financial system must remain open, resilient and supportive of growth and grounded in agreed international standards."

And

> "We welcome the finalisation of Basel III, which completes main elements of the post crisis reforms. We remain committed to the full, timely and consistent implementation and finalisation of the reforms and their evaluation to help identify and address any material unintended consequences and ensure that the reforms accomplish their objectives."

1.5 We note that the Basel III revisions were agreed as a finely balanced package of measures to support the stability and comparability of internationally active banks in order to mitigate systemic risks. We therefore believe that efforts by any jurisdiction to 'pick-and-choose' elements of this package in their implementation for these types of firms has the potential to severely undermine the Basel package, unnecessarily compromising the significant progress made in financial regulation since the Global Financial Crisis, which made it abundantly clear that consistency and cooperation is vital to collective financial stability.

1.6 We believe the revisions themselves further support financial stability by increasing risk sensitivity in several areas.

1.7 In an increasingly interconnected global marketplace we need tools to increase comparability and reduce unwarranted variability. This will benefit investors and end-users and mitigate against concerns that pockets of risks could emerge in one region that could spill over to others.

1.8 By the same token, we think it is clear to acknowledge that these revisions constitute minimum standards, and are not themselves sufficient to ensure financial stability, and jurisdictions, and competent authorities can adopt, or require, more conservative standards where necessary.

Question b) What are your views on the impact of the revisions on the financing of the economy?

1.9 We welcome the package, which we are confident meets the objectives of the Governors and Heads of Supervision at Basel and Finance Ministers at ECOFIN, both of whom agreed that there should be no significant overall increase in capital requirements. In doing so, both also acknowledged that the package should lead to some increase in capital requirements.

1.10 The Bank of England conducted a piece of analysis in 2015 'Measuring the Macroeconomic Costs & Benefits of higher UK bank capital requirements', which found the net present value of the cost of banking crisis to be 43% of UK GDP.

1.11 It is in that context that we strongly support the increase in bank capital since the financial crisis, as the consequence of another financial crisis would have far more severe impacts on the financing of the economy than relatively small increases in capital requirements and the minor short-term impacts on banks' cost of funding.

1.12 We also welcome the increased risk-sensitivity in Standardised Approaches across these revisions. There are times when there has been too much variance between RWAs for firms using Standardised Approaches (SA) and those using Internal Models (IRB), particularly for asset classes such as mortgages.

1.13 As the cost of capital is a major component in mortgage pricing models, these risk concentrations impact on the mortgage market, with SA lenders competing in one segment and IRB lenders competing in a different segment and some market segments being poorly served.

1.14 This package reduces the gap between SA banks and IRB banks where it is appropriate to do so. It is our view that this reduced variance will explicitly support competition in the marketplace, encouraging new and smaller players to challenge larger firms, increasing efficiencies, improving the services on offer to the consumer and ultimately supporting the financing of the economy.

1.15 In addition, we firmly believe that well-capitalised banks are stable banks, and that stable banks are better able to raise financing on the market to help finance the wider economy.

1.16 That said, we do support further analytical work to ensure capital requirements are implemented proportionately. We welcome the Basel and EBA impact studies to date, but they are missing verifiable data on smaller lenders.

1.17 While we think it is vital that the full suite of revisions apply to internationally active banks, we believe it is appropriate to investigate whether there could be increased proportionality for smaller lenders, who could benefit from simplified or differentiated rules so long as we can achieve the necessary levels of safety and soundness.

1.18 If there is the evidence base for increased proportionality of this kind, it could also lead to the benefits of increase competition already outlined above.

STANDARDISED APPROACH FOR CREDIT RISK (SA-CR)

Question c) What are your views on the revisions? Please provide details.

1.19 We strongly support the revisions, which reduce RWAs for most asset classes.

Question d) How would the revisions impact you/your business? Please specify and provide relevant evidence. More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

1.20 N/A

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

1.21 N/A

Question e) Where do you expect particular implementation challenges and why? Please specify.

1.22 We would highlight a few issues:

1.22.1 **'Income producing' residential real estate**. The Basel text specifies that national supervisors can determine a maximum number of properties a 'buy-to-let' investor can have before they receive higher RWs. We believe this discretion reflects the extensive variance in national markets and this threshold should therefore be a matter for a national or competent authority discretion.

1.22.2 **'Speculative' equity investments**. One of the few areas in the SA-CR where RWAs are being raised materially is for speculative investments in equity. Basel does not clearly define what constitutes a 'speculative' investment of this type. Therefore, further work is required to determine an appropriate definition which will not compromise real economy financing, particularly as non-bank equity investment is still an under-developed market in Europe relative to other parts of the world.

1.23 **Timing**. The revisions to SA-CR will mean a decrease in capital requirements for some asset classes and increases for others, as they address known shortcomings in the current framework. We should focus on ensuring that the implementation of the Basel 2017 measures is not unduly delayed, to ensure that benefits such as the more risk-sensitive capital treatment are realised as soon as possible.

INTERNAL RATINGS-BASED (IRB) APPROACHES FOR CREDIT RISK

Question a) What are your views on the revisions? Please provide details.

1.24 The new Basel measures introduce sensible reforms to restrict the scope of internal models. These reforms are important and the EBA's benchmarking exercises continue to show excessive variability in IRB model outputs, which pose stability risks and allows for an unlevel playing field.

Question b) How would the revisions impact you/your business? Please specify and provide relevant evidence. More specifically:

i. How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

1.25 N/A

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

1.26 N/A

Question c) Where do you expect particular implementation challenges and why? Please specify.

1.27 Timing will be a challenge, we need to provide as much certainty as possible to firms as soon as we are collectively able so they can get the necessary supervisory approvals.

CVA RISK FRAMEWORK

Question a) What are your views on the revisions? Please provide details.

1.28 We support the new CVA framework: it is right to remove models as there is insufficient consistency or predictability in the way these risks materialised.

1.29 Therefore, it is very positive that Basel has introduced a more risk sensitive Standardised Approach, which is more aligned to accounting models.

Question b) How would the revisions impact you/your business? Please specify and provide relevant evidence. More specifically:

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

1.30 N/A

Question c) Where do you expect particular implementation challenges and why? Please specify.

1.31 N/A

Question d) What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?

1.32 We think it is appropriate to review the existing exemptions, which Basel has determined as materially non-compliant, and would strongly support efforts to ensure future compliance with Basel.

1.33 These exemptions were introduced when the CVA requirements for SA firms were much tougher. Similarly, we have now embedded (and are potentially enhancing) the SME supporting factor, and may be introducing other supporting factors. As a consequence, we believe there is potentially far less authority to the argument that the exemption is necessary for the financing of the economy.

1.34 If it is determined, based on a comprehensive impact assessment, that the exemptions are necessary, we believe it would be appropriate to ask if this measure should be implemented more proportionately.

OPERATIONAL RISK FRAMEWORK

Question a) What are your views on the revisions? Please provide details.

1.35 It is right for Basel to remove the ability for firms to model operational risk – it is just too difficult to model reliably (which has seen several other jurisdictions banning it already, and supervisors in others applying significant Pillar 2 requirements on an ongoing basis). The single new standardised approach (SMA) offers a more risk sensitive non-modelled solution that builds on existing standardised approaches

1.36 We therefore strongly support the national discretion agreed in Basel which allows for the ILM factor to be set at 1 (in effect making the Business Indicator Component the only Level 1 requirement).

1.37 For the reasons outlined above, we would be fundamentally opposed to a Pillar 1 requirement that does not set the ILM equal to 1.

Question b) How would the revisions impact you/your business? Please specify and provide relevant evidence. More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

1.38 N/A

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

1.39 N/A

Question c) Where do you expect particular implementation challenges and why? Please specify.

1.40 We believe that national or supervisory discretions to set the ILM at 1 would be the most proportionate outcome, and the one most in line with the Basel standard, though we acknowledge that others may view the introduction of a new discretion as a problem – we would be open to further discussions on how to best implement this discretion.

1.41 However, in removing internal models for operational risk, we also need to be very careful not to reduce supervisory powers, or the availability of supervisory data, in this space.

OUTPUT FLOOR

Question a) What are your views on the revisions? Please provide details.

1.42 We support the Basel III output floor on RWAs as agreed as it is an essential backstop to guard against model risk in a more granular, risk-sensitive way. It will therefore act in a complementary fashion to the leverage ratio. It will also increase comparability and consistency in RWAs across different types of firms. We call for full and timely implementation of the Basel revisions, and in doing so we echo the comments made by Commissioner Dombrovskis that "It is now essential that all major jurisdictions implement all elements of this agreement".

1.43 Again, it is very important to highlight that the output floor was agreed as part of the entire package – which represented a finely balanced compromise. In the absence of an output floor we would see several jurisdictions demanding far less risk-sensitivity in the SA-CR and calling for much more restrictive approaches to IRB modelling.

1.44 It is our view that with a binding EU leverage ratio, and the more risk-sensitive SA-CR, it is possible that the impact of the floor will be lower than some expect it to be.

1.45 However, we acknowledge that high quality analytical work should be undertaken to ensure the proposals work effectively, supporting financial stability and the financing of the economy. In that context, while we are fully committed to a binding Basel III output floor for internationally active banks, we are open to seeing evidence that the application to smaller banks could be made more proportionate.

Question b) How would the revisions impact you/your business? Please specify and provide relevant evidence. More specifically:

i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver.

1.46 N/A

ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

1.47 N/A

Question c) Where do you expect particular implementation challenges and why? Please specify.

1.48 One of the main challenges is timing. With the Commission's proposed timetable – a legislative proposal come H1 2020 – it is unlikely that any requirements will enter into force until 2023/2024.

1.49 The goal should clearly be full calibration at 72.5% by 1 January 2027. Firms will have had 9 years from the Basel announcement to get ready, and they should not need any more time – we cannot see any virtue to a delay in the floor. If there end up being some EU revisions to increase proportionality for types of firms, these will reduce any legislative burdens and firms should have no problems responding.