Lessons from Covid-19 on Basel reforms and next steps

Keynote speech by Pablo Hernández de Cos, Chair of the Basel Committee on Banking Supervision and Governor of the Bank of Spain, at the BCBS-CGFS research conference, 11 May 2022

Introduction

Good afternoon. It is a pleasure to deliver the keynote speech for this research conference. I would first like to thank our colleagues and friends at the Programme Committee and Organising Committee for arranging this timely event, which is jointly hosted by the Basel Committee on Banking Supervision (BCBS) and the Committee on the Global Financial System (CGFS), and for putting together all the remarkable research on the effectiveness of policy measures to support bank lending during the Covid-19 crisis.

More than two years have passed since the onset of the pandemic. While infection rates might be subsiding, allowing some of us to meet in person today, the full impact may not yet be realised. Yet there is much to be learned from this episode. For the Committee, the experience has underscored the fundamental importance of three imperatives: the coordination, implementation and evaluation of Basel reforms. In my remarks today, let me elaborate on these points.

Then I will draw on the Committee's work on evaluating the Basel III reforms, starting with the report on "Early lessons from the Covid-19 pandemic on the Basel reforms"[1] published last July. The report showed that the increased quality and quantity of capital and liquidity held by banks in line with our post-crisis reforms have helped them absorb the Covid-19 shock to date. Next I will turn to the areas touched on by the report that warrant further consideration. These include the functioning of buffers, as covered in the conference session earlier today. I will also elaborate on the Committee's ongoing evaluation work.

Looking beyond this initial analysis of the Covid-19 crisis, I will then discuss the broader question of how the past decade's implemented Basel reforms have affected the banking sector's overall resilience and banks' behaviour. The empirical evidence will feed into the Committee's discussions of whether and what policy and/or supervisory responses are needed, this being a key part of the policymaking cycle.[2] As not all Basel III reforms have yet been implemented, we expect the evaluation work to be ongoing. I will touch on that as well.

I would like to reiterate that the Basel Committee greatly values its engagement with external stakeholders. We also seek input from the academic research community, especially when it comes to quantitative evaluation analysis. We look at the evidence and conclusions presented in research papers, such as those delivered at this conference. The methodologies and empirical strategies used in such studies are a valuable reference for the Committee's own evaluation work.

1 See www.bis.org/bcbs/publ/d521.pdf.

2 See www.bis.org/speeches/sp200130.pdf.

The three imperatives: coordination, implementation and evaluation

Let me first elaborate on three imperatives that will underpin the benefits of the Basel III reforms.

Coordination

The first is coordination, which has been a guiding principle for the Committee since its inception in 1974. Global financial stability is a public good that presupposes global cooperation. Strengthening the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability is the core mandate of the Basel Committee, as reflected in its charter.

The Covid-19 shock was the first global test of the standards developed by the Committee after the Great Financial Crisis (GFC). At the pandemic's onset, the Basel Committee's members cooperated closely in assessing the resulting risks to the banking system, shared information, coordinated initiatives, and agreed on measures to mitigate the short-term financial stability risks. The Committee reiterated guidance on capital and liquidity buffers, emphasising that these were to be used in times of stress to absorb losses and maintain lending to the real economy.[3]

Technical guidance was issued, clarifying that banks should take into account the extraordinary government support measures and payment moratoriums when calculating their risk-weighted assets and implementing expected credit loss (ECL) accounting frameworks.[4] On the latter, the Committee gave jurisdictions additional flexibility in deciding whether and how to apply transitional arrangements for the regulatory capital treatment of ECL.[5]

Finally, the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed the Committee's decision to defer the implementation of the outstanding Basel III standards by one year to provide banks and supervisors with additional operational capacity as they respond to the immediate post-pandemic financial stability priorities.[6]

Meanwhile, many member jurisdictions have used the flexibility embedded in the Basel framework to implement regulatory and supervisory measures with the aim of alleviating the pandemic's impact on banks. These measures seek to underpin banks' operational and financial resilience, while ensuring that they can continue to lend. The Committee supported these measures and reminded members that they had the flexibility to undertake further measures.[7] At the same time, to preserve a global level playing field and avoid regulatory fragmentation, the Committee closely monitored the implementation of such temporary adjustments to ensure they accord with the Basel framework's objectives and are unwound in a timely manner.

During the pandemic's aftermath, we will monitor any remaining jurisdictional measures. And while assessing its impact on the banking system, the Committee stands ready to deploy

3 See www.bis.org/press/p200320.htm.

4 See www.bis.org/bcbs/publ/d498.pdf.

5 See www.bis.org/press/p200403.htm.

6 See www.bis.org/press/p200327.htm.

7 See www.bis.org/press/p200320.htm.

additional policy or supervisory measures as needed. Recently, the Committee publicly shared its findings on pandemic-related credit risk issues after monitoring bank practices in assessing credit risk and asset quality and setting provisions.[8]

Implementation

The second imperative is implementation. The Basel Committee has set a high priority on the full, timely and consistent implementation of its standards. This was one of the lessons from the GFC. When the 2007–09 crisis broke out, it exposed somewhat patchy and inconsistent implementation. Full, timely and consistent implementation is critical to improve the resilience of the global banking system, promote confidence in the prudential ratios and encourage a predictable and transparent regulatory environment.

This rationale remains unchanged. It is as important today as it was before the pandemic, since some regulatory fault lines still persist. The outstanding Basel III reforms seek to address these weaknesses including excessive variability in risk-weighted assets. Although we deferred the implementation deadline by one year due to the pandemic, this in no way diminishes the importance of implementation, and member jurisdictions have made progress in implementing these reforms over the past two years.

Early this year, the Group of Central Bank Governors and Heads of Supervision (GHOS), the Committee's oversight body, reaffirmed its commitment to implementing all aspects of the Basel III framework, including the outstanding standards. Members unanimously underscored the importance of implementing these standards as soon as possible.[9] So, we will continue to closely monitor the implementation of all Basel III standards as part of the Committee's Regulatory Consistency Assessment Programme (RCAP), including through its regular monitoring reports.

The last mile is often the hardest but also the most crucial. Almost 15 years since the GFC, we owe it to all stakeholders to finalise this chapter and focus our attention and resources towards emerging risks and structural trends impacting the banking system. The Ukraine conflict has again reminded us of the risk from unexpected shocks and that this is no time to backtrack on reform implementation.

Evaluation

The third imperative is evaluation. In November 2020, GHOS members agreed to mark a clear end to the post-GFC Basel III policy agenda. Henceforth, the Committee's Basel III-related work is to focus on completing an evidence-based evaluation of the effectiveness of the reforms.[10] To do so, the Committee established a dedicated Task Force on Evaluations (TFE), following three general principles that I would like to recall here:

[8] See www.bis.org/publ/bcbs_nl26.htm.

[9] See www.bis.org/press/p220209.htm.

[10] See www.bis.org/press/p201130.htm.

- Principle 1: Reforms need to be implemented in order to be evaluated. Evaluations should focus on the standards already adopted and implemented in most member jurisdictions. Only when fully implemented can reforms be expected to achieve their objectives. For example, the Committee has stated that the Basel III objectives for the capital buffers are to absorb losses and maintain lending to the real economy.[11] And thus the evaluation work will provide an ex post appraisal of how far this policy objective has been attained.
- Principle 2: Evaluations should be based on rigorous conceptual and empirical analysis and should be agnostic to the outcome. We will remain open-minded about our findings and any potential policy response and/or supervisory implications. Of course, the conclusions from our evaluations could inform the Committee's future policy work. However, we should bear in mind that, as stated by the GHOS, the present agreement on the Basel framework marks "a clear end" and "any further potential adjustments to Basel III will be limited in nature and consistent with the Committee's evaluation work".[12] Thus, it is not policy considerations that are driving the evaluation work but rather the other way around. That is, evidence from the evaluation work will drive policy discussions.
- Principle 3: Evaluations should benefit from the views and input of a broad range of stakeholders. This is consistent with our approach to designing standards as well as with the principles that guide the Committee in pursuing its work programme. We have committed to engage with all relevant counterparts on robust methodological approaches, analytical issues, data collection and the interpretation of findings. Today's conference is an example of our engagement with researchers from academia, central banks, supervisory authorities and international organisations. This engagement will provide our evaluation work with valuable insights and improve the transparency of our decision-making process.

These are the principles that the Committee has been following in conducting its evaluation work. Now let me turn to discuss in more detail our initial and current work.

The early lessons from Covid-19 on Basel reforms

The overall resilience of the banking system

The Covid-19 shock was the first global test for the Basel reforms since they were introduced in response to the GFC. We used the early Covid period data to evaluate what effects the implemented Basel standards have had on the resilience of the banking system and banks' behaviour. The aim was to assess whether the reforms have worked as intended during this stress period. Our report on *Early lessons from the Covid-19 pandemic on the Basel reforms* was published in July 2021.[13] It showed that banks entered the pandemic with higher and robust capital and liquidity ratios.[14] At the global level, banks' CET1 ratios stood at 12.7%, as compared with 10.1% at the end of 2013.

11 See www.bis.org/publ/bcbs_nl22.htm.

12 See www.bis.org/press/p201130.htm.

13 See www.bis.org/bcbs/publ/d521.htm.

14 Refers to "Group 1" banks which are defined as internationally active banks that have Tier 1 capital of more than €3 billion and include all 29 institutions that have been designated as global systemically important banks (G-SIBs).

Leverage ratios rose from 4.5% to 6.1%. Turning to liquidity, the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) were 140% and 119% in June 2020, as compared with a respective 122% and 113% in 2013. And the banking system has remained resilient through the pandemic. To summarise, over this eight-year period, capital ratios were 25 to 35% higher, while liquidity buffers increased by 5% to 15%.

The report also found that the increased quality and higher levels of capital and liquidity have helped banks keep up their lending and provision of liquidity to the real economy. The value of a robust regulatory framework for a more resilient banking sector was evident – although we should also acknowledge the critical role played by the extensive and wide-ranging monetary and fiscal support measures that cushioned the shock.

Areas in the Basel framework that warrant further consideration

While the Covid-19 evaluation report found some features of the Basel reforms to have had the intended effects on the banking system's resilience and lending behaviour, some areas proved to be harder to evaluate. The report outlined areas that warrant further consideration, including the functioning of capital and liquidity buffers, the degree of countercyclicality in the framework, and the treatment of central bank reserves in the leverage ratio. I will briefly discuss these areas, while inviting the research community to do more empirical investigation on these topics.

- Usability of capital buffers

The analysis of capital buffers indicates that most banks maintained capital ratios well above their minimum requirements and buffers during the pandemic. This was partly due to the authorities reducing regulatory requirements, releasing buffers, and imposing restrictions on capital distributions via dividend payments and share buybacks. The support provided to borrowers also helped banks.

Regression results indicate that banks that had less headroom tended to lend less during the pandemic than those with more headroom. While some evidence suggests that banks may have been hesitant to use their regulatory capital buffers had it been necessary, it is unclear whether this reluctance reflects banks' uncertainty regarding potential future losses or the wider market stigma that may result if a bank were to use their buffers.

- Liquidity buffers

The evidence is similar but limited on the liquidity side. When the financial market stress was at its peak in March 2020, banks in most jurisdictions experienced downward pressure on their liquidity buffers. This was due mainly to borrowers drawing on their credit lines as they sought to raise cash, and in part due to early buybacks and loss of access to wholesale funding markets. In general, buffers of high-quality liquid assets (HQLA) increased, thanks to supportive measures taken by central banks and governments. These helped banks maintain market confidence and weather the pandemic.

A number of jurisdictions noted that a broader set of banks have taken or plan to take action to bolster liquidity. Some evidence indicated that certain banks have moved to preserve liquidity positions and hence avoid using their liquidity buffers. Overall, it is difficult to draw clear conclusions about the LCR's functioning given the relatively short period of liquidity stress, which quickly abated following the decisive action taken by authorities.

- Leverage ratio

While the leverage ratio was not a binding constraint for most banks during the pandemic, the analysis examines whether banks that had a smaller amount of capital above leverage ratio requirements and buffers were less active than other banks in financial market intermediation during the pandemic.

Overall, bank positions in government bond and repurchase agreement (repo) markets remained stable or rose in response to the rapid surge in client demand for liquidity at the onset of the crisis, although there is also evidence that the leverage ratio requirements may have reduced banks' incentives to mitigate the large imbalances that emerged in some markets. Several member jurisdictions have temporarily exempted central bank reserves from the leverage ratio calculation, which has eased banks' balance sheet constraints on their intermediation activity.

- Cyclicality of specific Basel requirements

The analysis of procyclicality indicates that extensive governmental support measures for borrowers significantly dampened the downturn's impact on bank capital. Early in the pandemic, authorities communicated with banks and auditors to ensure they took public sector support measures into account when forming their views on the likely economic trajectory and the implications for significant increases in credit risk.

The Committee's evaluation work has prioritised some of these topics for further analysis. Before I discuss this, I first want to mention the external feedback received on the published report and initial findings.

The perspective from external stakeholders

As mentioned earlier, the Committee highly values the academic input and perspectives of a wide range of external stakeholders. We regularly consult with academic advisors appointed by the Committee on the methodologies and interpretation of empirical results.

In December 2021, the TFE held an outreach event to exchange views with a wide range of external stakeholders on (i) the early lessons from the Covid-19 pandemic for the Basel reforms; and (ii) the more comprehensive evaluation of the reforms' effectiveness. These stakeholders included industry, academia, rating agencies and public interest groups. Participants agreed that one of the most important areas of analysis is buffer usability. The issues noted by stakeholders include stigma and other constraints on using the buffers. But it was recognised too that a coordinated regulatory response could help, by providing clear ex ante expectations. Stakeholders also discussed how the buffers should work for lending or loss absorption. A key question was whether it was fair to conclude from the Covid-19 crisis alone that the banking system is more resilient as a result of the Basel reforms, given the massive government stimulus and the temporary jurisdictional adjustments to standards as well as the fact that not all standards were fully implemented.

The broader evaluation of Basel reforms

Let me now give you an overview of our ongoing evaluation work in terms of scope, timeline and methodological approach.

Scope and timeline

The areas identified for further investigation in our July report that we are focusing on are buffer usability and procyclicality.

Capital and liquidity buffers are designed to sit above the minimum Basel requirements to provide a cushion:

- Capital buffers comprise the capital conservation buffer (CCoB), the countercyclical capital buffer (CCyB) and buffers for systemically important banks (G-SIBs and D-SIBs). While each of these buffers seek to mitigate specific risks, they share similar features. They both seek, first, to ensure that banks absorb losses in times of stress without breaching their minimum requirements; and, second, to help mitigate deleveraging trends that would affect the flow of credit to the real economy in a downturn by supporting lending to creditworthy businesses and households. Importantly, automatic distribution restrictions are established under the capital buffers framework to mitigate the risk that banks will deplete their capital by distributing earnings imprudently

- Regarding liquidity buffers and, in particular, the Liquidity Coverage Ratio, the aim is to ensure that banks can withstand liquidity pressures and continue to provide credit and liquidity facilities during stress periods.

As there is a trade-off between these aims, evidence of how buffers are treated and used in practice is needed to properly assess their functioning. In particular, we need to understand how they affect bank lending and resilience as they are used or otherwise. Assessing this trade-off empirically is no easy task, especially in view of the unprecedented government measures to contain the pandemic's economic effects and protect the financial system against losses. That's why our current analysis goes beyond the limited pandemic window and explores the quantitative and qualitative evidence provided by jurisdictions.

Excessive procyclicality of the standards is the other topic where more evidence is needed. I would emphasise the word "excessive" here, as any risk-based system will always have an element of procyclicality, I believe. We define procyclicality as "the reinforcing interaction between the functioning of the banking sector and the real economy, leading to excessive economic growth during upturns and deeper recessions in the downturns".[15] This feedback-based definition rests mainly on timing and correlation, since proof of causality is difficult. In particular, we focus on the impact of the Expected Credit Loss framework (both IFRS9, CECL and other GAAP) as compared with the prior incurred loss model (ILM). The CCyB is also related to addressing procyclicality. By serving as a macroprudential tool, it is expected to have an impact not only when released but also when initially raised.

This follow-up evaluation will be incorporated into a more comprehensive bank evaluation report covering the Basel reforms implemented over the past decade, which we expect to publish towards the end of the year. This work will look more holistically at the capital and liquidity standards, and the complexity of and interactions among requirements, as well as the systemic risk

[15] See www.bis.org/publ/bcbs189_dec2010.pdf.

dynamics. This broader report will bring together the evidence both from the pandemic and the longer period since the reforms were introduced.

Following our principles, the scope of this evaluation report is to focus on the elements of the Basel III reforms already adopted in most member jurisdictions, namely the capital, liquidity, leverage and macroprudential elements. The aim is to evaluate their impact on (i) the resilience of banks and the banking system; and (ii) behavioural incentives and financial activity. The outstanding Basel III standards, those finalised in 2017, are yet to be implemented and are thus out of the scope of the current Committee evaluation work. These outstanding standards will be subject to potential future evaluation work by the Committee.

Methodological approach

I also want to touch on our methodological approach. For the current analysis, we seek to go beyond the limited data from the Covid-19 period by leveraging the Committee's regular Basel III data collection exercises (QIS data since 2011) and augmenting them with market data and other information.

QIS data give a unique view of bank-specific regulatory requirements based on Basel III standards. Augmenting this information with market and other data for the past 10 years lets us estimate broader resilience as well as control for more bank-specific factors. In turn, the regulatory metrics provide more precise measures of banks' capital headroom while the market metrics help us shed light on market stigma.

As the impact of reforms could depend more on the actual jurisdictional implementation rather than the initial issuance of standards, we also make use of the Committee's implementation tracking since 2012. As reflected in our monitoring reports, we started to put this information on our website via a dashboard last year,[16] so that external researchers can apply the underlying data in their studies.

As the global data are not always detailed enough or sufficient in quantity to provide robust statistical evidence, we also turn to the more detailed domestic analysis by member jurisdictions, surveys, qualitative information and case studies. Finally, the academic literature and other studies yield relevant evidence, sample design and methodology to inform our approach to evaluation.

Next steps and some open questions

Before concluding, let me say a few words on the next steps, considering the policymaking cycle. The scope of potential policy or supervisory measures is not pre-defined as the evaluation is agnostic to the outcome. As I mentioned previously, any discussion of potential policy measures will follow the evaluation findings and any further potential adjustments to Basel III will be grounded in two main considerations.

First, any change must proceed from robust evidence that the reforms are not functioning as intended or that a gap has opened up. Certainly, we are aware of data limitations, confounding

[16] See www.bis.org/bcbs/implementation/rcap_reports.htm.

factors and variations in jurisdictional implementation that constrain the data-driven conclusions. It is important to keep in mind that, as I have previously stated, that the bar remains high for any potential future changes.

Second, any policy adjustments would not result in any adjustment to our pre-agreed implementation calendars for already agreed reforms. And such adjustments must not delay the implementation of the outstanding Basel III standards. This will naturally follow from the evaluation's focus on the standards already implemented.

Against this backdrop, and in the spirit of a research forum, let me pose some open questions about buffer usability. This issue has already received a lot of attention but continues to be an area of live debate. It is also an area where I expect ongoing research will be beneficial in addressing the following open questions:

- Do we have enough evidence on whether buffers are usable? Are there differences in buffer usability between G-SIBs and smaller banks?
- Are there sufficient "releasable" regulatory buffers in place to address future systemic shocks? Is the buffer framework appropriately designed to generate capital space to address unexpected exogenous shocks?
- Given potential market stigma, would more releasable buffers necessarily result in more use of buffers?
- How can the dual role of buffers (to cover unexpected losses and preserve lending in a downturn) be maintained or strengthened?
- Could regulatory coordination around buffer releases, restoration and usability address potential stigma or other constraints on the use of buffers?

Certainly, evaluating these questions is no easy task, due to the limited historic experience and as a result of the methodological challenges they pose. But that should not stop us from seeking to find the most appropriate analytical processes to ensure a robust and evidence-based evaluation, an area where the research community has an important role to play.

Conclusion

I would like to finish my remarks by reiterating our commitment to undertake empirical evaluations of the regulatory reforms, and to reflect on the results of those evaluations when considering potential adjustments to the Basel framework.

Looking ahead, evaluation will continue as further elements of the Basel framework are implemented. It will also be important to assess how changes in the economic environment and new and emerging risks affect our evaluations. I am confident that the Committee will build on its evaluation experience thus far.

Similarly, we can build on the experience and expertise of academic and other external researchers to improve the effectiveness of our reform evaluation work. And with that I want to thank you for your efforts to date and encourage you to continue to apply your analytical skills towards the important questions posed by regulatory reforms.