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COVID-19 and the Basel framework: initial conclusions

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Good afternoon.

Let me begin by thanking FELABAN (the Latin American Banking Federation) and the ABE (Spanish Banking Association) for their invitation to participate in this meeting. I will take this opportunity to share with you early lessons we have learned on the Basel Committee on Banking Supervision on the functioning of global banking standards, known as Basel III, against the background of the COVID-19 crisis.

As you know, in response to the 2007-2009 financial crisis the Committee made far-reaching changes to banking regulatory standards at the global level.[1] The aim – in response to the weaknesses the crisis had highlighted – was to strengthen the regulation, supervision and management of banking risk. Following the publication of this new regulatory framework, i.e. Basel III, the Committee agreed to assess its impact on the resilience and behaviour of the banking system. I should stress that the assessment of the effectiveness of regulatory standards is part and parcel of the regulatory policy cycle; on one hand, it shows us how successful and complete the standards are and, on the other, it provides for the consistent implementation of these standards.

The Committee's approach to this assessment is based on conceptual and, as far as possible, empirical, sound and rigorous analyses, without prior conditioning factors underpinned by wishes to recalibrate or modify the globally agreed framework. The Committee's programme is ambitious and will foreseeably be rolled out over the coming years. However, COVID-19 has, undoubtedly, been the first major shock to the financial system since the completion of the Basel III framework. And the Committee has deemed it advisable to conduct a preliminary analysis of what might be considered the early lessons on Basel III in a crisis setting. Admittedly, the pandemic and its effects are still not over, and the nature of this exogenous shock is not the same as what triggered the Basel III reforms. These, as I said, stemmed from the necessary response to the weaknesses of the system highlighted by the 2007-2009 crisis. In any event, bearing these caveats in mind, the Committee performed this initial assessment of the Basel III reforms that have been implemented in a report published in July.[2]

What are the initial conclusions so far?

Firstly, and unlike in the previous great financial crisis, where banks originated and spread instability, in this crisis the banking system has remained resilient and continued providing essential financial services that have helped cushion the impact of the pandemic on the economy in general. There are two major factors here that have contributed to this positive outcome:

- First, the unprecedented scope and scale of the public sector measures adopted in the fiscal, monetary and regulatory areas to mitigate the impact of the COVID-19 crisis have been pivotal. These measures have so far protected banks from losses.

- Further, the Basel III reforms have considerably reinforced the resilience of the global banking system, allowing banks to contend with the effects of the pandemic with higher solvency and liquidity levels and with an enhanced loss-absorbing capacity.

[1] See Basel Committee on Banking Supervision, "Basel III: international regulatory framework for banks" and "Minimum capital requirements for market risk".
[2] See Basel Committee on Banking Supervision (July 2021), "Early lessons from the Covid-19 pandemic on the Basel reforms".

> Indeed, the study shows that banks have faced the pandemic with substantially higher capital and liquidity ratios. No internationally active bank has failed or needed public sector financing. The resilience measures based on market indicators, such as CDS spreads, show that some banks were stressed at the start of the pandemic, but the increases in CDS spreads were lower for those banks with higher levels of capital. The findings of the study further indicate that better capitalised banks increased their lending to households and non-financial corporations to a greater extent. Accordingly, an initial conclusion would be that the global banking sector has been capable of complementing and strengthening the measures adopted by the public authorities to which I referred earlier.

The second conclusion I would highlight is that although the results show that the Basel III framework has met its objectives to date, there are also some facets whose assessment may require more in-depth work. I would include most notably three such areas: the functioning of capital and liquidity buffers; the degree of countercyclicality offered by prudential standards; and the treatment of reserves at central banks in the prudential leverage ratio.

The conclusions are not clear, for the moment, for several reasons. These include the difficulty of empirically and accurately isolating how specific variables might have behaved in the absence of the effect of the measures taken by the public authorities.

Without going into excessive detail, I will set out just one example. There is intense debate surrounding the extent to which capital buffers may be used. The restrictions on dividend payouts and on share buybacks imposed by various authorities and, more generally, the public measures taken to combat the economic effects of COVID-19 hamper the drawing of definitive empirical conclusions on banks' readiness to use the buffers. This is because banks have generally maintained capital positions comfortably above the minimum levels required and the buffers. Moreover, while the initial results obtained here suggest that banks might have been reluctant to use capital buffers even if it had been necessary, it is not possible to determine the causes behind such reluctance. Specifically, it is not clear whether this lack of readiness to use buffers stems from precaution over possible losses at a time of uncertainty, or from the wish to avoid the stigma that reducing capital levels might entail.

In any event, and precisely because of this, the Committee will continue assessing these aspects in the coming years, along with a more extensive assessment on the impact of the initial Basel III reforms in the past decade.

A third conclusion we may draw from recent – and not so recent – experience is that we cannot take the resilience of the global banking system for granted. Insofar as the pandemic continues to exert effects and, at the same time, the public support measures are progressively being withdrawn, additional losses might arise for banks. Also, the rise in levels of public and corporate debt might compound the structural weaknesses of bank balance sheets in the long term. In addition, the recent vulnerabilities in non-bank intermediation have highlighted their high interconnectedness with banks, whereby the risk of contagion cannot be ruled out.

In the second part of my address, I would like to convey some thoughts to you connected with the conclusions set out:

- Firstly, the implementation of the initial Basel III reforms has given rise to a clear net benefit for the global economy and for society at large. During the pandemic we have jointly harvested these benefits.

  In this respect, we should note how various academic studies indicate that the Basel III reforms have resulted in capital requirements that lie within the range of estimates suggesting net positive macroeconomic benefits derived from greater financial stability and from the enhanced shock-absorbing capacity provided by such requirements.[3]

  The benefits of the implementation of Basel III are not confined to the economies and financial systems of the member countries of the Basel Committee; rather, they are also relevant for other jurisdictions. These include Latin America, both because of the effect on banking systems locally and the influence of the internationally active banks operating in the region, which moreover influence the financial cycle globally. Basel III will contribute to lessening the likelihood of future crises occurring and, should they do so, it will minimise their impact. Without being exhaustive, the capital framework reforms, the new liquidity requirements and the introduction of a macroprudential approach will help increase the responsiveness and resilience of the region's banking sectors, contributing moreover to attaining a more level playing field.

- Secondly, we should be mindful that the regulatory reform is not over: some crucial aspects have still to be completed in implementing Basel III. The agreed reforms pending implementation, which contain a series of standards aimed at boosting the robustness and credibility of the risk-weighted assets framework, resolve shortcomings that remain as significant today as before the pandemic. In particular, they strengthen cross-bank comparability, which exerts a clear effect on the level playing field, and restrict the variability of capital requirements.

  It is increasingly clear that the Basel reforms pending implementation will act as a complement to the current regulatory framework and to its net positive impact on the real economy. For example, recent analyses by the European Central Bank show that the costs of implementing the reforms in Europe in terms of gross domestic product are modest and transitory, while their benefits will contribute to reinforcing economic resilience in the face of future shocks.

  The drafting of these standards benefited, moreover, from a thoroughgoing consultative process. Not implementing these measures in a full, timely and consistent way, as the G-20 leaders agreed on several occasions, would mean neglecting the remaining structural weaknesses and fragilities, thereby entailing a significant cost for the economy and global financial stability. COVID-19 has highlighted how crucially important it is to have the necessary mechanisms in place ahead of any shock; this is also applicable, no doubt, to prudential standards and to the security and robustness of the banking system.

[3] See Basel Committee on Banking Supervision (June 2019): "The costs and benefits of bank capital – a review of the literature".

Let me remind you here that the goal of full, consistent and timely implementation for internationally active banks is not incompatible with the application of a proportionate framework in keeping with the *Core Principles for Effective Banking Supervision.* These stipulate that supervisory practices should be commensurate with the risk profile and the systemic importance of the banks supervised.[4] What is more, the Committee has initiatives under way to promote the role of proportionality in banking regulation and supervision, including the development of practical guidance on the use and design of a proportionate regulatory and supervisory framework, to be used by jurisdictions on a voluntary basis.[5]

- Thirdly, and in parallel with the assessment programme the Committee is pursuing, it is essential to adopt a forward-looking supervisory approach in order to identify, evaluate and mitigate emerging risks and structural trends that impact the global banking system. Some of these risks and trends – including the digitalisation of finances, climate-related financial risks, and the development and sustainability of banking business models – had already been identified before the pandemic. Indeed, COVID-19 has but further stressed the importance of addressing them.

In conclusion, the implementation of Basel III responds to a global and collective interest. Both the fight against infectious diseases and the safeguarding of financial stability are global public goods that know no borders and that require cross-country collaboration. The pandemic will not be over until all of us are safe. Likewise, the global benefits of Basel III will not be reaped if the commitment towards full, consistent and timely implementation agreed by the G-20 and the Group of Central Bank Governors and Heads of Supervision is not observed.

[4] See Basel Committee on Banking Supervision (2012), "Core Principles for effective banking supervision".
[5] See Basel Committee on Banking Supervision, "Basel Committee work programme and strategic priorities for 2021/22".