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BASEL III TO STAY ON COURSE

G20 confirms its commitment. We are not surprised.

By Jeb Beckwith and Sanjay Sharma, Ph.D.

"We confirm our support for the Basel Committee on Banking Supervision's (BCBS) work to finalize the Basel III framework without further significantly increasing overall capital requirements across the banking sector, while promoting a level playing field."
– G20 Communique, March 18th, 2017.[1]

Nestled within the body of the G-20 communique[2] from Baden-Baden over the weekend was an important statement of support for the Basel III framework. With recent elections in the U.S., Brexit in the U.K., and the rise of nationalistic forces in France, there were growing concerns that the enormous thought and resources expended by the BCBS, global regulators and the banking industry to construct the Basel III framework would be undone.

The G20 statement, ostensibly agreed to by President Trump's Treasury Secretary, Steve Mnuchin, is an indication that the new U.S. administration stands behind the implementation of Basel III, complete with its timelines and new risk management frameworks. The only change between this week's G20 statement and the prior statement issued prior to the U.S. election was the removal of the phrase "we will resist all forms of protectionism." In context, this statement speaks more toward trade than financial regulation. This week's G20 statement lays to rest speculation that the forces driving nationalist movements around the world will somehow creep into global standards for banking regulation. The reaffirmation should jolt into action banks that may have expected Basel III to be diluted or defrayed.

How does this indication align with talk from the new Trump Administration[3] and the U.S. Congress about reducing financial regulation? On the face of it, we should assume that Basel III is not on the table, and the focus will likely be on domestic U.S. regulations.

john.beckwith@greenpointglobal.com
sanjay@greenpointglobal.com

GreenPoint> Financial

As we have written in recent articles[4], the focus of both Executive and Legislative branches in the U.S. is on enacting deregulation by attacking domestic rules and legislation. These include reshaping the Dodd-Frank Amendment (DFA), including the Volker Rule, reducing living will and CCAR requirements, revoking the Department of Labor (DOL) rules regarding financial advisory governance and changing the role of the Financial Stability Oversight Council (FSOC). To date, the Trump Administration has not publicly criticized the global regulatory framework promulgated by BCBS and implemented under the supervision of the Federal Reserve Board of Governors. Tables 1 and 2 summarize the distinction between Basel III components and domestic U.S. regulation.

The breadth of areas in U.S. domestic regulation reflects the opportunity for the Trump Administration to simplify the regulatory landscape by executive or legislative action. This could be a monumental task, given that most of these regulations and bodies are already in force and functioning. Changing global policies overseen by the Federal Reserve would have been even more challenging. Away from purely domestic policies, this week's statement from G20 should be viewed as a strong affirmation that Basel III provides the framework for leveling the banking risk field across geographies and regulatory jurisdictions, and thus, protects the global economy from future financial crises led by the banking sector. Steve Mnuchin and Gary Cohn, former President of Goldman Sachs & Co. and now Chair of President Trump's National Economic Council (NEC), are presumably the principal drivers of the Trump Administration's thrust for regulatory reform. Both are Goldman Sachs alums and should be well aware of the need for regulatory controls of the global financial markets. To date, both have expressed support for the Basel III framework so long as those regulations are adhered to globally.

The specific reference in the G-20 statement of support for Basle III framework "without further significantly increasing capital requirements" may turn out to be challenging for some of the BCBS initiatives – particularly FRTB. Initial quantitative studies performed by BCBS and others on the industry, as well as our own analysis, suggest that significant capital increases may be required, particularly if the new internal models approach under FRTB becomes over-burdensome or if the capital floor is set at too high a bar. We interpret this statement as an indication that there is movement towards keeping the floor towards a lower bound and thus maintaining the internal models approach to FRTB as a viable option even for smaller banks.

For banks that will face higher capital requirements for market risk under FRTB, the need for optimizing capital usage and deployment will be paramount. These banks

Table 1

Basel III Regulations[5]
• Fundamental Review of the Trading Book (FRTB)
• Total Loss Absorbing Capital (TLAC)
• Liquidity Coverage Ratio (LCR)
• Leverage Ratio
• Net Stable Funding Ratio (NSFR)
• Interest Rate Risk in the Banking Book (IRRB)
• Globally Systemically Important Banks (GSIB)
• Credit Valuation Adjustment (CVA)
• Pillars 1-3 Capital

Table 2

U.S. Only Regulations[6]
• Dodd-Frank Amendment (DFA)
• Volcker Rule
• DOL Rule
• Sarbanes-Oxley (SOX)
• Living Will
• CCAR
• Systemically Important Financial Institution (SIFI)
• Financial Stability Oversight Council (FSOC)
• FATCA

will need to mitigate significant declines in ROE. For some, this may even be lower than their cost of capital. Managements should gear up to evaluate risk portfolios, invest in improving risk and capital models, and focus on data quality improvements, optimization of capital deployment and improvements to operational efficiency.

There are significant concerns in the industry regarding global synchronization of FRTB implementation timeframe. Clearly, banks in regions and countries that adopt and implement FRTB within the BCBS prescribed time frame will be at a competitive disadvantage compared to those that may delay regulatory rule setting, and follow-up deadlines. This could be mitigated by phase-in periods of FRTB capital requirements, i.e. banks may be required to hold 65% of the total market risk capital charge mandated by "fully loaded" FRTB as proposed in Europe. A phase-in capital requirement could kill two birds with one stone for BCBS – it could muffle the industry protests about onerous capital requirements at a time when global economies are slowly recovering, and it could set the stage for taking a hard line on implementation timelines. This would also open the intriguing possibility that banks in "early-FRTB-adopter" regulatory regimes may actually have lower market risk capital charges during the phase-in period compared to those that are capitalized under Basel II.5

Finally, in response to the questions we have received about the Trump Administration's intention to undo the very idea of financial regulation, we conclude with these cautionary notes from President Trump's Chief Economic Advisor:

"We don't want to [reform] in an unregulated way. We want to do it in a smart, regulated way."[7]

"If you don't invest in risk management, it doesn't matter what business you're in, it's a risky business."[8]

– Gary Cohn

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1. Section 5 of Footnote 2
2. Relevant text of the communique:

   G20 Finance Ministers and Central Bank Governors
   March 18, 2017, Baden Baden

   1. We recognise the importance and benefits of open capital markets and of improving the system underpinning international capital flows while continuing to enhance the monitoring of capital flows and management of risks stemming from excessive capital flow volatility. To support this goal, we look forward to the IMF's and other IFIs' further work in this area, including on macroprudential policies. A number of non-OECD G20 members have declared their intention to join the OECD Code of Liberalisation of Capital Movements starting already the process of adherence this year. We welcome the current review of the Code, including work on appropriate flexibility, while maintaining the Code's current strength and broad scope. Those G20 countries that have not yet adhered to the Code are encouraged to participate voluntarily in the current review and to consider adhering to the Code, taking into consideration country-specific circumstances.

   2. An open and resilient financial system is crucial to supporting sustainable growth and development. To this end, we reiterate our commitment to support the timely, full and consistent implementation and finalisation of the agreed G20 financial sector reform agenda. We endorse the Financial Stability Board (FSB) policy recommendations to address structural vulnerabilities from asset management activities, ask the International Organization of Securities Commissions (IOSCO) to develop concrete measures for their timely operationalisation and ask the FSB to report on the progress of this work by the Leaders Summit in July 2017. We will continue to closely monitor, and if necessary, address emerging risks, in particular those that are systemic, and vulnerabilities in the financial system, including those associated with shadow banking or other market-based finance activities. We ask the FSB to present by the Leaders Summit in July 2017 its assessment of the adequacy of the monitoring and policy tools available to address such risks from shadow banking and whether there is need for any further policy attention. We also look forward to the FSB's comprehensive review of the implementation and effects of the reforms to over-the- counter (OTC) derivatives markets and

call on G20 members to complete the full, timely and consistent implementation of the OTC derivatives reforms where they have not already done so. We welcome the progress by the Committee on Payments and Market Infrastructures (CPMI), IOSCO and FSB towards developing guidance to enhance the resilience, recovery and resolvability of Central Counterparties (CCPs) and look forward to their publication by the time of the Leaders Summit in July 2017 as well as plans for any follow-on work as needed. We confirm our support for the Basel Committee on Banking Supervision's (BCBS) work to finalise the Basel III framework without further significantly increasing overall capital requirements across the banking sector, while promoting a level playing field. We reiterate the importance of progress under the work plan to address misconduct risks in the financial sector and look forward to the report from the FSB by the time of the Leaders Summit in July 2017. We will continue to enhance our monitoring of implementation and effects of reforms to ensure their consistency with our overall objectives, including by addressing any material unintended consequences. We look forward to the FSB's third annual report. We also welcome the FSB work to develop a structured framework for the post-implementation evaluation of the effects of the G20 financial regulatory reforms and we look forward to the framework, after an early public consultation of its main elements, being presented by the time of the Leaders Summit in July 2017 and published. We welcome the OECD Methodology for Assessing the Implementation of the G20/OECD Principles of Corporate Governance.

Source: Germany's Federal Ministry of Finance

3. *Gary Cohn's Vision for a Regulatory Rethink, WSJ,* February 3, 2017; *U.S. to World: Banking Deregulation Back On*, WSJ, February 3, 2017
4. See *Basel Under Trump* and *Regulation Under Trump* – GreenPoint Perspectives.
5. Not intended to be all-inclusive
6. Not intended to be all-inclusive
7. WSJ, February 3rd, 2017, *Trump Plans to Undo Dodd-Frank, Fiduciary Rule*
8. http://www.azquotes.com/author/42565-Gary_Cohn