Summary of the workshop discussion

On 21 March 2011, the EBRD’s Office of the Chief Economist (OCE) co-hosted a workshop on Basel III implementation jointly with the International Centre for Financial Regulation (ICFR). About 40 participants from the private and official sector attended together with EBRD and ICFR staff. Given the recent finalisation of the Basel III accord, and the meeting of the European Bank Coordination Initiative (EBCI) in Brussels in the previous week, this proved to be a timely event. The meeting was held under Chatham House rules, based on which the following summary emerges.

The workshop was entitled ‘Adopting Basel III in the Central and Eastern Europe (CEE) Region: Revisiting the Regulation of Financial Integration in Europe’, to underline the specific interest in the impact of new prudential requirements on economies that are highly open to financial services provided by European bank groups. The workshop addressed both the process of translating Basel III into EU and national regulations, and specific issues, such as capital and liquidity requirements and the new macro-prudential requirements. A key question motivating the workshop was whether new prudential requirements and an implementation that will be subject to considerable national discretion will put at risk a banking model based on the close financial integration between local subsidiaries and their parents in western Europe – a model that has served the region well throughout the crisis.

The first session underlined that while the Basel III accord laid out many provisions for better micro and macro-prudential supervision, implementing these in practice and translating them with the EU Capital Requirements Directive (CRD) will take some time and will continue to involve a significant element of discretion in application. Although an extended timeline had been set out for introducing the new proposals it was clear that in some cases, certain jurisdictions and institutions were moving ahead more rapidly, and some were ‘gold-plating’ the Basel recommendations. This could put pressure on the EU and non-EU countries with very open financial markets. In addition to the Basel framework, much work still has to be done to clarify the next steps on certain G20 recommendations, for instance regarding cross-border resolution and regulation of systemically important financial institutions.

The CEE region is among the emerging market regions most open to international financial transactions. At the outset of the recent financial crisis, there was hence a concern that the region would be subject to sudden and disruptive asset withdrawals. The fact that this has not happened, can be attributed to both the strong commitment by parent banks to their subsidiaries, but also strong commitment by home country authorities to back up subsidiary capital and liquidity where needed. Even today, business potential is seen as promising in these largely underdeveloped markets.

An assessment of the key prudential requirements demonstrates that for most banks active in the region, neither the capital adequacy nor capital quality present significant challenges. However, questions remain about the distribution and “fungibility” of capital within banking groups across the EU region and between autonomous regulatory jurisdictions outside the EU. Limitations on this fungibility due to ‘subsidiarisation’ and local liquidity requirements might inhibit the gains accruing from integrated treasury management typically practiced within bank groups in the region. Local capital markets in the region are relatively underdeveloped. The liquidity and net stable funding ratios could hence present considerable challenges and intensify competition for deposits and increase funding costs. Maturities available to the corporate sector could shorten, inhibiting investment. Most governments seek to address this shortfall through a more active development of local funding capacities, though in the absence of strong institutional investors this may be a challenge.
The workshop also focussed on a number of implications and unintended consequences of Basel III/CRD implementation, including: disincentives to market making from changes to trading book asset weightings; disincentives to senior debt funding due to bail-in uncertainties or potential haircuts to holders of senior bank debt; the need for a wider regulatory net to reduce the likelihood of a shift to the shadow banking sector as a response to Basel III, and concerns about the ability of national central banks to assert authority.

There were also concerns over macro-prudential tools, an area where Basel III mandates that local requirements imposed by host countries based on the counter-cyclical buffer concept will be reflected in consolidated supervision. Most countries in the region have already experimented with such tools before and during the crisis. A simple addition capital requirement will likely make capital budgeting less predictable, and in any case is unlikely to be sufficient or effective in stemming the region’s traditionally wide swings in credit growth.

The workshop concluded with a discussion on issues to be taken up in the working group convened by the EBCI. A key ambition should be to prioritise issues that are unique to the region or emerging markets more broadly, and to achieve a connection between differing perceptions of public and private sector. Given the imminent adoption by the EU Commission of the draft CRD-IV directive this work has become quite urgent, and should address prudential requirements that put at risk integrated treasury management and the gains from financial integrations, as well as implementation issues that risk raising operational costs. In a future stage implementation issues under the macro-prudential framework should also be addressed, taking account of the new EU supervisory framework.