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The Basel III Framework and Digital Market Infrastructures

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In PAY 21 October, Jerome Kemp, President of Baton Systems, talks to Bill Coen about the Basel III Capital Framework and today's emerging digital market infrastructures. Bill is senior advisor to Baton and former Secretary General to the Basel Committee on Banking Supervision and was one of the principal architects of the Basel III Framework, a set of measures designed to strengthen the regulation, supervision and risk management of banks.

The thinking behind Basel III

Asked by Jerome about the drivers of the Committee's thinking post-Global Financial Crisis as it embarked upon the revision of the regulatory capital, which comprised the bulk of the Basel III reforms, Bill 's response is unequivocal.

"Some of our thinking," he says, "was driven by the glaring inadequacies of the existing framework. The reforms that we made were readily apparent and needed, like the amount and quality of capital."

Bill describes some of the reforms as 'searing lessons' from the Global Financial Crisis, citing in particular the credit and operational risk frameworks as well as market risk, subsumed under 'The Fundamental Review of the Trading Book (FRTB).' While some reforms were designed to enhance existing rules, others were novel, such as the leverage ratio, which had previously existed only in the US and Canada. The idea was to take a 'multiple metrics' approach rather than to rely on single measures that characterised the pre-Basel 3 framework. The result, Bill explains, was a series of new standards and requirements, encompassing leverage, liquidity, and funding as well as baseline capital ratios.

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Bill goes on to speak about the system of buffers such as the Capital Conservation Buffer where banks would be restricted on how much capital they could distribute in the form of dividends or share buybacks if their capital levels fell below a prescribed threshold. Another such buffer is a Countercyclical Capital Buffer, where banks build capital to draw on in times of market downturn. "This was driven by the Global Financial Crisis," Bill says. "Our objective was to make the framework future-proof but we could not be certain as to how exactly these new measures would behave in real time."

The other two elements of the framework pertain to banks' exposures to central counterparties and margin requirements for non-centrally cleared derivatives. "These were very consistent with the G20 call to move towards central clearing for as broad a spectrum of assets as possible," says Bill. "All of these measures together have made for a much better, well-informed regulatory framework."

Mission Accomplished?

However, Bill thinks it is still too soon to be able to say that the broader framework has achieved what it set out to do. "Undoubtedly the framework is better and banking systems around the world are stronger," he says. "The experience that we have had with COVID so far and the pressure we have seen in the markets, particularly on asset quality, have been a good test case, but I don't think it was a complete validation." He points out that not all the provisions of the Basel III Framework have yet been fully implemented. "But things are definitely moving in the right direction," he adds.

Cryptoassets: a natural progression of the regulatory framework?

Bill explains that, although the Basel Committee only recently published a Consultative Paper on crypto and digital assets, they were a point of discussion for the regulatory community as far back as 2014. "This is not a new topic," he says. "It's imperative for regulators to keep up with the times and to have a high awareness of growing risks and bank practices, as well as market developments."

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A balanced approach

When it comes to emerging or evolving issues like crypto-assets, Bill says it is important that the regulatory community toes a careful line. An approach that is too heavy-handed could squash a growing and important asset class, but too light a touch could lead to very high growth in that asset class and potential market instability. The Basel Committee's approach as detailed in the recently published Consultative Paper tries to strike that balance, and is a work in progress.

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The Paper makes a very clear distinction between crypto-assets (assets using cryptography) and digitised assets (assets represented by a token). Bill believes that this distinction is necessary.

“The whole notion of products like Bitcoin or Ether as currencies is a very sensitive point for the central banking community,” he says. He explains that the community considers that there is tremendous volatility around these products: they are not a mature asset class, they are not issued by a central authority and market participants lack experience in them. They do not meet the true test of a currency, so central bankers prefer to refer to them as crypto-assets rather than to define them as a new form of currency.

Tokenised, digital products, on the other hand have a clear link to the underlying assets. “This is why the distinction made by the Basel Committee is important,” Bill says.

Press coverage about the Committee’s consultation has largely focused on the proposed punitive treatment of crypto and digital assets, Bill says. “But that’s just looking at the Bitcoin/Ether part of it,” he stresses. “The really important takeaway is the acknowledgement by the Basel Committee of blockchain and of technologies like distributed ledgers. I think there is a clear recognition that we have evolved in the financial system. There’s got to be an awareness and recognition of these technologies and I think that the Consultation Paper provides that recognition.”

These relatively novel technologies represent a new way for market participants to communicate amongst each other. Bill believes that there has always been a sensitivity in the central banking and regulatory community regarding the sector’s ability to keep up with the latest developments. “There is a keen awareness that it is imperative that policymakers and standard-setters keep up to date with the latest technologies,” he says. “There is no way the central banking or regulatory community can ever outpace the private sector. The best they can hope for is to remain current on latest developments.

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“The regulatory community feels an imperative to keep up to date, and, if possible, to get ahead of the curve.”

“Let’s think about prudential rules,” Bill says. “We apply them on a bank-by-bank basis, and if a bank runs into trouble and experiences some pressure, there may be a knock-on-effect. The worst- case scenario is that there is contagion.

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"Now let's think about market infrastructure. The volumes are orders of magnitude higher. If a payment system has a hiccup it reverberates around the rest of the financial system. I think it's important to make a distinction between the use of technology at a bank level and the use of technology for market infrastructure. Regulators want to keep up to date with current developments but the stakes are higher when it comes to market infrastructure."

This does not mean, Bill adds, that there should be additional regulatory requirements with respect to digital assets. Market stability is a common thread for policymakers preparing rules for banks and those with oversight of market infrastructure. There is a keen awareness among regulators of the need for new technologies but there is also an acknowledgement that the stakes are high.

Innovation is key

Bill says that innovation will be a major theme over the next few years in terms of market infrastructure. "Looking ahead," he says, "I'm well aware of the keenness in the regulatory community to continue to embrace technological advances. Regulators are keenly aware of the rapid pace of change and are doing everything they can to remain current and not to serve as a roadblock to the benefits conferred by these advances.

"It continues to be an exciting time. I don't see the pace of change slowing down and I see the regulatory community continuing to immerse itself in these changes."

About Baton Systems

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