Monitoring the impacts of financial reforms on the EU economy

This document was drafted by Eurofi with input from its members. It does not engage in any case the EU Polish Presidency or the Polish financial authorities.

According to the BIS and the EU Commission, the new regulatory frameworks – Basel III, Solvency II - should not impact growth in the long term.

Nevertheless Eurofi members remain concerned on their actual impact. Indeed those reforms, beside the impact of higher costs of finance, should deeply modify financing mechanisms and reduce some financial institutions activities possibly to the detriment of the economy in particular in Europe, the region where Solvency II will apply and lending is highly intermediated.

To quote an EU Central Bank executive[1] "Banks have several possibilities to adjust their capital ratios. For instance, they can raise capital, increase lending spreads, reduce dividends and/or downsize (risk-weighted) assets. In practice, it is likely that banks' adjustment is going to be achieved through a combination of all these measures. There is empirical evidence, however, that in the short term and in crisis periods in particular, banks react to capital (and liquidity) constraints by de-leveraging and by tightening of credit conditions that can have a measurable impact on loan supply and thus on economic activity. Whatever methods banks choose to adjust their capital ratios, the overall effect is channelled to the macro-economy via various transmission channels."

As these "effects" are difficult to anticipate and modelling assumptions always create arguments, a closed proactive monitoring of the actual consequences of the new prudential frameworks is both vital and urgent.

Moreover at a moment when economic growth is abating, recovery is very dependent on the capacity of the banking sector to provide financing. In such context compelling banks to increase the regulatory capital may be pro cyclical. Indeed depending on market conditions, it would be difficult for banks to raise new equity, which would lead them to reduce their assets and the granting of new credits.

Policy makers must tread carefully to avoid constraining bank's ability to lend to customers. An appropriate monitoring process capable to early detect any unintended consequence and achieve the possibly required regulatory adjustments should be set up. It is required to be up to the event of unintended significant consequences on the European economy, growth and employment. For both the on going monitoring and the regulatory adjustments process the European Systemic Risk Council is particularly well suited. This is essential to have the capacity to possibly review the implementation timetable depending on the pace of the recovery and adjust regulatory requirements overtime to the real needs of reinforcing the solvency of the different financial activities. Lastly, this process should allow verifying the appropriateness and the impacts of certain measures.

1. According to the BIS[2] the new Basel regulatory framework should not impact growth

Notwithstanding the effects of capital surcharges recently imposed to the Global SIFIs have not yet been assessed, according the BIS the macroeconomic impact of the transition is unlikely to be significant

To examine potential transitional impacts on lending and investment, the Financial Stability Board (FSB) and the Basel Committee assembled the Macroeconomic Assessment Group (MAG), consisting of macroeconomic modellers from a number of central banks, national regulators and international organisations. The MAG concluded that the transitional effects were likely to be modest. Using median results from the suite of models and relatively conservative assumptions, the group estimated that bringing the global common equity capital ratio to a level that would meet agreed targets over eight years would result in a maximum decline in GDP, relative to baseline forecasts, of 0.22% over 35 quarters. This is equivalent to a shortfall from baseline in average annual growth of GDP of 0.03 percentage points (3 basis points) during these 35 quarters, after which the growth rate would accelerate back towards the baseline. The 97 models used in the study produced a wide range of estimated impacts. The 20th percentile estimate produced a maximum GDP decline of 0.1% and the 80th percentile estimate a decline of almost 0.5%. However, most of the results clustered around the median, with the estimated paths between the 40th and 60th percentile tending to be very close to the median forecast. The macroeconomic impact of liquidity requirements was more difficult to estimate but also seemed to be small.

The MAG noted that banks may choose to implement the reforms on a faster schedule than the one set out by supervisors. The group found that implementing the reforms over four years rather than eight would lead to a slightly greater decline in the average annual growth rate of GDP over a shorter period, specifically a reduction of 5 basis points from baseline over 18 quarters, followed by a return towards baseline.

Over the longer term, the BIS expects the will benefits outweigh the costs

A Basel Committee subgroup examined the long-term economic impact (LEI) of the reforms, comparing costs with benefits. The costs

[1] Speech by Vítor Constâncio, Vice-President of the ECB, at 20th Annual Hyman P. Minsky Conference, organised by the Levy Economics Institute, New York, 15 April 2011

[2] BIS 2010 annual report

mainly related to higher lending rates linked to a higher cost of bank funding. The group made the assumption that this was a conservative approach, since it ignored the fact that safer bank balance sheets should reduce the costs of banks' equity and debt funding to an extent that would at least partly compensate for the cost of holding more equity relative to debt. Another assumption considered as conservative was that any increase in bank funding costs would be passed entirely into lending rates.

These costs were set against a number of benefits, including a likely reduction in the frequency and severity of banking crises. The group found that, historically, banking crises occur in any given country on average once every 20–25 years. Estimated cumulative discounted output losses from banking crises vary widely but have a median of 60% of pre-crisis GDP. Thus, for example, a 1 percentage-point reduction in the likelihood of a crisis should yield a benefit of around 0.6% of GDP.

The LEI group concluded that the long-term benefits of stronger capital and liquidity requirements substantially exceed the costs for a broad range of minimum capital requirements. The magnitude of the benefits depends critically on whether output after a financial crisis eventually return to where it would have been had no crisis taken place or permanently moves to a lower path. If, as concluded by most studies, a crisis leads to a permanent relative reduction in output, then the net benefit from reducing the risk of a crisis should be correspondingly greater.

The impact of the new banking standards will be monitored and some unintended consequences addressed

This time frame includes an observation period to review the implications of the liquidity standards for individual banks, the banking sector and financial markets, with a view to addressing any unintended consequences. Similarly, the Committee will assess the impact of the leverage ratio on business models during the transition period in order to ensure that it achieves its objectives.

However the global banking regulator has not been explicit so far on the related observation process.

2. According to EIOPA, European insurers are expected to meet Solvency II requirements. However, this framework is expected to significantly influence their investment strategies, thus their role in the economy and reduce the product attractiveness

The European Insurance and Occupational Pensions Authority (EIOPA) published its QIS 5 report in March 2011. Even though, the report failed to address the consequences of QIS 5 on both growth and financial stability, the European Commission gave them a positive welcome, considering that, while the approach still needs to be fine-tuned, the insurance and reinsurance companies are well positioned to meet the new capital requirements under Solvency II.

Another message coming out of QIS5 was the potential impact of the Solvency II on insurance companies as providers of products with long-term guarantees due to the volatility of own funds and the measurement of specific risks that these undertakings are exposed to. Without commenting on the possible consequences on the economies, the EU Commission underlined that the QIS 5, reinforced the general concern about the volatility of the capital charges and consequently their pro-cyclicality.

For its part, the Committee on the Global Financial System (CGFS)[3] report reveals that since within the market risk module, the three largest contributions to capital charges come from equity risk, spread risk, and interest rate risk, insurers with low capitalisation might have to reduce their holdings of equity and credit positions.

Overall the resulting shorter-term investment strategies will reduce the financial performance of insurance products. Even though there has never been a greater need for protection, policyholders will be offered more expensive products with lower returns and reduced guaranties, and will shoulder a larger part of the risk.

Actually this will be detrimental not only to the policyholders, but also to European growth and competitiveness and ultimately to the European employment.

Indeed insurer will turn away from these stable investments, which offer high long-term risk-adjusted rates of return, the value creation of which stems from the introduction of new technologies or products (e.g. new sources of energy, infrastructures, new technologies...), which provide long-term increases in productivity or in general welfare, and lead in turn to an enhanced and sustainable development of GDP.

3. Monitoring the effective consequences of the new prudential frameworks is both vital and urgent

The BIS assesses that in terms of the impact on output there is considerable room to tighten capital and liquidity requirements while still yielding positive net benefits. It states that the reforms may not damage growth.

However, there are several factors, which highlight the need to rapidly implement a systematic monitoring to early detect its actual consequences:

- The assessment of impact and unintended consequences for measures not yet implemented always create arguments around modelling assumptions, particularly so when the stakes are so high; in addition the significant variations in results mean that the level of potential error is huge. If BIS estimates were wrong, the reduced net positive economic impacts could quickly turn negative;

- The Basel III requirements begin to take effect from the beginning of 2013 and will be phased in by 2019. This time frame includes an

[3] Fixed income strategies of insurance companies and pension funds – CGFS paper – July 2011 - page 31

observation period as agreed by the G20, to review the implications of the liquidity standards for individual banks, the banking sector and financial markets, with a view to addressing any unintended consequences. Similarly, the Basel Committee will assess the impact of the leverage ratio on business models during the transition period in order to ensure that it achieves its objectives. Nevertheless it has not made any commitment to monitor this ratio's impact on the economies, particularly those were financing is very reliant on banking intermediation.

- Basel bases its impact analyses on a 1.3 percentage point increase in capital levels (core tier 1 up from 5.7% - average recorded on a sample of 74 leading international banks - to 7%, as provided for under the new regulations), raising capital levels by an average of 23%. However, the banks generally expect to see much more significant increases in capital levels, potentially multiplied by five[4], which would compound the negative impact on growth.

- Basel III reforms should be implemented in a way that does not exacerbate the current economic slow down. At a moment when economic growth is abating, recovery is very dependent on the capacity of the banking sector to provide financing compelling banks to increase the regulatory capital is pro cyclical: given the current market situation, it is difficult for banks to raise new equity, which leads them to reduce their assets and the granting of new credits.

- The impact analyses carried out by the Basel organisations have not factored in the new regulatory framework's striking impacts on the magnitude of the returns on equity (ROE) for various financial activities. And yet, these developments are likely to lead to far-reaching changes in the strategic priorities of financial institutions, scaling down certain activities. These changes need to be monitored carefully, assessing their consequences on the economies from one region to another.

- In particular among the regulatory changes, the introduction of flat-rate provisions to supplement risk-based arrangements is questionable. Far from representing a backstop, in many cases this is affecting proven longstanding banking models which have effectively weathered the crisis, without actually providing any assurances that the riskiest financial institutions will be strengthened. The fact that the Basle Committee has planned for a flat-rate limit to reduce the leverage of banks, without factoring in the more or less risky nature of their assets and business model, is penalising many lower risk banks and will encourage the banks to reduce their outstanding loans and concentrate their assets on riskier operations to generate the higher returns required.

- As far as insurance is concerned, the CGFS report illustrates the strong incentives under the new European prudential framework for insurers to stay away from certain instruments financing the economy. For instance[5], it reveals that for a given capital charge, it is possible to finance 0.17 of equities, and for a given maturity, 1 of A rated corporate bonds, 1.5 of AAA rated corporate bonds, and 2.3 of AAA rated covered bonds[6].

- The table presented in the appendix, extracted from Quantitative Impact Study 5 on Solvency 2, shows that the involvement of an organisation such as the European Investment Bank[7] (through the contribution of subordinated capital), which makes it possible to improve the rating of financial instruments issued to finance infrastructure projects and therefore reduces the capital charge for financial institutions which subscribe for them is not sufficient to offset the prudential regulatory incentives for insurers to prefer short maturities reducing the appeal of the EIB's planned involvement. For example, under Solvency II standard formula a five-year BBB listed debt requires a capital charge of about 12%, lower than the level required by the 10-year operation raised to A by the EIB backing. Moreover a A-rated bond and a BBB-rated bond with the same duration of 25 years would attract exactly the same capital charge[8] of more than 32% actually vanishing the EU-supported credit enhancement".[9]

4. Main points of impact to be monitored

- The consequences of the actual increase in the banks' capital levels need to be measured as quickly as possible and on an ongoing basis. More specifically, it is essential to check that these increases in capital levels do not result in any reduction in lending activity. In this way, each country needs to constantly monitor changes in the various financial products and services and their pricing, in addition to verifying that the duration of financing facilities is consistent with the needs of the various economic players.

- For this monitoring to be effective, the States need to identify the most significant financing mechanisms for economic growth: raising of capital by businesses, loans to SMEs, financing for the transfer of businesses, public authorities, infrastructures, consumer goods, international trade, etc.

[4] Actually, the Core Tier 1 has been set at 7% coming from 2% without taking into account the impact of SIFIs capital surcharges. In addition the new definition of the capital represent – by themselves – an substantial effort to strengthening the prudential capital. Moreover, a deep revision of the methodologies for assessing market weighted assets, multiplies the related regulatory capital by 3 (as assessed stated in a speech of N. Wellink President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision), In this context, for banks that have 1/3 of market activities (RWA x 3), and 2/3 of retail activities (RWA unchanged), the equity capital is multiplied by 5,8 (the core Tier 1 is rising from 2% to 7% x 1.66(RWA) = 11.62%).

[5] Fixed income strategies of insurance companies and pension funds – CGFS paper – July 2011 - page 35

[6] Covered bonds are debt securities backed by cash flows from mortgages or public sector loans.

[7] Cf. consultation sur les Project Bonds de la Commission Européenne

[8] More precisely, 32.2% for an A-rated bond and 32.5% for a BBB-rated bond.Under Solvency II, the market (spread) risk factors for bonds as of the QIS 5, lead to the following capital charges: 5 year BBB 2.5%x5=12.5% - 10 year A 1.4%x10=14%; 25 year BBB 2.5%x13 (duration cap 13 years) = 32.5%; 25 year A 1.4%x23 (duration cap 23 years) = 32.2%.

[9] F. Bassanini, G. del Bufalo and E. Reviglio, Financing Infrastructures in Europe: Project Bonds, Solvency II and the «Connecting Europe» Facility, 2011

- Banks generally respond with conservatism to regulatory measures. This has already induced retention of economically unhelpful levels of capital. Moreover with falling ROEs across the banking sector and with the proportion of equity capital only likely to rise, the banking sector could become a less attractive investment - investors may choose to deploy their capital in other economic sectors.

- Since financial institutions are now adapting to the new regulatory prudential framework, steps must be taken to ensure that the public institutions responsible for monitoring the impacts of the new prudential regulations on mechanisms for financing the economy regularly report on their observations to the financial regulators, central banks and public authorities.

- Since it takes time to put alternative financing and guarantee mechanisms in place, such as direct access to the financial markets for public local entities (regions…) and businesses, particularly small and mid-size firms, making it possible to reduce the cost of financing, particular care must be taken in order to plan ahead sufficiently for their rollout.

- For each one of these financing mechanisms, it is also necessary to plan for palliative regulatory arrangements if the new Basel framework had excessive consequences. It is therefore necessary in parallel to plan to review those regulations in the Basel Committee for banks, and the European Commission for insurance firms, after a two-year period of monitoring, in order to embark on the regulatory changes whose negative impact has been evidenced.

Without seeking to be exhaustive, the financing activities listed below illustrate the need to continuously monitor the economic impacts of Solvency 2 and the Basel 3 reform.

- The short-term liquidity ratio penalises financing for local authorities, projects, consumer goods, etc. (cf. Eurofi liquidity memo) since they are not backed with deposits. Particular care must therefore be taken with such financing facilities.

- Long-term financing - project, business, mortgage financing - also needs to be monitored. Indeed, the long-term liquidity ratio aims to reduce the banks' transformation role. In addition, Solvency 2 penalises the holding of corporate bonds or shares by insurance companies, insofar as they are included under the highest market risks and therefore consume more capital.

- Financing for businesses, particularly with unlisted equity, and financing for business transfers, also need to be monitored. Indeed, they are considered to be high risk and are therefore penalised in particular by the capital quality requirements (deduction of minority interests from the core tier 1)

- Trade finance, one of the key enablers of cross-border business, - we are talking about short-term loans, letters and lines of credit, and guarantees for SMEs as well as larger commercial companies to enable them to sell and buy goods - would be materially discouraged by some measures of the Basel 3 framework, in particular the leverage ratio. This leverage ratio will include all off-balance sheet items, such as letters of credit. The Leverage Ratio proposes to treat all off balance sheet assets with a 100% Credit Conversion Factor, whereas the recent International Chamber of Commerce survey of more than 5.2 million trade transactions from 2005 to 2009, demonstrates that less than 110 items defaulted from the pool of those that related to off-balance sheet items: that is 110 from 2,392,257 transactions - some way short of 100%! If implemented unchanged, this will create a prohibitive capital cost to writing this sort of business.

- It is also important to check that standard banking practices - at the time of the individual assessment of the economic viability of long-term projects e.g. infrastructure, transports, renewable energy, etc., which, by definition, consume capital and are bound by liquidity ratios - do not lead to demands in terms of the return on assets that might result in such operations being discouraged or scaled down. As a consequence banks should be forced to neglect low-risk operations to favour riskier, hence more profitable, transactions.

- The offer aimed at promoting banking inclusion, already costly within the current regulatory framework (Basel 2), will be undermined by the expected increase in the cost of credit linked to the higher levels of capital imposed on the banks by Basel 3. Another illustration makes it possible to present the negative incentives brought about by the new regulations: a 2.5% increase in the capital imposed on a G-SIFIs above the tier 1 standard 7% (+35%), leads to a 25% reduction in the dividends paid out, encouraging financial institutions to increase the percentage of risky but profitable activities, although these practices represent one of the factors behind the financial crisis.

Organisation of monitoring

The European Systemic Risk Council should be tasked with monitoring these impacts and issuing any warnings and recommendations that may prove necessary.

While waiting for the Basel Committee, following an observation period (see above), to propose long-term solutions, it would hence be up to the national authorities (Ministry of Finance, Central Bank, etc.), often organised in national systemic risk monitoring committees, to propose the temporary measures to be rolled out in response to such recommendations.

5. Possible adjustments to be taken into consideration

The possible recommendations include:

Alternative financing mechanisms:

- Creating public or private guarantee funds, which facilitate the deconsolidation of asset portfolios from bank balance sheets using securitisation mechanisms, or possibly reduce capital requirements. (Monolines, Public guaranty schemes etc…)

- Arrangements facilitating direct access for small and mid-size businesses to the financial markets.

- Creating specific funds which channel savings towards long and relatively illiquid assets (real estate, unlisted, infrastructures and projects).

  Putting in place government sponsored entities, backed with public guarantees, which are allowing the United States to remove loans from the banks' balance sheets (real estate, public authorities, etc.), would not be recommended out of principle and in view of the public budget constraints involved.

Adjustment of prudential constraints

- The definition at European-level of a regulatory framework that is specifically geared to the reality of long-term risks, which requires a revision of the capital charges set for the assets put in place against long liabilities. This framework would apply to insurers, public financial institutions with a specific purpose, and pension funds.

- Reviewing the volume of prudential capital resulting from the combination of RWA, the capital ratio and countercyclical buffers, depending on the role performed by each type of asset in terms of economic growth, and its actual exposure to large-scale shocks.

  Indeed, it is legitimate to consider adjustments when we can see that a sovereign risk rating below (B–) requires only 50% more capital than a BBB company, and that a subprime (weighted at 40%) requires 60% less than a loan to the latter (see Appendix).

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EU recovery is very dependent on the capacity of the banking sector to provide financing. An appropriate monitoring process capable to early detect and face up to any unintended consequences on the economy during the rollout of new financial regulations has to be urgently put in place.

This is essential to have the capacity to possibly review the implementation timetable depending on the pace of the recovery and adjust regulatory requirements overtime to the real needs of reinforcing the solvency of the different financial activities. Lastly, this process should allow verifying the appropriateness and the impacts of certain measures.

Appendix

Capital charges

	Bonds			Non-EEA Goverment /1		
Rating Category	**Stress Factor**	**Duration Floor**	**Duration Cap**	**Stress Factor**	**Duration Floor**	**Duration Cap**
AAA	0.9	1	36	0	-	-
AA	1.1	1	29	0	-	-
A	1.4	1	23	1.1	1	29
BBB	2.5	1	13	1.4	1	23
BB	4.5	1	10	2.5	1	13
B or lower	7.5	1	8	4.5	1	10
Unrated	3.0	1	12	3.0	1	12

Source: QIS5 Technical Specifications.

The regulatory capital required under the spread risk sub-module of Solvency II depends on both the rating category of an asset and its duration. The market value of an asset is multiplied by a rating-dependent stress factor, as well as by its duration, which is subject to floors and caps. Accordingly, long duration assets are subject to much higher capital requirements than short duration assets of the same rating category.

The stress factors and duration limitations for some key types of assets held by insurers are shown in the table above.

Capital charges: Extract from Basel II

Counterparty category	**Rating**					
	AAA to AA-	**A+ to A-**	**BBB+ to BBB-**	**BB+ to B-**	**Less than B-**	**Not rated**
States and multilateral development banks	0%	20%	50%	100%	150%	100%
Banks	20%	50%	100%	100%	150%	100%
Companies	20%	50%	100%	100%	150%	100%
Detail: real estate						40%
Detail: other						75%

Risk weightings in the standard Basel II approach