THE EU SHOULD ADAPT THE LATEST BASEL III AGREEMENTS

1. Context

In 2008, the G20 Leaders agreed on an ambitious and comprehensive strengthening of international bank regulatory standards. The subsequent Basel 3 standards have imposed unprecedented levels of high-quality capital, notably on the EU banking system, which has already implemented these evolutions well in advance of the agreed schedule. The Basel 3 rules also imposed two new minimum liquidity standards i.e. the liquidity coverage ratio (LCR), and the net stable funding ratio (NSFR), which are being rolled out in the EU. Furthermore, Basel 3 introduced a leverage ratio (LR) to constrain leverage.

Regulators at the Global level also aimed to improve risk management and governance as well as strengthen banks' transparency and disclosures. In July 2009, the Committee introduced a package of measures to strengthen the 1996 rules governing trading book capital and to enhance the three pillars of the Basel II framework based on the risk weighting of banks' assets.

The Basel Committee is now seeking to propose measures to address the variability in risk-weighted assets (RWAs) currently observed, which is considered excessive, and increase their comparability and simplicity.

These measures notably include:

- revisions to the standardised approach for credit risk (SA-CR);
- revisions to the internal ratings-based approaches (IRBAs) for credit risk;
- an overhaul of the credit valuation adjustment (CVA) framework;
- a new standardised approach for operational risk (SA-OR), which replaces all existing approaches for this risk; and
- the replacement of the «Basel II» floor with an aggregate output floor.

The removal of internal model approaches for certain risks and imposing tighten constraints on the outcome of internal models, particularly capital floors derived from the standardised approach are intended to address the excessive variability in risk-weighted assets (RWAs).

The Ecofin Council reiterated on 12 July 2016 its support for the work of the Basel Committee to refine elements of the Basel 3 framework by the end of 2016 to ensure regulatory certainty, its coherence and effectiveness, while preserving the risk sensitivity of banking regulation.

The Council also stressed the importance that the Basel Committee carefully assesses the design and calibration of this reform package, on the basis of a comprehensive and transparent quantitative impact analysis, taking into account in its global calibration also the distribution of its impact on the different banking models and across jurisdictions.

It moreover noted that "the reform package would not be expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions of the world.»

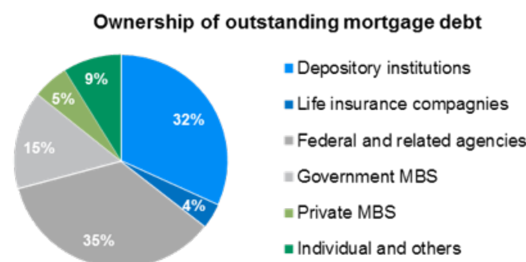
On 7 December 2017, the Group of Governors and Heads of Supervision (GHOS) endorsed a package of amendments aimed at finalising the «Basel III framework», the internationally agreed prudential standards for banks developed by the Basel Committee on Banking Supervision (BCBS) adopted in the wake of the financial crisis.

BCBS members agreed to full, timely and consistent implementation of all elements of the package by 1 January 2022 with the exception of the output floor, where the transitional arrangements include a phased-in implementation until 1 January 2027. The implementation of the agreement in the EU would require amendments to existing EU legislation (mainly the Capital Requirements Regulation or CRR).

2. The latest adopted Basel III measures fail to factor in the specific bank risk profiles stemming from regional financing mechanisms

The latest measures adopted by Basel do not achieve an equivalent level of risk mitigation across regions globally, although international standards should be regulatory minima taking into consideration the differences in terms of financing mechanisms and banking market structures between the world's main regions.

Indeed, less than 50% of the financings to US households are held by US banks, that transfer in particular the mortgage loans they originate to Government Sponsored Entities (GSEs), which fall outside the scope of the Basel rules. This strongly reduces US banks' balance sheets and consequently regulatory capital constraints[1].



[1] Federal Reserve data as of Q1 2019.

Conversely, since in the EU, banks account for three quarters of the financing of the economy unlike in the United States where three quarters of the financing is provided through financial markets, the proposed banking regulations have a three times greater impact on the EU economy than on the US one.

Eventually, US risk transfer mechanisms fundamentally transform banks risk profiles by transferring "conforming loans[2]" risk to GSEs balance sheets, and mainly maintaining in US banks' balance sheets "non-conforming" mortgages. On the contrary, in the EU the banks hold diversified mortgage risk profiles largely dominated by low risk ("prime") mortgages. In addition, the loans themselves are very different:

- A significant proportion of "junior lien" or "revolving" mortgages in the US, higher risk products that do not exist in the EU;
- No recourse to the borrower in the US, unlike in the EU, translating into much better recoveries in the EU.

In this context, it is not wise to assert that the new Basel RWAs calculations involving input and output floors, enable a further effective comparison of bank risk profiles, nor can it be said that the new capital requirements provide similar risk mitigation across regions. Finally, although during certain periods many US banks show higher cumulated write-downs[3], because these banks have higher RWA density[4] the new Basel III evolutions require instead further capitalising... EU banks.

In the global competitive context, the Basel measures to be transposed into the EU, would eventually give US banks operating in Europe an unjustified competitive advantage.

Furthermore, whereas the Basel regulations aim to ensure that taxpayers are no longer called on by developing bank bail-in capabilities, the potential losses on these mortgage loans are taken on by US taxpayers since these loans are guaranteed by the Federal State. The GSEs represent a mechanism for socialising potential losses (bail-out). The situation is different in Europe where mortgage risks are not "socialised", i.e. not borne by taxpayers if necessary, but by the banks themselves, either individually or collectively through IPSs or other frameworks, such as "Credit Logement" guarantees in France.

3. Although it is the quality of loans that is essential for financial stability, the planned Basel approach reduces the risk sensitivity of banking practices

In 2010, Basel 3 regulations corrected the quantitative and qualitative prudential shortcomings - notably liquidity and maturity transformation issues - brought to light during the crisis. In parallel, in the wake of the subprime financial crisis, internal models for credit risk, approved by the supervisory authorities, were gradually adopted by many European banks in line with the Basel 2 schedule. Immediate and massive increase in capital ratio requirements were implemented by adding new buffers[5].

The adoption of these measures has made it possible to de-risk bank balance sheets because these regulations address liquidity and transformation risk and impose capital requirements based on the individual risk profile of each bank.

Such an evolution is a primary explanation of the variability of Risk-Weighted Assets (RWA) observed. Indeed, the variability of RWAs seen in Europe is linked to:

- The differences in customer risk profiles for banks and the specific features of the various domestic markets.
- A significant part of the variability of RWAs in Europe is also caused by the discretionary constraints that have been imposed on banks by national regulators looking for additional safety nets. The EBA has concluded in this respect that in Europe the variability of RWAs is 66% due to differences in business model and supervision[6].

However, global regulators who are concerned by this variability are proposing the introduction of caps and floors into the forthcoming Basel proposals. This reflects their reluctance to take into consideration the low probabilities of default (PD's) and low loss given defaults (LGD's), observed by banks and validated by supervisors, and to reflect them in adjusted RWAs. This Basel approach eventually reduces the risk sensitivity of banking practices which was the major breakthrough of the Basel framework.

4. The proposed measures will affect all EU banks including small and mid-sized ones, which represent the backbone for financing the economy in many EU countries

Overall, the results of the Basel III capital monitoring exercise, based on data as of 30 June 2018, show that European banks' minimum Tier 1 capital requirement

[2] FICO scores are used by Fannie Mae and Freddie Mac to establish minimum eligibility criteria for different types of loans. While the precise cut-off varies by loan type and the presence of other risk factors, both Fannie and Freddie have adopted minimum FICO score thresholds of 620. 620 corresponds to a default rate of 8.2%.

[3] See Chart 6 in "TOWARDS MORE CONSISTENT, ALBEIT DIVERSE, RISK-WEIGHTED ASSETS ACROSS BANKS" Mayte Ledo https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/11/ref0321%20.pdf

[4] The risk-weighted assets (RWA) density ratio is RWA compared to total assets .

[5] The minimum CET1 requirement shifted from 2% to 7% + systemic buffers, with a total average "capital demand by the SSM reaching 11.5% in the SREP 2018 exercise.

[6] "two thirds of the dispersion for non-defaulted assets can be attributed to other drivers such as differences in underlying credit risk, use of credit risk mitigation, modelling and supervisory practices. The geographical location of the exposures, notably the different economic conditions and other country-specific aspects, also play an important role. Regarding SMEs, the size of the enterprise influences variations in RWAs." EBA - 18 December 2013 - https://www.eba.europa.eu/-/eba-publishes-reports-on-comparability-of-risk-weighted-assets-rwas-and-pro-cyclicality.

would increase by more than 25% at the full implementation date (2027). The leading factors of these increases are the output floor (9.1%), operational risk (3.3%) and standard and IRB approaches with a similar impact of 2.7% each. Medium and Small banks' expected increases of T1 MCR are respectively +9.7% and +10.7% while G-SIIs should face an increase of 28,6%.

Small and mid-sized banks, for which it is costly to adopt internal models, have to use a standardised approach. Although Small and mid-sized banks expected regulatory shortfall is expected to be limited, the issue in this case is that this international standard approach is not particularly well-suited to the actual levels of risk of European markets, which should reduce accordingly the risk sensitivity of the framework. Indeed, the international standardised approach for credit risk is defined according to the region of the world that has the worst level of risks (which is not Europe).

Such a negative impact is particularly strong in Europe because small and mid-sized banks in EU countries represent a large part of the financing of the European economy.

In addition, the complexity of the new standardised approach which also serves as a floor for the IRBA, will significantly rise. This will lead to higher IT and compliance costs for especially those banks for which it was meant to be a less complex, though more conservative approach to follow. We therefore urge those concerned to fundamentally reconsider these planned changes. Some in the industry call in this respect to pay attention notably to the calibration of the leverage ratio and to review risk weights[7].

5. Basel rules would raise capital requirements by more that 20% for European banks, whose profitability levels are already too low, triggering a new wave of deleverage, with dramatic consequences for the still fragile recovery in Europe

The return on capital of European banks slightly grew from 2,2% in 2013 to 5,6% in 2017, compared with 8% for US banks in 2017[8]. This is due in particular to the high level of competition in the EU and the difficulty of increasing credit rates in the current monetary environment. For example, the best US companies have to pay interest rates that are twice as high as those paid by firms in Europe (3.3% versus 1.7%). This competitive environment explains why the price-to-book ratio for European banks is around twice as low as for US banks[9]. One explanation would be that investors consider that European banks are riskier than their US counterparts. However, this is decidedly not the case since Credit Default Swap (CDS) levels for most major European banks are similar to those of large American banks (they range from 40 to 200 Basis points).

However, with the adoption of projected prudential measures, European banks could see their Tier 1 capital ratios decline from 15.3% to 11.5%. Compensating for this deterioration would further reduce their profitability ratios. The return on capital seen in 2017 would mechanically drop from 5,6% to 4,5%, which would trigger a new wave of deleverage and mean that many of these banks would no longer be able to cover their costs and perform their intermediation role. The EBA[10] has simulated that to comply with the new constraints EU banks should retain 10% of their earnings over the full transition period to make up for the shortfall, while banks unable to generate profits would be left with a shortfall of 50bn€ requiring they issuie rights in financial markets, should it be possible.

6. These proposals would also have several adverse effects

In addition, the Basel proposals will have adverse impacts because they would require a consolidation of the industry in Europe, calling into question the valuable diversity of bank business models in Europe. These changes would also reduce the banks' effective close relationship with their customers, which is one of the strengths of the financing systems in certain EU countries today.

The regulations being considered by the Basel Committee are also detrimental to the role played by banks in the monetary policy transmission mechanism to the real economy. These prudential measures would also require an increase in financing costs, which would go against the effect targeted by the ECB through its quantitative easing policy.

7. Certain banks in Europe face excessive levels of non-performing loans. A general increase of capital levels of all European banks would not solve this issue, which is independent of the volume of RWAs

In Europe, the main issue is the existence of pockets of vulnerabilities linked to an excessive level of Non-Performing Loans (NPLs) in certain regions i.e. inappropriate provisioning policies rather than underestimated RWAs[11]. These were caused mainly by the European sovereign debt crisis and its economic implications, significantly and suddenly affecting the profitability of many businesses in these countries. This happened in a legal context in some of these countries, in which banks were not in a position to quickly exercise their guarantees due to inefficient insolvency rules.

Requiring a further recapitalisation of generally healthy and resilient European banks as a direct result from increased RWAs would not help to tackle the issue posed by high levels of NPLs, existing bank overcapacity and

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[7] ESGB website: https://www.wsbi-esbg.org/Our%20Positions/Banking%20Supervision%20and%20Regulation/CRD/Pages/default.aspx

[8] Fed St Louis - U.S. Banks with average assets greater than $15B

[9] See "Recent developments in banks' price-to-book ratios and their determinants" ECB May 2019

[10] EBA report p 5

[11] One key finding was the importance of defaulted assets which account for over half of the variation in risk weights and expected losses. The underlying portfolio mix represents around a third of the variation in the overall Global Charge (GC) and Risk Weights (RW) for non-defaulted assets. EBA - 18 December 2013 - https://www.eba.europa.eu/-/eba-publishes-reports-on-comparability-of-risk-weighted-assets-rwas-and-pro-cyclicality.

insufficient cost to income ratio in the EU, and on the contrary would slow the much-needed efforts to address digitalisation and energy transition challenges .

8. It is still essential in Europe that the SSM should continue its policy to maintain models that it launched in 2014

Internal models for weighting risks need to be continuously maintained. More specifically, it is essential to permanently check that RWAs are consistent with the actual risk behaviour of banking assets (back testing) and make any adjustments required. This is what the SSM embarked on in 2014 with a review of these models spread over four years (TRIM).

Lastly, stress tests are regularly organised for the top 130 European banks by the EBA and SSM to check that capital levels are sufficient to cover the losses recorded in banks' portfolios faced with adverse scenarios. These stress tests show that banks are sufficiently capitalized to absorb stressed losses, which support the ECOFIN statement that no significant capital is needed.

9. Conclusion

In conclusion the RWAs of European banks, approved by their supervisor, although lower than in certain regions, are reliable and constantly improving. We believe that the latest Basel evolutions, which were not designed with the objective of an equivalent level of risk mitigation across regions in mind, should not be accepted in their present state by the European Union. In addition, they do not address the main EU issues i.e. remaining pockets of high level of NPLs, low profitability linked to the persistently low rates and the intense competitive environment in Europe. Above all, not only do they create a permanent unlevel playing field between American and European banks to the disadvantage of the European banking industry, but they reduce the impact of accommodative monetary policies on mortgages, SME and project financings, which eventually mostly benefit sovereigns and large corporates.

Moreover, these measures may actually worsen the situation of EU banks impacting their profitability and triggering further deleveraging. Moreover, these unprecedented levels of regulatory capital discourage possible movements of concentration, in particular cross border ones.

Finally, as a consequence of this, the creation of jobs and growth being the main objectives of the current European Commission would be highly endangered due to a lack of credit capacity in the finance industry which cannot be compensated by the Capital Markets Union project.

They would also compromise the benefits of an international regulatory framework that has led the banks to lend with a primary focus on their customers' risks and would reduce the attractiveness of the Single Supervisory Mechanism´s action that it launched in 2014 to maintain models.