IMPACTS OF BASEL III ON EU FINANCIAL ACTIVITIES

1. The current situation

1.1. Initial impact assessment and underlying assumptions

A regulator noted that in order to assess the impacts on banks' risk-weighted assets (RWAs) and increase of capital requirements of implementing the last Basel III measures, the European Banking Authority (EBA) did an analysis of comparative aesthetics looking at the existing situation of banks' portfolios.

That came out with an average impact of 24.% increase in Tier 1 minimum required capital (MRC) for the industry overall. However, the impact is not homogenous across the distribution of banks within the EU. When looking at the distribution of banks, the median impact in the sample is an 10.6% increase in Tier1 MRC. For the smaller banks, it is 5.5%, and one quarter of the sample is subject to a T1 MRC increase close to 0% or a capital relief. It depends on a bank's business model. A policymaker noted that the EBA figures indicate that the impact on EU banks' MRC is likely considered to be quite significant. Not only because of the estimates for the average impact in terms of MRC, but in particular the more specific impact for globally systemically important banks (G-SIBs) that of +28.6%.

An industry representative noted that the increase in capital requirements will be difficult for the industry to absorb and will imply a big deterrent on overall economic growth. The potential shortfall of total capital is estimated to be about €135 billion for the sample, of which €91.1 billion of common equity tier 1. A simple analysis is also provided, which is how much of that capital could be absorbed by those entities facing shortfalls by their ongoing operations. The EBA had looked back and asked what the profitability had been for these banks in the period 2014 to 2018. Assuming they retain profits during the transitional period to rebuild their capital base, only EUR 58.7 billion of the shortfall in total capital would materialise in 2027. This shortfall is mostly borne by institutions that did not make any profits between 2014-2018.

At the same time, a regulator stressed that the EBA has based itself on very conservative assumptions on a number of issues. Additionally, it assumes that banks' balance sheets remain static during the implementation of the Basel III reforms, while in reality banks optimise their assets/liabilities structure in reaction to new requirements. Furthermore, some of the existing requirements, particularly those under pillar 2 or for macroprudential purposes, may be addressing issues that have been identified as weaknesses in the current version of Basel III. Supervisors can therefore be expected to re-consider the appropriate level of these requirements. Also, the impact was computed using the calibration of the outdated 2016 market risk regime, disregarding the revisions to the FRTB that the BCBS agreed in January 2019 and that are expected to lower the increase in capital requirements. Taken together, these caveats provide strong indications that the actual impact of the final Basel III reforms is likely to be much lower than one would expect from the headline figures in the EBA's report.

At the same time, we should not downplay the enormous challenges that the final Basel III standards will entail for European banks.. That is why continued work is needed to understand the drivers behind the impacts, and what this will mean, not only for the capital ratios of banks but also for financing the economy. That will be the purpose of the Commission's impact assessment, which will be published together with the legislative proposal in Q2 2020.

In the meantime, the final report by the ECB on the macroeconomic impacts of the reform will come forward in November 2019. The results suggest that there are modest transitional costs of the final Basel III implementation, which fade over time. The overall macro impacts of the reform are highly positive, according to the ECB estimates.

A regulator explained that the impact on Japanese banks is also mixed. Some banks are affected by the increase of the risk rate on equities. Advanced internal rating-based (AIRB) banks tend to be affected by output floors. Finally, a significant number of banks would require adjustment in their capital strategies, but many banks have gone through a period of reduced dividend payments and share buybacks, so the preparation for the implementation of finalised Basel III is broadly completed in capital strategy terms.

2. The industry perspective

2.1. Impacts anticipated by the industry

2.1.1. The proposed framework penalises at one and the same time EU consumers, corporates, the shareholders and the economy

An industry representative noted that everything depends on implementation, but it looks like a big mistake is perhaps being made. The capital framework should reflect the real risk being run and implementing this as proposed will definitely penalise particularly low-risk portfolios with high-quality unrated corporates, of which there are a large amount in the Nordics. It will penalise retail mortgage, where the Nordics have loss ratios of close to zero going back 20 to 30 years. This could have an unreasonable impact on the Nordic financial system. The country with best availability of credit and lowest cost of credit for SMEs is Finland; it has a very efficient, good banking system. Loss ratios are low, credit cost is low, and credit availability is there. There is a very serious concern that these proposals will have a real impact. The banks will survive, as they are strongly capitalised. The ones who pay for it are the customers.

An industry representative explained that their organisation sees a strong impact for corporates, and for corporate banking as a consequence. Indeed, a huge number of corporates in general in Europe do not have ratings. The European market of financing is very much banking focused, and therefore there is no upside for them to go into the rating procedures. As a consequence, this leads to either an increase of the costs of those lending procedures for corporates, or a significantly reduced variety when they want a certain instrument. Both are out of line with what is wanted in Europe. Another issue is the impact of the projected regulation on classical risk hedging, which corporates need to do, especially those unrated. There at present an expected uptick of 250% which drives some of hedging instruments out of business. There is a risk that Europe reduces the number of banks that can offer that, leading to a situation where only a non-European bank can offer certain financing. That is not in Europe's interests.

Another industry representative explained that their organisation has come to the conclusion that if, over time, it wants to come to the new regulatory capital targets, it has to curb the growth of its RWAs. With the same level of RWAs, everything being equal, €135 billion of additional money has to be frozen in the EU banks. This money will never be recovered by the shareholders, because the reserves are going to be the same as before, and the same business will be done. It is exactly like a tax over the years. Consequently, their organisation is going to limit its business and find the middle of the road, where it can keep certain activities and reduce others. Ultimately it will constrain the economy.

An industry representative emphasised the importance of accuracy. The anticipated €135 billion is only the shortfall of the current outstanding capital compared with the forthcoming minimum capital requirement. However, the true shortfall will be in fact the additional capital required to maintain current ratio of capital to RWAs, which is today in Europe 14.1% in average. It will require all existing capital in excess, plus €135 billion. Indeed, what matters for investors is the coverage of RWAs by capital. Beyond the expected regulatory adjustment, the banks will have to replenish that also. The real shortfall is much higher and has not been calculated by the EBA.

In this context, investors are not confident today in the future profitability of banks. The euro stocks banking index is close to the minimum reached during the crisis, and investors are not ready to invest in European banks. The new Basel IV requirement means future profitability will be lower.

Finally, the representative stressed that if the anticipated no macro impact or positive macro impact on the economy were right, then the regulatory capital ratio should go directly to 100%. However, the consequence of capital requirements on credit, the simple ratio to be considered is that, any additional capital requirement of €1 billion, reduces the ability to grant credit by €10 billion.

2.1.2. The projected standard represents a deep shift of the founding principles of bank regulation

An industry representative noted that the output floor and what is called 'Basel IV' are the outcome of a complete shift in the prudential approach. Basel II introduced a completely new approach based on risk- calculated internal models. Basel III confirms this approach, but with higher requirements. The Basel Committee now proposes keeping some internal models, but with input and output floors leading to almost excluding internal models. This happens in a context where in the last 20 years, regulatory instability has been eroding market confidence. At present the European bank stock index is close to the worst level reached during the financial crisis.

The main objective of the output floor is to reduce the excessive viability of the RWAs across institutions, although internal models are approved and controlled by supervisors. In addition, both the ECB with its Target Review of Internal Models (TRIM) exercise and the EBA with its IRB Repair Initiative have gone a long way to enhance internal model assessment methodology and comparability. All of this should address any supervisory uncertainty attached to internal models. Finally, the question is what the output floor will bring in addition to supervisors in terms of certainty, that the current supervisory powers and efforts cannot. Furthermore, whenever internal models are properly verified, they give the best objective assessment of RWAs.

An industry representative noted that like for the credit risk aspects for which the introduction of the output floors and the input floors introduces a complete change of approach, the Basel III latest proposals regarding market risk aspects are also a complete change. Indeed, the Fundamental Review of the Trading Book (FRTB) introduces a shift from a value at risk (VAR) approach to the expected shortfall one, which relies on a completely different in philosophy. Finally, it entails a lot of IT investments. Even smaller banks, who may be less affected, will have to pay for implementing the new, much more complicated, "standard approach".

2.1.3. Implementing the standards in the EU requires important consistency efforts

An industry representative noted that when implementing the new Basel III framework, the enforcement of output floors, it is just one component which may be balanced by an easing of other requirements. However, regulators are not actually coordinating and are not taking a holistic view. The end result is a capital base unrelated to the underlying risk.

An industry representative added that when considering implementation, it is also necessary to think about what the ratings of the parent company and its subsidiaries, should be. The rating of the Parent company needs to be further considered for the whole group, and this case the framework could be simplified. The environment is one of relatively stable negative interest rates.

2.2. Implementing Basel III in a context of reduced growth and unconventional monetary policy is per se a challenge

An industry representative noted also that banks already face conflicting demands from the same supervisors. On the one hand, the ECB tries to incentivise banks to grow eurozone lending. On the other hand, most banking supervisors in the eurozone incentivise banks to reduce lending by setting the counter-cyclical buffers to reduce what they see as overheating. More than half of European supervisors have such buffers, which are directly contradictory to the ECB. Today, the ECB tries to restore some moderate inflation and to stimulate credit further, by lowering the reference rate to 50 basis points to push people to borrow more. On the other hand, the Basel Committee and its EU members announced a further tightening of capital rules for the so- called Basel IV triggering and an anticipation of credit slowdown. The ECB, by lowering rates, wants also to lower return on savings, to incentivise households and corporates to invest in the economy. On the other hand, regulators impose on banks to finance their balance sheets with longer maturity, the net stable funding ratio (NSFR), with more subordinated debt, which is not only the TLAC but even the minimum requirement for own funds and eligible liabilities (MREL), which is a pure European thing, and hence sterilise a significant portion of investors' money for compliance to regulations.

A representative of the industry is of the opinion that the input and output floors are the outcome of a negotiation in the Basel Committee, they are not based on an objective or factual approach. They calibrate the Basel parameters mainly to reach a supervisory goal, ignoring the objective risk assessment given by internal models properly approved and controlled. In this context, since supervisors have no intrinsic democratic legitimacy, they could be challenged by legislators who may take into account other aspects, especially EU growth and competitiveness. Indeed, an industry representative stresses, it is the macroeconomic environment which led to the 2016 ECOFIN position that the ministers do not expect from the new framework any significant increase of regulatory capital in the EU. Today the environment is unfortunately one of relatively stable negative interest rates, with the side effects onto economies. That needs to be taken into account during the implementing process of the latest Basel III reforms in the EU, by considering notably whether corporates have access to appropriate financing to carry out their projects.

EU governments set a very clear mandate to the EU members of the Basel Committee, about the finalisation. There are many Europeans sitting at the Basel Committee table who made their case, yet the balance of powers at the Basel table led to this mandate being completely ignored. Indeed, the impact will be significant in Europe. According to supervisors themselves, bank profitability is insufficient. The gap of 10-15% additional capital will be reached and will perhaps trigger a triple dip in Europe. EU policymakers need to take a political decision as to whether it is still relevant to suffocate the banks, or whether the priority should be to implement growth-conducive strategies. Precisely implementing Basel IV would increase the un-level playing field, increasing the gap between the state of the regulation in the US and in Europe.

A policymaker noted that it is true that investors are worried about banks' profitability in Europe, but this has also to do with the banks themselves. Banks should first see themselves what they can do to enhance profitability. The idea that the US is not going to implement Basel III is not in line with signals the European Commission has received.

A regulator noted that the Japanese FSA and the Bank of Japan together with many European authorities insisted on the various points made all throughout the negotiation process of Basel IV. At the time of the negotiation, only Japan had real life experience of living in a low-for-long environment for more than a decade. It can affect the basic profitability level of banks. A capital market requires a certain level of internal equity for all industries.

3. The future of international standard setting

3.1. The EU legislative process should clarify whether in the EU the projected evolutions focus on reinforcing weakest banks, preserve an effective level playing field and reinforce mutual trust at the global level

An industry representative felt that between the financial or macro impact, macro impact is the one always looked at. However, the banking industry players also need to be looked at, and whether a level playing field for banks that are running lower risk businesses, or lower risk models, is achieved. In the Nordic region, banks are known to run relatively low business model risk. Much of the excesses are attributed to the G-SIBs, however they are already strongly capitalised banks. However, a system is eventually being produced in which the strong banks are being held back and the weaker ones propped up, and there is a suffocated European banking system. The industry is over capacity, and if this is implemented wrongly it will result in a suffocating the banking industry.

An industry representative thinks that should European banks not be capitalised enough, investors would be unsettled. Yet this is not happening. The evidence of the way the markets are looking at the credit quality of a bank is reflected in the credit default swap (CDS). Looking at banks as they are now, the CDSs are showing that they are not better in the US than in Europe. For example, the CDS of Crédit Agricole is better than JP Morgan. The depressed level of the value of the European bank stocks, express the lack of confidence in their capacity to deliver some return not undercapitalisation. Part of this EU bank undervaluation stems from the looming bank regulation. Conversely in the US, it is widely accepted that even Basel III is not going to be fully implemented let alone Basel IV. The current mood in US regulatory circles is not to add new constraints on banks.

A regulator noted that more capital requirements are not an end in itself, but capital requirements should be risk based. There is no proposal for 100% capital requirements or anything like it, but given the experience during and after the crisis regulatory and supervisory action was and is warranted to restore confidence in the risk-based capital framework. The goal of the Basel Committee is to provide global standards that provide a foundation for a resilient banking system including through adequate risk management and adequate capitalisation of the risks that banks are exposed to, with a view to promoting trust in the global financial system. The real estate market have been mentioned. These are very sensitive markets. A large part of the crises seen across the world had their roots in real estate markets, and booms and busts in these markets channelled through the banking sector. That issue is a cause for concern.

3.2. The EU policy objectives regarding the implementation of latest Basel III standards in a global context

3.2.1. The evolutions should preserve the risk sensitivity of Basel requirements

A regulator explained that Basel III would be a difficult agreement that took a long time and that would be perceived as an equilibrium. From the European perspective, the most important aspect of the Basel agreement is that it preserves a big emphasis on risk sensitivity. The risk sensitivity aspect, particularly the use of internal models, is widely recognised as a positive aspect. Part of that risk sensitivity is a trade-off and ultimate compromise on applying as a backstop, floors in some cases.

3.2.2. The concerns expressed by the banking industry are taken very seriously

A policymaker did not feel it is entirely fair to portray what is a capital requirement aiming at financial stability for everyone as a tax on very specific economic actors. This being said, the concerns expressed by the banking industry are taken very seriously and will be duly analysed by the Commission.

However, people should not leave the debate with the illusion that the implementation of Basel III can be done away with, or that Europe could deviate in a major way from the core elements. International standards are needed, and to not implement Basel III or introduce major deviations would significantly hurt confidence in European banks. On the final capital impact, the European Commission needs to await its own impact assessment. It is unlikely that the capital impact will be as large as it has been described by the EBA.

The output floor has to be implemented by 2027, not 2022, and that will also give time to banks to smoothen the impact. The output floor does a good job at catching banks that have low risk weights but should have higher risk weights. At the same time it may also catch banks that have low risk weights, but in a justified manner. That is something that needs to be looked at carefully.

A regulator also explained that the EBA actually has a mandate from the Commission to assess before yearend the relationship between the capital requirements and the total loss-absorbing capacity (TLAC). Part of the challenge is that some of the TLAC target requirements are still being worked through the banks, but an assessment will be done on the impact of the implications of this.

3.2.3. A consistent implementation globally

Regarding the preparation for implementation in Japan, a regulator drew attention to 11 standards agreed after the agreement of the initial Basel III, and before the finalised Basel III. Those are expected to be already implemented between 2016 and 2019. Japan implemented nine out of 11, Europe five out of nine, and the US three out of nine so far. This is not a promising number.

It was noted that the European Commission would be committed to the Basel III agreement and its faithful implementation in the EU. Implementing the agreement would be good for maintaining global regulatory cooperation and a global playing field. In addition, it is also good in that it preserves the very essence of risk sensitivity.

However, there are specificities where adjustments could appear necessary in the European context, and should be evaluated and analysed against the benchmark. Basel III is a good agreement, which fits in the global integration of financial markets, and is important to ensure a level playing field argument.

A regulator insisted on the fact that emphasis should be given to the importance of the mutual reliance on other jurisdictions' capital adequacy rules. The foundation of international banking is that banks from other countries can be trusted as truly well-capitalised. If that disappears, things go back to mutual recognition regimes.

3.3. The global consensus results from a complex decision-making process which has to encompass various regional banking specificities

A regulator noted that when Basel II was agreed many books published in Japan emphasised the defeat of the Japanese negotiators. There was a similar newspaper article after Basel III in the US. Also, there are reports in Europe emphasising that European banks are disadvantaged.

A policymaker highlighted that they were Europeans who had been at the table of the Basel Committee. The intention of the US was to do away with internal models completely in the first place, and to have an output floor around 85% or 90%. Thanks to good European cooperation within the Basel Committee, a compromise was reached, which preserves risk sensitivity in the system and internal models. It is something that that can be implemented in the EU.

An industry representative added that the framework applies across regions in the world, to banking systems with huge structural differences in banks' balance sheets. Indeed, compared to US ones European banks hold the assets on the balance sheets, in general for far longer. This leeds to apply the output floor on different basis one on either side of the Atlantic.