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Basel III finalisation might reduce European financial stability

The regulatory tightening of the financial sector following the financial crisis of 2008-9, with Basel III 'pre-finalisation' standards at the forefront, has made banks far more resilient and ready to face future crises. However, in recent years, the profitability of banks has been a major challenge. The length and depth of the recession in the wake of the COVID-19 pandemic crisis is yet to be seen, but it is already evident that this crisis affects all aspects of micro- and macroprudential regulation. Nevertheless, so far the updated framework has passed the test and proven that banks are now part of the solution and not part of the problems of a global recession. In combination with the swift response from global and European regulators clarifying or fixing regulatory inconsistencies, this has made banks capable of supporting the real economy through the recession.

Looking forward, the final part of new global standards in the form of Basel III finalisation is yet to be implemented in Europe. It is positive that the European Commission has decided to review its impact assessment in light of the COVID-19 crisis. However, given the current 'live stress test' scenario with increasing credit risk in both a broad and a sector-specific perspective, assessing the extent to which the already implemented Basel III 'pre-finalisation' framework would prove sufficient to deal with severe crisis situations should be strongly considered.

In the current situation for all European banks, any increase in capital requirements will reduce their capacity to support the real economy throughout the COVID-19 recession – and, not forgetting, to accommodate the already pre-COVID-19 urgent need for households and businesses to make sustainable investments. It is difficult to see how banks could improve their profitability although operating cost reductions are on the agenda in many banks. Thus in case of increasing capital requirements, banks will find themselves caught between a rock and a hard place – either cutting the lending book to improve capital ratios or using all retained earnings only to build up capital – in both cases not capable of maintaining their lending capacity to the creditworthy part of the real economy.

From a broader perspective, the Basel III finalisation standards have not been calibrated taking European specificities into account. For instance, European specialised, low-risk banking business models might end up being less resilient in a crisis. European banks have a much larger share of low-risk lending on their balance sheets compared to e.g. US banks, something that will be severely punished by the new 72.5% output floor, which will greatly increase REA levels and thus capital requirements in spite of no clear risk reduction effects. One example is Danish mortgage lending, characterised by especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn of capital – corresponding to a 34% increase in capital requirements. Thus, with the prospect of such a massive increase in capital requirements, for many banks it would be best to drop their low-risk business activities and instead include far riskier exposures in their lending book. This will be a problem for financial stability when the next crises hit the real economy.

The reforms implemented immediately after the financial crisis were well founded and addressed a fundamental lack of risk management in certain parts of the financial system. With Basel III finalisation, this fundamental motivation for risk management will be undermined, and the ability of banks to make quick and flexible adjustments and support the real economy in a crisis will be reduced. Based on the current shock to the global economy, it is time to reconsider the implementation of the Basel III finalisation framework. ●