Proposed changes to BCBS prudential framework : a view from the EU industry
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<u>Introduction by Bertrand Lussigny</u>, Head of the Banking & Accounting Supervision Department, Fédération des Banques Françaises

Basel III's ambition covered 5 main topics :

. increase solvency through higher levels of equity
. constrain liquidity and maturity transformation via the implementation of LCR and NSFR ratios
. limit leverage through a new leverage ratio
. constraint procyclicality through capital buffers
. achieve a better consistency and comparability of RWA (Risk Weighted Assets).

Basel III should be finalised by the end of the year. Final outcome on the RWA treatment is still uncertain; what is clear though is that, if RWA may be slightly decreasing in some areas, the increase in Risk Weighted Assets is expected to be quite significant in some other areas.

In a meeting on Oct. 12 with the European Parliament's ECON Committee, William Coen, Secretary General of the Basel Committee, after summarising the outstanding post-crisis reforms (enhancing the risk sensitivity and robustness of standardised approaches, considering additional constraints to the role of internally modelled approaches in the capital framework, and finalising the design and calibration of the leverage ratio and a potential capital floor based on standardised approaches), stated that final adjustments to capital requirements would have only measured impact on banks' capital. This is actually not true, and the banking industry expects an additional significant impact on capital needs.

Indeed, additional constraints on banks may cause direct limitation to the financing of the European economy. Banks still account for 75-80 % of the financing of companies in Europe vs 20 % in the US. European banks have already done quite a lot to adapt to Basel III requirements, through massive deleveraging: BNP Paribas for instance is twice smaller in size than it was before the 2008 financial crisis. All 5 largest banks in Europe (including 4 French banks), which account for 35 % of total bank assets in Europe, had to deleverage very significantly and limit some activities in complement to capital increase.

Banks will in any case continue to adapt. They are looking above all for clarity and certainty, as well as for a real level playing field. Banks thus stand ready for acceptable adjustments that may help conforting confidence and resilience of the financial sector. However, a Basel III/IV final outcome resulting in new capital increase over 5 % at EU level would not be acceptable by the banking sector: knowing that FRTB requirements already account for close to 5 %, it leaves almost no room for additional capital requirements for credit and operational risk.

Banks call for not underestimating the impact of Basel III final implementation, which brings much more than adjustments. This is why what is currently being discussed in the BCBS - actually a whole new set of rules - should rather be referred to a Basel IV.

Presentation by Gonzalo Gasos

Basel III has been accomplished

This statement does not originate from the banking sector only. It is fully acknowledged by the BCBS, which in its Basel III Monitoring Report dated March 2016 indicates that « all large internationally active banks meet Basel III minimun and CET1 target capital requirements ». This is official recognition of the tremendous efforts from banks to recapitalise as requested.

When first assessing the Basel III impact in 2010, the EBF estimated a €559 bn need for additional capital, a figure later confirmed by EBA with had estimated initial shortfall of €544 bn in 2011. EU banks recapitalisation reduced the shortfall in total capital down to only €5 bn in 2015 and in CET1 to 0. The ambitious program set out by the Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, can thus be considered as completed. Banks have indeed set up a very substantial recapitalisation: CET1 jumped from 5.3 % in June 2011 up to 12,7 % in Dec. 2015, while Total Capital increased from 8.1 % to 15.8 %.

In principle, no further increase in capital is thus sought. The BCBS has been continuing working on the finalisation of Basel III, and decisions are expected in the coming weeks. The implementation of final measures to complete Basel III is actually supported by the G20 finance ministers and central banks governors. The G20, however, explicitely stated that they support the work by the Basel Committee to refine elements of Basel III framework <u>without further significantly increasing overall capital requirements</u>.

There is nevertheless a sense across the sector that the resulting demand for fresh capital could amount into hundreds of billion euros. Work is underway at BCBS with outcome by year end.

Where does the EU banking system stand ?

EU banks recapitalisation has now been very largely completed. Between 2010 and 2016^{E}, CET1 of European banks grew by 210 %. The iIncrease was much lower (63 %) in American banks, where CET1 was higher in 2010 than in European banks, but is now significantly lower than in their European peers.

This resulted in an unsustainable model for the European banking industry. As evidenced in the ECB communication on « Challenges for the European banking sector (2016) », the cost of equity for listed euro area banks has been exceeding return on equity since 2009, when a ROE gap appeared. Additionally, price of euro area banks has been consistently remaining below book value, whereas US banks have been regaining since 2014 a price to book value ratio higher than 1. EU banks have, as a consequence of lower profitability and strong deleveraging, been sliding in world rankings: while 15 European institutions appeared among the 30 largest banks by market value in 2003, there are only 6

European banks among the 30 largest bank capitalisations in 2016, whereas American banks were maintaining their positions.

Various factors (international emergence of Chinese banks, resilience of Canadian and Australian banks, …) certainly contribute to explaining this drop in rankings for European banks. However, the impact of prudential regulation is undoubtly key in this evolution, which may ultimately raise questions about the adequate cover of the financing needs of large European companies.

The impact of Basel IV would be huge for the EU, unless current proposals are carefully reviewed

Basel III, which was the anwser of the Basel Committee to the financial crisis, included in its Dec. 2010 définition 4 chapters or objectives :

. strengthen quality and quantity of capital : this has been completed
. improve risk coverage : this is currently being implemented (FRTB/market risk)
. implement a leverage ratio : in process
. improve management of the liquidity risk through the creation of the Liquidity Coverage Ratio (LCR, 1 month liquidity ratio) and the Net Stable Coverage Ratio (NSFR, 1 year liquidity ratio) : in progressive implementation untill 2018.

What is not included in this package does not really belong to Basel III. In that respect, Basel IV introduces a wide pack of new high impact rules:

. a revision of the strandardised approach for credit risk
. constraints and removal of internal models
. new floors based on the standardised approach
. a revision of the operational risk framework.

Additional prudential requirements are even sometimes refered to as Basel IV+ :

. the potential impact of IFRS9 Expected Loss model
. the TLAC requirements as of 2019
. the TLAC requrements as of 2022.

Untel now, the Basel rules had concentrated on the numerator of the capital ratio. Work is being done now on the denominator (RWA). Potential impact on assets derives quite logically from increasing the mesure of RWA and keeping the capital ratio unchanged: assets should clearly be adjusted downwards.

The risk weight density is actually similar in the EU and the US

Comparing the risk weight density - defined as the quotient between RWA and total assets - is misleading and has given rise to a widespread misconception that EU banks bear less prudential pressure. In an IMF landmark study, EU banks exhibit lower risk weight density (35%) than their US peers (57 %).

Various factors can actually explain the difference:

. accounting standards: total assets under IFRS look much bigger than under US GAAP due to derivative netting rules; as a result, the RW density looks smaller under IFRS than in US GAAP (countries under IFRS typically show RW density of 35 to 40 % vs 64 % for non-IFRS countries)
. mortgage loans : in Europe, the residential mortgage class represents 24 % of bank loans (€6.5 tn in bank balance sheets) with lower risk profile pulling down the RW density of EU banks, whereas the bulk of mortgage loans in the US is transferred to Governmement sponsored entities and disappear from banks' balance sheet
. Pillar 2 : Pillar 2 requirements (2 to 8 % for the majority of EU banks) are not taken ito account for RW density, which relates to Pillar 1 only
. operational risk : RWA for operational risk are not counted in the risk weight density metric
. software : Europe requires full deduction instead of 100 % as for plants and equipement; this element grows in importance due to inceasing investment in software and fintech related activities.

When cumulated, those factors are equivalent to 20 % of risk weight, and bring the EU density up to 55 % i.e. at a similar level as the US, which means that there is actuallyno level playing field issue for RW density.

What should be done ?

The EBF provides a series of recommendations :
. maintain Advanced Internal Risk Based (AIRB) models for corporate exposures
. define and calibrate Unilaterally Cancellable Commitments (UCC) :
. recalibrate mortgage RWs in the standardised approach :
. leverage ratio should prevail over output floors
. make operational risk requirement stable
. let regulators and supervisors review IRB models according to global standards, as EBA is engaged in.

It is necessary to fully assess the impact of ongoing discussions in Basel on the various banking business lines: bank exposures, corporate exposures, retail exposures, equity exposures, specialised lending (where special concern exists about possible increase in capital requirements in infrastructure financing despite low level of losses) or residential mortgage portfolio. The pressure is very high on output floors, but level and calculation will have to be more explicit.

Conclusion

Basel III has been accomplished. Additional refinements can of course be considered, but this should be done without a significant increase in capital in the EU. Anyway, it is time to turn the page of Basel III/IV in order to let banks operate in a clear and stable context, and concentrate on the real challenges of the banking industry which are the low interest rates, low returns and technology change. Finalising Basel III/IV is also necessary to give to the market a sign that the banking post-crisis reforms have now been fully implemented. The European Banking Federation remains extremely concerned by the risk of adverse impact - on banks and on the financing of the EU economy - of ill-calibrated measures which may emerge from the ongoing discussions in the BCBS.

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Following the presentation, the discussion was about :
. the low ROE in the industry, which can be explained by the combination of uncertainties as regards the outcome of discussions in Basel, some remaining distrust on the sector fuelled by concerns of banks in some countries, and the above-mentioned challenges
. the need for improved governance of data management and reporting frameworks at national and European levels
. the responsibility of supervisors as regards bank internal models, which must not be considered as black boxes: supervisors must ensure building adequate human resources to be able to go deep into models in order to be in capacity to challenge and then validate them
. the necessity to reach an agreement on Basel IV to close a long period of dicussion and uncertainty: proposals of the Basel Committe should be discussed at the level of the GHOS on January 11, 2017; if necessary, it would be better to postpone by a few months to reach a agreement acceptable to all, but turning the page rapidly now is highly desirable.