

FINDING THE RIGHT BALANCE OF THE NEW BASEL FRAMEWORK

Introduction

European banks wish to draw the lessons from the crisis and take all necessary measures to reinforce the financial system and play their full role as fund providers to the economy.

Banking regulation and supervision in Europe - but also globally - is subject to a process of intense reform. The driver for that reform is the government-driven G20 roadmap

A number of remedial actions have already been taken in the past by the regulators/supervisors and the European banking industry in the aftermath of the crisis:

- Strengthening the capital base, incl. the capital requirements of banks' trading book;
- Regulation of securitisation (retention mechanism at origination and reconsideration of the use of special purpose vehicles);
- Recapitalisation of the industry by means of a reassessment of capital treatment of banks' trading book
- Design of new, reinforced supervisory authorities in the EU.
- Revision of supervisory approaches in a number of jurisdictions.
- Stress testing exercises.
- Improvements of risk management practices
- Closer control and tangible improvements in internal governance under a tighter supervisory environment.

In this context, European banks re-affirm their support for the G20 measures have to be implemented and agree that in particular, the banks' own funds need to be strengthened where risks are greatest. They therefore support the Basel Committee proposals on trading book and the objective of the harmonisation of the definition of capital.

There is, however, a limit to the amount of extra regulation that the banking sector can sustain, particularly if it is to preserve its capacity to finance the economy. There is also a limit to the competitive distortions in the global market place that the European sector can withstand as a result of ill-implemented regulatory changes.

In addition to the ongoing remedial action described above - that still need to be fully implemented and its functioning properly assessed - the European banking sector is facing two new, major waves of proposed regulatory change:

- The December 2009 Basel proposals on how to strengthen global capital and liquidity regulations.
- Proposals targeting "systemically important financial institutions" (SIFIs) which tally with policy debates around avoiding massive government rescue measures in the future. It includes proposals on specific capital and liquidity surcharges for SIFIs and crisis management (i.e. contingency plans and resolution frameworks).

The subsections below contain a number of concerns as to the specifics of the above proposals.

In Europe, the economy is very dependent on bank lending. According to the European Central Bank, bank loans have accounted for around 85% of the total external financing of the private sector in recent years. Bank lending is therefore vital to make entrepreneurial activity possible and to stimulate much needed growth to the economy.

As a result of the crisis, investors' pressure has, however, forced banks to hold capital well in excess of the regulatory requirements. Banking supervisors have also put additional pressure on firms to have stronger capital bases commensurate to their business model and activities. The regulatory changes mentioned above will also underpin that trend. Should this pressure continue to build up, bank lending to the real economy will inevitably be affected. Every euro, pound, or kroner more of core capital translates into a multiple reduction of the banks' lending capacities.

Furthermore, in Europe, the banking sector is regulated on the basis of parameters that are dissimilar to those in other major, competing jurisdictions, notably the United States which have not yet implemented Basel II and do not yet seem determined in doing so. Significant differences persist also in connected regulatory areas, such as accounting rules. The lack of regulatory convergence is eroding the European banking industry's competitive position.

EBF's principles for regulatory reform

In order to avoid the negative consequences highlighted in the preceding section, the EBF thinks that the regulatory reform underway should respect the following four principles, namely:

- a) Preservation of banks' lending capacity in the EU.
- b) Consistency in regulations (single rulebook).
- c) International level playing field.
- d) Maintenance of the banking sector competitiveness incl. the ability to raise new capital.

EBF Comments on the new Basel proposals

1. The regulation of capital and liquidity

The Basel proposals cover the following main areas:

- increasing the quality, consistency and transparency of the capital base;
- reviewing the risk coverage as regards counterparty credit risk and the use of external ratings;
- introducing a leverage ratio;
- introducing a number of measures addressing pro-cyclicality;
- introducing liquidity metrics.

The impact assessment is being carried out in the first half of 2010. Depending on the result of this assessment, the Basel Committee will then review the regulatory minimum level of capital and the reforms proposed, so as to arrive at an appropriately calibrated total level and quality of capital. The fully calibrated set of standards will be developed by the end of 2010 to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012.

(i) Raising the quality, consistency and transparency of the capital base.

The new Own Funds definition which Basel proposes basically aims at purifying the concept in using common equity (+ retained earnings) as a basic reference. The EBF shares this approach and has long called for single, global definition of capital.

Key concerns, however, for EBF have been identified in the proposed treatment of:

- Minority interests: the requirement should be that, if excess capital within the subsidiary would be so significant that it would influence the capital ratio of the consolidated group in a substantial way, the excess should be deducted from the capital of the consolidated group;
- Deferred tax assets: as DTAs do have value for firms and are verified by auditors (on the basis of strict criteria assessing a firm's future profitability), they should not be deducted from regulatory capital;
- Defined pension fund assets: We do not agree that defined pension fund assets should be deducted from the common Equity component, but do agree that the two questions of the *quantum* and *level* of any deduction in respect of such liabilities should be addressed;
- Double counting of insurance holdings: the issue of potential double counting effects of own funds between banks and insurance companies has been identified in Europe in the late '90s and we invite the Basel Committee to base its approach on that.

The Basel Committee has not calibrated yet the minimum required level of the Core Tier one, and the total ratios. Moreover, it has not yet defined what "predominant" portion of Tier 1 needs to be core capital. We reject the idea of different capital requirements for banks of different legal forms as complex competitive distortions will arise.

Appropriate transition periods will be necessary in terms of timing on the quantitative elements as well as sequencing of the qualitative elements of the new regime. The Committee has not put forward a clear proposal for the timing of transition periods, but qualitative elements can perhaps be implemented sooner whereas quantitative changes should be last. The transition periods should apply in the same way to all key jurisdictions (in synchronisation) so as to avoid regulatory arbitrage.

(ii) Expanding risk coverage by the redefined capital base

The counterparty risk involved in derivative transactions should be reassessed without removing their contribution to the effectiveness of the financial markets. We are concerned

that the Basel Committee's proposal might lead to a capital charge for credit valuation adjustment (CVA) risk that is disproportionate to the risk involved. The CVA risk is already taken into account to some degree in the current capital requirements for counterparty credit risk.

The respect for the right incentives to risk management should be observed. This involves the recognition of the diverse methodologies used in different institutions. Their functioning should only be challenged in the supervisory review process.

The counterparty valuation adjustment and other related proposals should be performed within the scope of Pillar 2.

The important role of OTC derivatives in offering efficient financial hedging to commercial transactions would be put at risk by the newly proposed measures. Non-standardised OTC derivatives remain an indispensable tool for efficient, "perfect fit" risk management of trade and industry enterprises. We advocate placing incentives to the use of CCPs without unreasonably penalising OTC derivatives notably those linked to international commerce. Moreover, the systemic risk arising from the concentration risk on CCPs should also be carefully assessed and addressed.

We believe the Basel Committee should not take a step backwards in the improvement of risk assessment by removing the use of external ratings in the standardised approach for credit risk, which would only put smaller banks at a disadvantage.

(iii) Supplementing risk-based capital requirements with a leverage ratio

The EBF appreciates the concern to address leverage in the economy from the point of view of macro-prudential supervision.

Regarding the proposed measure, however, there is widespread continued resistance to a leverage ratio as a matter of principle as it is a counter-intuitive measure in the context of a risk-based framework and, therefore, regarded as a step backwards. As stated we support more stringent requirements in areas where the crisis has shown that risks were underestimated. But a leverage restriction is by its very nature risk-insensitive. The European industry still fails to understand the **precise** objective of such a non-risk measure. In these circumstances, it is impossible to have an informed discussion on the overarching principles determining what should be in the denominator or numerator of the ratio.

The EBF advocates a "Pillar 2 approach" when it comes to assessing a bank's leverage as this allows for the necessary flexibility to take into account the business model of a bank.

Our level playing field concerns as to the comparability of a proposed leverage ratio prevail for as long as there is no clear adjustment for differences in accounting treatment across G20 member jurisdictions.

(iv) Reducing the pro-cyclicality by promoting counter-cyclical buffers

The EBF understands that more clarity on the subject of pro-cyclicality, Expected Loss provisioning and capital buffers will be provided at a later stage. The EBF especially draws attention to the lack of clarity surrounding buffers on top of the Pillar 1 minimum requirements and how all these different proposals relate to each other.

The EBF supports the provisioning based on Expected Losses (EL) model and is putting forward a proposal for a provisioning model based on the EL concept, which captures the economic reality of the lending activities of financial institutions in line with the BIS six principles to achieve sound EL provisioning approach. The EBF believes that the forward-looking element of the provisioning system will contribute to mitigate pro-cyclicality in consequence.

The proposed restrictions to dividend pay-outs would put the banking industry at a disadvantage vis-à-vis other economic sectors.

We share the concern of the Basel Committee about the excessive credit growth during the upside of the economic cycle and we look forward to participating in the outlining of measures geared to enhance stability.

(v) Liquidity risk measurement, standards and monitoring

The main driver for the proposals was apparently to ensure that individual firms would never again experience difficulties in funding their liquidity needs in the future. However, the proposals may have a very negative impact on the economy (on lending, the pricing of banking products, etc).

The EBF positioning is critical (in particular of the long-term ratio), but aimed at providing constructive input. EBF agrees with the main building blocks of the proposed framework:

- It recognises the soundness of the basic methodology which the Paper proposes to measure liquidity risk, i.e. (i) using a Liquidity Coverage metric (LCR) covering the short-term liquidity risk and (ii) using a Net Stable Funding metric (NSFR) covering funding risk.
- It accepts the LCR as an absolute metric provided that the composition of the liquidity buffer is revised. The LCR buffer relies on an assumption that an idiosyncratic crisis occurs in combination together with a market-wide crisis: in such a scenario it is impossible to imagine that central banks will not step in. Therefore, the LCR buffer necessarily needs to include central bank eligible assets.
- It accepts that banking supervisors should have at their disposal a benchmark to contain funding risk – although it believes that the NSFR should be applied in a flexible way, incl. the use of advanced approaches.
- The lack of an opt-out for banks with internal models and the highly conservative nature of the requirements mean that there is virtually no incentive to refine models. Mechanisms and parameters used in banks' liquidity risk management are therefore

likely to become extremely homogeneous in future. There is then a danger that banks will all respond to a crisis in a similar way, thus exacerbating the situation.

- It understands that central banks do not wish to be considered as lenders of a first resort. However, this concern is addressed by means of the NSFR requirements which build in sufficient safeguards.

2. Proposals on systemically important financial institutions: the management of systemic risk

Policy-makers have been voicing concern over systemically important financial institutions (SIFIs). Notwithstanding the further development by the Basel Committee in subsequent papers of the advisability of making SIFIs subject to specific constraints, such as capital and liquidity surcharges, the EBF believes that it is not size but other factors, such as interconnectedness, which have proven to pose risks of a systemic nature.

Size is not the concern – bad risk management and interconnectedness are, and here important corrective steps have already been taken by European regulators through the introduction of a harsh large exposures regime, including the interbank markets, which aims to ensure that a bank has sufficient capital in the event of failure or /default by an individual client or group of connected clients. These measures should serve as a benchmark more widely. Whilst intra-group exposure within the same jurisdiction has been exempted, the new limits in a cross-border context are expected to potentially restrict the flow of liquidity within such groups. They may be forced into the interbank market, despite liquidity being available at a group level. Raising funds in the interbank market is by nature more unstable and expensive than intra-group funding, and in the new regime itself also limited. Systemic stability considerations have prevailed at the expense of increased cost of sporadic funding for cross-border operators.

Further steps have been taken to reduce risk in the system through the introduction of central counterparties for OTC derivatives trading and remuneration principles designed to align compensation to a firm's risk profile.

Furthermore, exogenous systemic risk can be reduced to a significant extent by making sure that banks are in a position to exit the market in an orderly manner by means of appropriate resolution plans. The call for appropriate exit strategies also has to do with complexity stemming from national differences in resolution regimes and bankruptcy procedures which may result in uncoordinated behaviour from authorities in times of financial distress where cross-border banking groups are concerned.

Initiatives to reduce national differences are now being prepared both on an international as on an EU level (cross border resolution tools). More particularly, the Basel Committee is proposing to develop an internationally consistent intervention and resolution regime for internationally active institutions whilst the European Commission is working towards establishing a common framework for European crisis management.

Basically, however, the call which is being made for appropriate exit strategies aims at making sure that banks are prepared for crisis situations. Therefore, banks' managements

need to have in place a Recovery Plan spelling out a range of measures that may be taken to help the bank survive and recover from a stressed environment. Moreover, to be prepared for the possibility that the bank will not succeed in recovering, a Resolution Plan will need to have been put in place that will help the college of supervisors to wind down the bank in an orderly way, i.e. without impacting systemic risk.

[Pending the outcome of the Board (and preceding Executive Committee) deliberations it is proposed to insert a reference to financial sector tax and the interrelation with a resolution fund (two variants proposed):

- (i) European banks reaffirm that those of them who have benefitted from state aid must reimburse them, with a view to maintaining fair competition. They do not favour the introduction of new taxation mechanisms, which they think would only reduce further their levels of capital, and therefore their lending capacity. They however feel that, if such a system was to be established, it would have to meet competition and transparency rules and to benefit the stability of the overall financial system and be based on internationally strengthened principles. This means that banks in any case would oppose a tax purely to finance national budgets.*[On the other hand, banks could consider a harmonised system of national resolution fund mechanisms, provided it is part of a proper crisis management framework to be set up and meets principles agreed on at international level. -to be confirmed pending discussion at the Board.]*
- (ii) Winding a bank down in an orderly way, or putting the competent authorities in the position to intervene at a very early stage to fix an emergency situation, requires the definition of a new EU crisis management framework as well as the setting-up of a banking sector's private fund to finance e.g. the creation of a bridge bank or a smooth winding-up of the ailing bank. The EBF therefore supports the creation (of a European fund, or) of an EU network of national funds, fed by contributions from EU banks, which could arise from the financial sector levy currently under discussion at EU and global level. This means that banks in any case oppose a tax purely to finance national budgets.]

Our perception is that many banks are now in the process of preparing recovery and resolution plans and are entering into a dialogue with their supervisors on whether the arrangements which are being considered in such plans are adequate. We encourage this dialogue which we see as part of the Pillar 2 Supervisory Review and Evaluation process (SREP).

All in all, the EBF welcomes the realisation that the soundness of individual institutions need not automatically bring with it the stability of the entire financial system and applauds the creation of a **European Systemic Risk Board** (ESRB), whose role will be to supervise the stability of the whole European financial sector. The ESRB should improve the interaction between micro and macro prudential analysis, issue warnings of systemic vulnerabilities and recommend action to competent authorities. The timely information collection and exchange with micro-level supervisory authorities will be essential, also to foster greater confidence and trust among competent authorities.

Again the attribution to the **Financial Stability Board** of the same task to monitor systemic risk at the global level can only serve to forewarn competent authorities of a potential build up of exuberance in parts of the market across the globe and permit preventive rather than only corrective action as in the present crisis. This attribution can only be seen as positive.

Macro-economic impact assessments

The EBF has long been committed to understand the consequences of the regulatory overhaul from a wider perspective including the effects on the banking sector and on the real economy.

The results of the impact assessment conducted by the EBF proved the huge materiality of the capital needed in order to preserve the current levels of capitalisation over the minimum requirements, without taking into consideration the impact of the new liquidity proposals.

[The outcome of this EBF exercise led to a preliminary estimation of extra capital requirements for European banks in aggregate to the order of at least €500 bn. The main impacts are to be expected from the stricter definition of Tier 1 capital, new capital buffers and securitisation and trading book charges.]

As regards the wider economy, the preliminary findings of the EBF in collaboration with the Institute of International Finance (IIF), point to a sharp increase in the core equity shadow price. The higher cost of capital will inevitably push upwards the bank lending spread to the private sector thus shifting the credit supply curve to a reduced amount zone. This trend will end up in GDP reductions during at least the first years after the implementation of the new rules (if they are implemented in the same terms as currently proposed) since credit to households and businesses a major driver of GDP growth. The EBF is concerned as this trend will take place especially over a period of time when budgetary and monetary policy may be less supportive of the economy.

The EBF and the IIF aim to release their findings as to the impact of the new capital proposals on a number of major economic zones in a near future to assist policy-makers in the understanding of the perceived impact on the real economy across the globe.

In conclusion

The EBF acknowledges that the capital base of the banking sector needs to be reinforced, but the right balance needs to be struck between bank resilience and economic recovery.

Resilience should not be based just on more capital and liquidity but first and foremost on better regulation and improved supervision. In our understanding better regulation does not automatically translate into more regulation but is meant to enhance the resilience of the banking sector without imposing undesirable side-effects on the wider economy. In turn, improved supervision should be closer and focus on evaluating risk management and governance of institutions.

There is a need for a 2nd consultation after the calibration exercise by regulators. Despite the industry having dedicated huge resources to the analysis of the new proposals during

the last months, the newness and complexity of the measures makes us think that further assessment is needed. We understand that the BCBS has left a number of key points undefined waiting for the subsequent calibration process. In the same vein, we request the BCBS to conduct a second consultation when the results of the calibration are known and to invite the industry to revisit this first analysis (the implementation of Basel II required 5 QIS exercises). Further to the quantitative impact study, more clarity would contribute enormously to the management of the expectations of market participants, rating agencies and the industry.

Special attention is drawn to the potential penalisation of bank lending resulting from the cumulative impact of the capital and liquidity measures, if they are approved as proposed.

Transition periods and appropriate grandfathering of the existing stock of tier 1 capital should be provided for in order to allow for adaptation by banks to the new set of rules.

International coordination and synchronisation of the implementation of all these measures is indispensable. Regulatory arbitrage should be avoided and to that effect, all G20 countries should implement the package at the same time and under a homogeneous basis of accounting standards.