Basel regulations: a danger for European banks

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The ongoing Basel IV discussions seek to impose additional capital requirement on banks, a move that would disproportionately affect those in Europe. Whilst the EU is tightening its financial regulations by implementing Basel III, the US regulation is likely to be streamlined starting in 2018/19. If Europe does not react, European banks will lose importance on a global scale and it will become more difficult for them to fund the European economy.

Introduction

Since the last financial crisis, central banks have pursued a very loose monetary policy by introducing low interest rates. Gathered in the Basel Committee, central banks are now focused on macro-prudential policies by banking regulations to control the flow of credit. A better outcome is possible if they raise interest rates instead.

Basel IV

The Basel Committee on Banking Supervision (BCBS) brings together central banks and authorities responsible for banking supervision from around the world to define new regulations. Once members of the committee reach an agreement the recommendations are usually adopted on a global scale, by legislatures when needed.

The Basel Committee is currently discussing Basel IV (July 2017), a set of rules that seek to raise the capital reserves of banks, notably by forcing banks to apply globally observed default averages when evaluating their risks and to hold a corresponding amount of capital. Today, European banks extensively use internal models to calculate their capital requirements. This enables them to take into account bank-specific or country-specific elements that they employ to lower their risks. As such, bank capital requirements using internal models is generally lower than using a standardised approach.

Europe is considering draft proposals to meet all Basel III requirements, by January 2019. The US, on the other hand has not started the legislative process for a number of these recommendations.

This 'one size fits all' approach would raise output floors, which means that it would reduce the permitted difference between capital requirements using a bank's internal models and capital requirements using a standardised model. If an output floor of 75% is imposed, a bank's measure of Risk-Weighted Assets (RWAs) using internal models can in aggregate be no lower than 75% of the RWAs that would result if the bank had applied the standardised approach (that are not country-specific) (Binham, 2017). This measure would thus force European banks to increase the amount of capital they hold.

How would these changes affect European banks compared to American ones?

The European and American financial systems are different. This means that a regulatory change that would not necessarily have a negative impact in the US might have a drastic impact in Europe.

The proposed measure would mean that European banks would have to apply globally observed default rates on their residential mortgages, for instance. European banks, however, have adopted a different lending culture to that of their American counterparts, with a more rigorous assessment of each customer's creditworthiness. This is because of one crucial difference: European banks record mortgage loans on their balance sheets while American banks offload a significant amount of their residential mortgage exposures onto the securitization market, mainly to government-sponsored enterprises Fannie Mae and Freddie Mac. This means that forcing European banks to use standardised models would dramatically increase their capital requirements while American banks, because they comparatively hold much less residential mortgages, would remain virtually unaffected.

To give an order of magnitude, the five largest American mortgage-lending banks (JP Morgan Chase, Bank of America, Wells Fargo, Citigroup and U.S. Bancorp) combined hold $986bn of real estate mortgage loans (Forbes 2017). By comparison, French banks alone hold just under €1,000bn of real estate mortgage loans (Fédération Bancaire Française, 2017). These five American banks, however, also service $2.4tn of residential mortgage that they have offloaded to third parties, putting the total of their residential mortgage servicing at over $3.4tn. The total of US housing debt is evaluated at $9.1tn, with only a fraction hold by American banks (Federal Reserve Bank of New York, 2017).

If these changes enter into force, European banks will either have to reduce the number of loans they make or raise several billions of unusable capital. The first measure would severely limit these banks' ability to fund the economy, and would especially impact first-time house buyers, while the second measure would be very costly. To put this into context, major French Banks have already doubled the amount of high-quality capital or Common Equity Tier 1 capital (CET1) they hold, from 2008 to 2015, going from €132bn to €275bn. The European Banking Federation estimates that, if the output floor is set at 60%, Tier 1 capital requirements will increase by €50bn (Resti, 2016). If the floor is set at 90%, Tier 1 capital requirements will increase by €202bn. This is in addition to €250bn needed due to input floors (risk parameters for specific portfolios) and new rules on Low Default Portfolios.

It is also worth noting that additional capital requirements have already been imposed on European banks with the Minimum Requirements for own funds and Eligible Liabilities (MREL), which ensure that banks have enough capital and eligible liabilities to bail in. Capital requirements of Global Systemically Important Banks (GSIBs) will further increase in 2019 and 2022 with Total Loss-Absorbing Capacity (TLAC) requirements.

The different European institutions have repeatedly said that, even though they are committed to completing the Basel process, they will not accept any measure which would require significant increases in overall capital requirements for banks and they will not accept measures which put European banks in a disadvantageous position compared to other international banks. However, while the US is examining how to simplify the regulatory framework, Europe is currently focused on tightening regulation of the financial sector. On the 4th July 2017, Presidents Juncker and Tusk reaffirmed that the agreed reforms have to be implemented and that they should not be rolled back (European Commission, 2017).

Changes pushed by the US at a time where it plans to lower its own financial regulations

Even though the United States pushes for stricter standards at the Basel Committee, it is becoming clear, after the election of President Trump, that the US is unlikely ever to implement many of the Basel IV recommendations.

Looking at the previous round of Basel discussions, Basel III, the European legislator is considering draft proposals to meet all Basel III requirements by January 2019, a number of which focused on raising capital requirements. On the other hand, the US has not even started the legislative process for a number of Basel III recommendations and is preparing for an overhaul of its regulatory system (Bank for International Settlements, 2017). Less than a month after his inauguration, President Trump signed an executive order outlining his simplified vision of the regulatory system while also asking the Treasury to evaluate the current legislative framework. The Treasury published the first report on the 12th June 2017 with three more reports to come (U.S. Department of the Treasury, 2017).

While some of this report's recommendations would need to pass Congress, and are thus unlikely to be adopted, given the difficulty of passing a bill in the Senate, the majority of the recommendations consist of changes in the implementation of existing rules. This means that these changes are relatively easy to implement and could enter into force relatively quickly (2018/19) after President Trump replaces the heads of the regulatory agencies. These recommendations are thus more likely to be eventually implemented. Bank of America Merrill Lynch estimates that the proposed regulatory changes could unlock up to $2tn of lending or balance sheet capacity, or 11% of GDP. The increased regulatory pressure in Europe combined with a simplified regulatory system in the US would be very damaging for an already weak European banking sector.

The European banking sector is weak

In European, Middle Eastern and African (EMEA) markets, in 2011, European investment banks (excluding Swiss banks) held a 53.7% market share.
In 2015, this share had dropped to 46%.

During the same period, US banks increased their market share from 34.7% to 44.6%.

The increased regulation in Europe has been an important contributing factor to the ongoing decline of European banks on global but also European scale, as it has forced them to retrench and cut from capital market activities.
On a global scale, in 2010, European investment banks (including Swiss banks) held a 35% market share (Goodhart and Schoenmaker, 2016). In 2015, this had decreased to 30%. During the same period, their North American counterparts (US and Canadian) increased their market share from 58% to 62%. In European, Middle Eastern and African (EMEA) markets, in 2011, European investment banks (excluding Swiss banks) held a 53.7% market share. In 2015, this share had dropped to 46%. During the same period, US banks increased their market share from 34.7% to 44.6%.

Among other factors, the increased regulatory burden has already severely affected European Banks and has forced them to cut from capital market activities. While American Banks have taken an increasing share of the European Market, it is important to recall that they came under intense pressure to reduce their European assets during the last financial crisis. If European companies have restricted access to capital while other competitors around the world have more options to fund themselves, European companies will be at a serious disadvantage.

Conclusions

For all these reasons, the best option would be for central banks to rely less on less macro prudential policies and stop pursuing a very loose monetary policy by raising interest rates instead. This would allow market forces a greater role in determining the flow of credit. In designing and implementing new regulatory measures, the EU must also consider whether the regulatory burden imposed on the financial system will help or hamper the European economic recovery. At this stage, a report similar to the one published by the US Treasury may be useful to understand the full impact of the proposed regulatory framework.

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