EBA EUROPEAN BANKING AUTHORITY

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Why Basel III is good for EU banks

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Introduction

I am delighted to be here at this important event dedicated to the implementation of Basel III in the EU. The finalisation of Basel III is a key achievement at the international level. It completes the post-crisis G20 roadmap, creates a clear and solid regulatory framework, allows common rules to be applied by all the banks around the world, and ensures global level-playing field. The loyal implementation of the global standards is key for the credibility of the EU regulatory community and restoring trust in the EU banking sector.

While the global agreement in Basel is an important milestone, a lot of work still lies ahead to ensure that the framework is transposed in a timely and consistent way in each jurisdiction. Our assessment is that the long-term benefits of the reforms largely overweigh the possible short-term adjustment costs, but we need to ensure that the phase-in of the new rules is gradual in order to mitigate these short term costs. It is also of utmost importance that, while transposing the new

rules, banks overcome their own challenges, strengthen business models and improve competitiveness.

I would like to elaborate on these ideas, and, to do this, I will focus on three aspects:

First, I will provide a flashback of what the EU banking sector was just five years ago. Over the past years, there has been incredible progress in the repair of the EU banking sector in many areas, including capital and NPLs.

The progress is there, but full trust in the EU banking sector has not been restored yet. I will continue by showing how EU banks are underperforming compared to banks elsewhere in terms of investors' appetite. We must continue to work to ensure full trust in the sustainability of the EU banking system.

Finally, I will argue that implementing Basel faithfully is necessary for restoring confidence in EU banks. A strong and credible banking sector is a precondition for steady financing of the economy and growth.

An incomplete repair of the EU banking sector since the crisis

The financial crisis has caused a fall in the trust in the EU banking sector. During and in the immediate aftermath of the crisis, there was large uncertainty on the distribution of toxic assets across banks and, thus, of potential losses. There was also a strong perception that the level of capital was overall insufficient to cover those losses and the capital buffer too thin or not existent. The immediate action required was, therefore, to recapitalise banks. This recapitalisation happened quickly in the US and more slowly in the EU and unfortunately with national solutions that caused fragmentation in the EU banking area and a dangerous loop between banking risk and sovereign risk.

With the level of capital enhanced and the regulatory repair in place thanks to the first agreement on Basel III, doubts were raised on the quality of banks' assets, particularly on the level of non-performing exposures. It took the harmonisation of definitions and EU-wide asset quality reviews for gradually dispelling uncertainty of credit quality. The Council's NPL roadmap provided an incredible boost to the reduction of legacy assets.

The results of these actions are visible. Since the great financial crisis, banks have managed to raise significant amounts of new capital. Market data shows that since 2008, banks in the EU raised more than EUR 500 billion of capital. For US banks the corresponding amount was more than USD 270 billion[1]. It shows that banks have successfully been working on their capitalisation, meeting capital requirements, and better managing their capital usage.

Banks' efforts in raising capital is well reflected in their capital ratios. Since 2009, the CET1 ratio – proxied with Tier 1 ratio excluding hybrid instruments for the period 2009-2013 – increased from 9.0% to 14.6% in June 2019. This trend was of course supported by banks' de-leveraging and de-risking, which resulted in an RWA reduction of slightly less than 10% during these ten years. However, the increase in capital was by far bigger, reaching more than 40% between 2009 and now. During the recent quarters, the growth of capital ratios has decelerated. However, banks at the lower end of the dispersion have still increased their ratios. Banks representing 99.5% of total EU assets have CET1 ratio higher than 11%.

Similar to the capital ratios, banks' liquidity has also improved. The EBA monitoring of liquidity coverage requirements indicates overall strong liquidity positions[2]. Since 2016, when the ratio was reported the first time, the liquidity coverage ratio (LCR) increased from around 140% to now nearly 150%. Steadily improving LCR ratios since September 2016 have been driven by an increase in banks' holdings of high quality liquid assets (HQLAs). Furthermore, trends in EU banks' loan to deposit ratios indicate a rising importance of deposits in their funding mix. The ratio has contracted throughout the years. It is now 116.4%, which compares to 124.7% as of year-end 2014. The decline was driven by a lower growth of loans than deposits.

On asset quality, banks have also shown great efforts in reducing their NPLs. EU banks' NPL ratio is now 3.0%, which compares to 6.5% at the time of the introduction of the non-performing exposures (NPE) definition at the end of 2014. The NPL ratio has improved by an average of 80 bps each year. The improvement in the ratio is mostly attributed to the reduction of the gross carrying amount of NPLs, which stood at EUR 636 billion in June 2019, nearly half of the amount in 2014. Increasing total loan volumes have also helped reduce the ratio.

[1] Source: S&P Market Intelligence (transaction statistics, including primary and secondary offerings, but might not include private capital raisings).

[2] See EBA 2019 'Report on Liquidity Measures under Article 590 (1) of the CRR', 2 October 2019, based on a sample of 136 banks, https://eba.europa.eu/eba-reports-on-the-monitoring-of-the-lcr-implementation-in-the-eu.

Despite their many achievements in different areas like capital and asset quality, EU banks have struggled to improve their profitability. On average, EU banks' return on equity (RoE) is below their cost of equity (CoE). EU banks' current RoE stands at around 7.0%. It compares to CoE, which is currently estimated by analysts at around 8% to 10%. The EBA's Risk Assessment Questionnaire similarly confirms that a majority of banks estimate their CoE within this range[3].

The RoE of EU banks is also below their US peers. The RoE of US banks reached 10.8% as of Q2 2019, which is nearly 4 p.p. above their EU peers. This difference in performance has been persistent during the last years. In 2014[4], the RoE of US banks was 7%, exactly twice the value of EU banks' RoE.

Higher profitability of US banks is supported by their higher efficiency. EU banks' cost to income ratio (CIR) was 64.1% as of June this year, according to the EBA Risk Dashboard, which compares with 62.4% for US banks[5]. Whereas this difference is not significant, the underlying trends have been strongly diverging. EU banks increased their CIR since 2014 from 62.9%. US banks, in contrast to their EU peers, managed to reduce their CIR during the same period, down from 71.8% in 2014. EU banks have not able to reduce their costs at the same rate their revenues contracted. The EBA's Risk Assessment Questionnaire confirms that banks are aware of this challenge, with more than 50% of the banks agreeing that operating expenses are a key priority area for improving their profitability. In their answers, they highlight mainly reductions in overhead and staff costs while pointing to the need to increase investments in automatisation and digitisation.

Market valuation also shows a general reluctance of global investors to invest in EU banks. Less than 30% of EU banks were trading at a price to book multiple above 1 as of September this year[6]. In contrast, more than 80% of US banks trade at a price to book ratio above 1. The different situation contrast to similar valuations between US and EU banks at the beginning of 2008. These multiples show that investors have doubts on the long-term sustainability of the earnings of EU banks. There might be many reasons for such dynamics, including macro-economic conditions and trade disputes, impact from monetary policy, credit growth and competitive dynamics. I must admit that uncertainties related to the regulatory environment might add to this.

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[3] Source RAQ (autumn 2019, not yet published): 57% of the banks see their CoE between 8% and 10%, 18% below 8% and 24% above 10%.

[4] 2014 was chosen as since then, a broad sample of EU banks have reported this data to the EBA.

[5] Source for US data: Quarterly Trends for Consolidated U.S. Banking Organizations, NY Fed, https://www.newyorkfed.org/research/banking_research/quarterly_trends.html.

[6] Source: Bloomberg data.

In my view, however, EU banks also suffer partly from lack of trust due to the way the EU implementation of global prudential standards is perceived. In 2014, the Regulatory Consistency Assessment Programme (RCAP) came to the conclusion that the EU adoption of the Basel risk-based capital standards through the CRR and CRD IV is materially non-compliant. Following this assessment, Fitch for instance argued that "making EU banking regulation fully compliant with Basel standards will be [...] important for […] restoring investors' confidence in risk-weighted assets (RWA)." They concluded that "an EU move to improve Basel compliance would aid [the] analysis of bank capital, and reduce investor scepticism."[7]

Similarly Moody's stressed that, and I quote, the "BCBS' finding is credit negative for EU banks, because they are subject to a regulatory regime and to capital requirements that are not as rigorous as those in other countries." The analysts stressed that the EU's assessment was the weakest at those times.[8]

These aspects have hardly been the reason for banks' subdued profitability in the EU, and for the banking sector suffering from low valuations, but they are like to be contributors – and something we all have to work on.

Towards the implementation of Basel III

This brings me to the core of today's conference: how to implement the final Basel III package in the EU. The financial crisis has shown that the previous system of international rules was not fully adequate, in part because the credibility of internal models was questioned, leading to markets challenging the capitalisation of some banks, and to an uneven playing field.

Already in December 2013, an EBA report on comparability and procyclicality of own funds requirements under the IRB approach showed substantial divergences in the approaches taken by institutions and approved by supervisors. As a result, the EBA set out a roadmap in February 2016 to face the concerns about undue variability of own funds requirements for credit risk stemming from the application of internal models. The objective of that roadmap was to enhance robustness and the comparability of the internal risk estimates and own funds requirements of institutions in

[7] See FitchRatings, Full Basel Compliance Will Be Tough for EU, 11 December 2014, https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Full-Basel-Compliance?pr_id=948175.

[8] See "Inconsistencies in the EU's Implementation of Basel III Are Credit Negative", in Moody's Credit Outlook, 11 December 2014, pages 7 to 9.

the EU, as well as to improve the transparency of the models and their outcomes, in order to restore the trust in the use of IRB models.

The EBA consulted on the prioritisation and general outline of the review with the industry. Although the regulatory review required institutions to restate historical data and redevelop models, the industry was supportive of the need for improvements and clarifications. Both supervisors and the industry shared the motivation to improve comparability of risk parameters, while maintaining the risk sensitivity of own funds requirements. The regulatory review was based on the belief that the IRB framework has proven its validity as a risk-sensitive way of measuring own funds requirements and that significant advantages of this approach result from improved internal risk management practices required by IRB institutions.

In November 2018, with the publication of the final draft regulatory technical standards (RTS) on the nature, severity and duration of an economic downturn, the EBA finalised its regulatory review of the IRB approach as set out initially.

The EU preference was for a bottom-up repair of internal models and our stance at the Basel table has been quite clear from the beginning, namely putting an emphasis on maintaining a risk-based framework. In many aspects, we have been successful. The standardised approach tomorrow will be more granular and more risk sensitive than today.

The EU also defended the specificities of our banking market. This is how the Basel framework became closer to the EU approach, acknowledging the lower risk weights for SMEs (in EU this took the form of the SME supporting factor), different treatment for covered bonds, as well as the loan splitting approach for real estate. All these measures that have been part of the EU framework already for years, have now been incorporated into the Basel rules and hence they will be adopted by our international partners too.

There are also aspects that are viewed as less favourable for the EU banks. The most obvious one is the output floor, which is clearly a compromise, which was fiercely negotiated down by the EU from much higher levels. It is a compromise making all parties relatively unhappy, but it was the price to pay to reach a final global agreement that preserves the use of internal models. Its final calibration is much better than what was originally discussed.

Together, all these rules represent the new global standards that should apply to all jurisdictions that are committed to Basel guidelines, including the EU.

In 2018, shortly after the publication of the new standards, the European Commission launched a request to the EBA to assess the impact of the final Basel III standards, if implemented in the EU. In August this year, the EBA published its quantitative assessment of the impact and policy recommendations. We assessed the increase of overall capital requirements, including total capital, Pillar 2 and buffers.

Due to the complexity of the exercise, to assess the impact we had to make several simplifying assumptions. We assumed that banks do not change their behaviour as a response to the new rules, their balance sheet remains unchanged and that Pillar 2 and all other buffer regulatory requirements also remain the same as today when expressed as % of the new RWA after the implementation of the Basel 3 reform. We also assumed that the existing provisions in the EBA regulation that were not currently Basel compliant will be changed in line with the Basel regulations. In summary, we made rather conservative assumptions.

Using these conservative assumptions, the EBA’s assessment is that capital requirements may increase by 24.4%, on weighted average terms. While I do not want to go into all of the technicalities of the calculation, it is important to understand how the EBA methodology works, as the impact is not purely driven by the final Basel III rules.

First, the reform has a materially higher impact on large and systemically important institutions than on medium-sized and small ones. On average, large banks see their capital requirements increase by 25%, while medium-sized and small banks see their capital requirements increase from the baseline levels by 11.3% and 5.5% respectively. There is even a non-negligible group of institutions in the sample who see their capital requirements decrease as a result of the implementation of the final rules.

This is what was intended. It is large systemic banks that are the most ardent users of IRB models and who posed the largest risks during the crisis due to their systemic importance. Increased requirements to offset those risks should not come as a surprise. In fact, the rules were designed in such a way as to impose higher capital requirements to these types of banks. In other words, this distribution of the impact across banks is not an unintended consequence that we need to address.

We can see similar patterns for the shortfall. The aggregate capital shortfall was found to be EUR 135 billion, out of which EUR 134 billion (i.e. more than 99%) is in the large institutions. Among the smaller ones, many actually show surplus capital.

Second, a large part of the impact in our analysis comes from reversing EU specific policies that are non-compliant with Basel, such as the SME supporting factor and CVA exemptions. In the EBA view, the reduced capital in these cases was not justified from a risk perspective in the first place in the original CRR. To be fully compatible with the Basel rules, these deviations need to be reconsidered. Europe should align with the Basel agreed standards on this front. As you know, Basel is going to consult the calibration on CVA and we think we should stick as close to Basel as possible.

The impact assessment is not finalised yet. Since Basel issued the rules on FRTB only in January 2019, we also delayed the impact assessment on FRTB. In addition, the possible recalibration of CVA requirements may also have an impact. The results of this updated assessment will be published soon by the EBA, and will also include the macroeconomic impact assessment. Just to give you a flavour, the macroeconomic impact assessment shows that there are modest transitional costs of the final Basel III implementation, which fade over time, while the longer-run benefits are substantial due to higher long-term growth and lower probability of financial crisis.

Finally, given the assumptions of static balance sheet requirements that we used, the estimated impact assumes that existing Pillar 2 and other buffers remain at current levels. To the extent that some of these buffers currently reflect weaknesses in Pillar 1 requirements that will be addressed by these final changes in Basel 3, the existing buffers may well be revised. In fact, the EBA makes an explicit policy recommendation in our response to the Commission that overall requirements should be reviewed in light of recalibration of Pillar 1 to avoid possible duplications.

The industry has numerous times shown concern with regard to the level playing field, particularly in relation to the US banks, after the final implementation of Basel III. This is something we care about too. Basel monitoring results show that the impact of the reforms is higher on the EU banks than on the US banks.[9] However, while we did not do a detailed assessment to compare the current EU versus US requirement, the baseline from which the impact on EU banks is measured was more favourable, due to various EU policies that allow for lower requirements -such as the CVA

[9] Basel monitoring (March 2019): The impact on MRC across regions is very heterogeneous for Group 1 banks with a moderate increase shown in the Americas (1.5%), a moderate decrease in the rest of the world (-2.7%) and in contrast to this a strong increase in MRC for European banks (+21.3%). (data as of 30 June 2018).

exemptions and SME supporting factor- which do not exist in the US. In addition, the US banks already apply a version of the output floor. All this shows that the impact of the new rules are relative, and we cannot say that the rules in the EU are harsher than they are in the US just based on the impact figures alone – we need to understand also the baseline. In fact, final Basel III rules, when implemented in full by all the jurisdictions adhering to Basel, will ensure this level playing field.

Taking all these results into account, we made many recommendations to the European Commission that would facilitate a smooth implementation of the new rules. I would like to insist on three general principles underlying the main recommendations and explain why we made them and what are their implications.

First, now that the Basel III is finally here, it is important to ensure that EU implements this in full, and avoids any material deviation. The reforms will introduce more risk-sensitivity in the framework and the output floor will serve as backstop to internal models. Should we instead choose to deviate substantially from Basel, we risk undermining the overall global framework. The EBA stance on this point is, therefore, clear, that we need to loyally implement the reforms. Any argument to adapt the agreed reform to European specificities should remain faithful to the intended goals in the Basel reform.

Second, international co-ordination is necessary to ensure full implementation by all jurisdictions and global level playing field. Unilateral implementation by only a partial number of jurisdictions will not bring us to a better system. Deviating in the long-term would risk fragmenting the rules underpinning the global financial system. Differences in the rules across jurisdictions would likely trigger a regulatory race to the bottom, which is not a prudentially sound outcome and will certainly backfire in the event of another financial crisis.

Finally, in the EU we should recalibrate overall capital requirements to take into account enhancements from the Basel reform. While this will remain a case-by-case decision, competent authorities should take due account of the new requirements (including the impact of the output floor) and avoid overlap in objectives between the Pillar 1 rules established by Basel and other measures such as Pillar 2 and systemic risk buffer.

We will continue to closely monitor and assess any developments in the implementation of the reform. Moreover, we received an additional request from the Commission to conduct a more

detailed analysis on a number of issues including the treatment of equity participations, the impact on MREL requirements, and the impact of the output floor on an individual and sub-consolidated level. Some of this analysis will require further data gathering from banks and we are in the process of collecting it. We will deliver a response to the European Commission in Q1 2020.

Conclusions

Implementing Basel III in the EU as agreed by the BCBS is a necessary condition to maintain open global banking markets and a level playing field. It is also our chance to build trust in our banking sector and show our commitment to global standards. The loyal implementation and preservation of open global financial markets will also bring substantial long-run benefits in terms of higher long-term growth and lower probability of financial crises.

As Europe progresses in the implementation of this crucial reform, the EBA stands ready to contribute to the debate on this topic and provide all the necessary support to the European Commission and policy makers. In any case, an open and informed debate will surely enhance our understanding of the reasons behind each policy and ensure that everyone, including the industry, are on board with the upcoming changes.

Thank you very much for your attention.