Vulcan Insight: EU BANKING – Revised Basel III

Monday 21 November 2016

Key Dates

28th Nov 2016	Basel Committee on Banking Supervision meeting
29th Nov 2016	Basel Committee on Banking Supervision meeting
5th Dec 2016	Eurogroup Finance Ministers Meeting
6th Dec 2016	ECOFIN Finance Ministers Meeting
8th Dec 2016	Governing Council of the ECB: monetary policy meeting followed by press conference
9th Jan 2017	Governors of the Bank for International Settlements to affirm Basel committee decision
10th Jan 2017	Governors of the Bank for International Settlements to affirm Basel committee decision

Key Analysis

Capital Market reaction for European Banks in the days after the US election results reflected, in part, investor expectation that European Banks stand to gain from a consequential capitulation by the US on BASEL III changes (sometimes referred to as BASEL IV) under a Trump Presidency.[1]

The key source of division within the proposed revisions to BASEL III, is whether Banks can use their internal risk models to determine how much capital they should set aside for certain type of lending or securities (EU favour this position), or whether a standardised model set by regulators should be adopted (US favour this position).[2]

For the first time, in July of this year, the 2016 EBA (European Banking Authority) stress tests included "operational risk losses".

> "The methodology of the 2016 EU-wide stress test required banks to project operational risk losses applying their internal models, but subject to strict floors based on their loss experience. In

[1] http://www.wsj.com/articles/bank-stocks-in-europe-soar-1478779448
[2] https://www.ft.com/content/15e6e51a-a279-11e6-82c3-4351ce86813f

particular, additional guidance and reporting requirements were set for material conduct risk events determined primarily by interaction between supervisors and banks and featuring for example mis-selling, market manipulation and money laundering."[3]

On the 12th of July 2016, all 28 EU Finance Ministers agreed a joint statement which stated that the group;

> "NOTES that the reform package [Basel III] would not be expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions of the world."[4]

It was reported on the 23rd of September 2016 that the EU are opposing the US calls as part of BASEL III to impose "a restriction on firms' use of their own statistical models to measure" operational risk and replace with a "a standardized formula set by regulators".[5]

The European opposition to revisions has subsequently been spearheaded by the German banking industry with Deutsche Bank, at certain moments, leading the charge. In the 2016 EBA Stress Tests, Deutsche Bank reported under the baseline scenario operational risk exposure of €94.5 billion which the CEO John Cryan has stated is of even greater concern to the Bank due to potential changes from the Basel Committee on Banking Supervision for calculating operational risk. The disputed changes according to Cryan could lead to "quite a significant inflation in the amount of capital that would be required".[6]

At a press conference on the 28th of October 2016, the head of Germany's BdB banking association, which represents Deutsche Bank and Commerzbank, stated that Europe should not implement the revised Basel III rules as a last resort, if these changes are forced through.[7] The head of the Association of German Public Banks (VÖB), which represents Germany's Landesbanken, has also expressed their opposition, stating that that the proposed changes "would be a huge disadvantage for the European financial system and would also hit the economy in Europe."[8]

It is not just German Banks opposing the changes however, banks in Denmark, Sweden, Finland and the Netherlands have all expressed their opposition in a joint statement on the 15th of November 2016.[9] French

3 http://www.eba.europa.eu/documents/10180/1532819/2016-EU-wide-stress-test-Results.pdf
4 http://www.consilium.europa.eu/en/press/press-releases/2016/07/12-conclusions-banking-reform/
5 http://www.bloomberg.com/news/articles/2016-09-23/eu-opposes-key-plank-of-basel-s-global-bank-capital-rule-revamp
6 http://www.bloomberg.com/news/articles/2016-06-02/deutsche-bank-sees-capital-hit-as-basel-rules-add-to-legal-woes
7 https://www.ft.com/content/fba46544-9cf4-11e6-8324-be63473ce146
8 https://www.ft.com/content/fba46544-9cf4-11e6-8324-be63473ce146
9 http://www.reuters.com/article/eu-banks-idUSL8N1DG1IZ

Bank SocGen has already indicated that it "may be forced to adjust its capital targets depending on the final shape" of the new Basel changes.[10]

Valdis Dombrovskis, a vice-president of the European Commission in charge of finance and economic policy, has already stated on the 29th of September 2016 that the EU would not accept any reforms that "lead to a significant increase in the overall capital requirements shouldered by Europe's banking sector."[11]

On the 10th of November 2016, the Economic and monetary affairs committee in the European Parliament voted in favour of a resolution that the current revision of Basel III rules is "not to increase significantly overall capital requirements".[12]

Striking a contrarian position however is the President of the Eurogroup (Eurozone Finance Ministers) and Dutch Finance Minister Jeroen Dijsselbloem, who has already indicated that "the consequence [of Basel III revisions] could be that individual banks in Europe will face higher capital requirements" rather than suggesting the Europeans would simply not implement the rules. [13]

It is important to note however, that the Basel Committee represents banking supervisors from nearly 30 countries and does not include the European Commission, European Parliament or EU Finance Ministers. While the European Commission may have responsibility for proposing any regulations necessary to bring the changes into the ambit of EU law, the European Commission has no decision making powers on the revised changes from Basel. The actual decision making from a European perspective on Basel, will fall largely to the ECB as single supervisor of all European Banks, with potentially the Bank of England having larger sway from a UK perspective in the BREXIT environment.

The final meetings for the Basel Committee on Banking Supervision to find agreement on these issues are due to take place on the 28th and 29th November 2016, and were supposed to be ratified by the Governors of the Bank for International Settlements meeting on the 9th and 10th of January 2017.

All of these meetings take place before the inauguration of Donald Trump. There is no evidence that Daniel Tarullo, Federal Reserve Governor in charge of bank regulation who is considered to be holding a strong

---

[10] https://www.snl.com/interactiveX/snapshot.aspx?ID=113818&GraphType=0 'SocGen may change capital targets depending on Basel IV', 4th November 2016
[11] https://www.ft.com/content/eca57e3f-4391-3a53-a55b-555562ff4a87
[12] http://www.europarl.europa.eu/news/en/news-room/20161108IPR50512/basel-iii-revision-meps-want-to-ensure-the-eu-banking-model-is-not-penalised
[13] http://www.bloomberg.com/news/articles/2016-10-11/eu-banks-may-face-capital-hit-in-basel-revamp-dijsselbloem-says

line against Europe on this issue, would be out of a job under a Trump President, with his position not due to expire until 31st of January 2022. Tarullo summed up the US positioning on this point in a speech he delivered at the 'Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, Illinois' on the 8th of May 2014.

> "The combined complexity and opacity of risk weights generated by each banking organization for purposes of its regulatory capital requirement create manifold risks of gaming, mistake, and monitoring difficulty."[14]

William Coen, Secretary-General of the 'Basel Committee on Banking Supervision' is already reported on the 12th of October 2016, as indicating that "his organization won't yield to pressures from European lenders to water down proposed new standards which could increase capital requirements."[15]

The key European decision maker on Basel is Danièle Nouy, Chair of the Single Supervisory Mechanism of the ECB, and in her testimony before the European Parliament on the 9th of November 2016, she indicated that "it is still too early to confirm the outcome at this stage."[16]

Since the Basel Committee on Banking Supervision was established in 1974, it has always been able to reach agreement on rules that have been transposed into US and European laws and regulations.[17] The 'Basel Committee on Banking Supervision' meetings on the 28th and 29th November 2016 are undoubtedly crucial meetings for the Eurozone banking system.

Should the Europeans refuse to implement the rules, or the US soften their position to find agreement, it will further feed a capital market narrative that financial deregulation for Financials in the Eurozone and the US will shape the long term outlook for the banking system not just in the US but also in Europe.

Info@vulcanconsulting.eu

[14] https://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm
[15] http://www.wsj.com/articles/basel-committee-chief-says-new-capital-rules-are-on-track-1476278276
[16] http://cn.reuters.com/article/eu-banks-basel-idCNL8N1DA5SA
[17] https://global.handelsblatt.com/finance/a-dispute-over-big-money-620606