# Vulcan Insight: EU Banking – In-depth Analysis of Basel Committee Reforms ''output floors''

**Thursday 8th December 2016**

## Key Dates

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| **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 conf. |
| **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 |
| **12th Jan 2017** | ECON Parliamentary Committee Meeting |
| **25th Jan 2017** | ECON Parliamentary Committee Meeting |

## Key Analysis

On the 28th and 29th of November 2016, the Basel Committee on Banking Reform met in Santiago, Chile with the intention of signing off the latest Basel III reforms of the global banking industry. While there was agreement on some aspects of the proposals, the key principle in relation to reducing variation in credit risk-weighted assets or ''output floors'' as they are generally known as failed to reach agreement.[1]

With this setback, the Basel Committee will almost certainly miss their self-imposed year–end deadline to secure an agreement on this wide-reaching reform. These ''output floors'' would restrict the use of banks' internal model for calculating risk-weighted assets (RWA) or loans, which in turn would determine how much capital banks must have at hand.[2]

[1] https://www.ft.com/content/7d2fdaca-b71d-11e6-ba85-95d1533d9a62
[2] http://www.economist.com/news/finance-and-economics/21711074-changes-global-rules-bank-capital-remain-incomplete-revising-bank-capital

The Basel Committee on Banking Supervision first proposed these reforms back in March of this year and were immediately highlighted by both US and European banking officials as possible roadblocks. It consulted on changes to the advanced internal ratings based approach (A-IRB) and the foundation internal ratings based approach (F-IRB). The former A-IRB approach uses parameters that are based on internal and statistical data for the probability of default (PD), the loss given default (LGD) and conversion factor (CK). While the F-IRB approach only applies for the PD.

Three core reforms were proposed[3];

- Removing the option to use the IRB for certain exposures (specifically banks and other financial institutions);
- Adopt exposure-level and conservative model-parameter floors for smaller portfolios where the IRB approach does not apply, and;
- Provide greater specification of parameter estimation to reduce variability in RWAs for portfolios where the IRB approach still remains available

These proposals arise after the Committee conducted a survey analysing the level of exposures that banks, corporates, and other financial institutions faced. Its results published in July 2013 found that;

> ''This study confirms that risk weights for credit risk in the banking book vary significantly across banks, a result that is evident based on confidential supervisory information currently available for global cross bank comparisons as well as from publicly available data.''[4]

It highlighted that there was a high degree of consistency in banks' assessments and ranking portfolios of individual borrowers. Significantly however, there was a notable dispersion in the levels of estimated risk, as expressed in the PD and LGD that banks assigned to the same exposures. The low default nature of the assessed portfolios and the lack of appropriate data for risk estimation was one of the key factors in differences across banks.

Therefore, as banks and other financial institutions are usually considered to be low-default exposures which makes the reliable parameter estimation difficult, and such exposures are usually highly rated by credit rating agencies and thus subject to significant market analysis. The Committee's proposals in March of 2016 made the following conclusion;

[3] http://www.bis.org/bcbs/publ/d362.pdf
[4] http://www.bis.org/publ/bcbs256.pdf

> ''It is unlikely, therefore, that banks' internal estimates of potential defaults or losses from such exposures will be any more reliable from a supervisory perspective than using estimates based on market data, on which the standardised approach to credit risk is based. As a result, the Committee proposes to remove the IRB approaches for exposures to banks, other financials and large corporates.''

Specifically, those that would be subject to this new standardised approach would be;

- Banks and other financial institutions (including insurance companies), and;
- Corporates belonging to consolidated groups with total assets exceeding €50bn:

Corporates belonging to consolidated groups with total assets less than or equal to €50bn and annual revenues greater than €200m would be subject to the F-IRB approach while those corporates also belonging to consolidated groups with total assets less than or equal to €50bn and annual revenue less than or equal to €200m would be subjected to €200m.

These wide-ranging proposed standardised measures would also apply to equities to ensure consistency and comparability. It is the opinion of the Committee that banks would unlikely have specific or above public knowledge of equities and therefore ''it is difficult to justify capital requirements for these exposures varying between banks.''[5]

The so-called ''output floors'' of banking capital requirements included in the new standardised approach that had been recommended by the Committee was to set an ''aggregate output floor which could be calibrated in the range of 60% to 90%.'' Although this scope is only a consideration and the final design and calibration will be informed by a comprehensive quantitative impact study and the Committee's intention not to significantly increase the overall capital requirements for banks.

Although these proposals cover a broad mandate, it is the issue that banks, other financial institutions such as insurance companies, equities, and corporates belonging to consolidated groups with total assets exceeding €50bn are to be subject to the new standardised approach that was most contentious and caused a breakdown in negotiations.

Moves to restrict the use of banks' models for calculating risk-weighted assets has been welcomed by the US and is being pushed by the current Obama administration. But, as previously noted[6], European bankers

[5] http://www.bis.org/bcbs/publ/d362.pdf
[6] http://vulcanconsulting.eu/wp-content/uploads/2016/11/No.1-Vulcan-Insight-EU-Banking-21.11.16.pdf

and officials had long regarded these proposals with scepticism and complained that they would penalise low-risk corporate loans or mortgages, which would particularly hit European countries such as Germany and Sweden.

EU policymakers raised concerns that the Basel III revision must not penalise the EU banking model and that any changes must be done so to promote fair and competitive conditions. MEPs regarded the extra capital that banks would need to be set aside to meet the new requirements as factors which would reduce the EU banks' ability to lend to the real economy and therefore weaken their international competitive position. Particularly at a time when European banks are faced with remaining high levels of non-performing loans (NPLs) and sustained low profitability, as highlighted in the European Banking Authority's (EBA) latest report on the sector's risks and vulnerabilities[7].

The economic and monetary affairs committee of the European Parliament adopted a resolution on November 23rd that stressed any rule changes must take into account the diversity of EU banking models, the various sizes of banks, and the different risk profiles which all play a key role in financing the EU economy. The groups chair, S&D MEP Roberto Gualtieri, stated that this resolution would send a *''very clear and strong signal''* to the Basel Committee.[8]

Similar concerns were raised by the International Ratings Agency, Fitch Ratings. The agency regarded any proposals to increase capital requirements for lower risk-weight portfolios, such as mortgage loans, to disproportionately hit European banks, despite the Basel committee's intention not to significantly raise capital requirements for banks globally. It acknowledged that ''European Banks generally hold larger mortgage portfolios and would be more affected''.[9]

Furthermore, it contrasted the European position with their counterparts in the United States. It deemed that US banks would be less impacted upon by these proposals as they typically sell their mortgage loans to the US government agencies and larger firms already hold capital on the higher of the standardised IRB approaches. Morgan Stanley analysts raised warnings that adopting these output floors would hit lenders across the Netherlands, Denmark and Sweden the hardest.[10]

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[7] https://www.eba.europa.eu/-/eba-sees-high-npl-levels-and-low-profitability-as-the-main-risks-for-eu-banks
[8] http://www.europarl.europa.eu/news/en/news-room/20161117IPR51564/basel-iii-revision-eu-banking-model-must-not-be-penalised-say-meps
[9] https://www.fitchratings.com/site/pr/1015093
[10] https://www.ft.com/content/7d2fdaca-b71d-11e6-ba85-95d1533d9a62

These opposing positions are evident in remarks made by US regulators such as Thomas Hoeing of the US Federal Deposit Insurance Corporation (FDIC), who warned against any possible dilution of the reforms and stressed that banks should be held to higher standards of capital to ensure safe long-run finance and economic outcomes.[11]

With Europe and the US holding conflicting views on the Basel III proposals on reforming internal models for assessing credit RWAs, it was unsurprising the most recent meeting of the Committee on Banking Supervision failed to reach a conclusive agreement on this matter. Speaking after last week's meeting in Chile, the chairman of the Basel Committee, Stefan Ingves, revealed that he still expected an output floor will be part of the reform package and *''it will be based on the standardised approach and the final calibration of the floor is subject to endorsement by the GHoS*.''[12]

If Mr. Ingves' view is vindicated, it is very probable that the European authorities will simply ignore and fail to implement any new Basel capital requirements. This view was all but confirmed at an event[13] which took place in Brussels yesterday, which was attended by Vulcan Consulting. At the event, Olivier Guersent, Director-General for Financial Stability, Financial Services and Capital Markets Union at the European Commission was interviewed. When asked whether the EU would ignore any new requirements agreed by the Basel Committee he said this is "*not an objective for the EU*" but this could be "*an undesirable consequence*".

The GHoS (Group of Governors and Heads of Supervision) is the Basel Committee's supervisory board will be meeting again in January 2017. With no final and definitive output floor being decided upon until then, it remains unclear whether this impasse can be overcome. Mr. Ingves apparent confidence on the likelihood of reaching a deal based on the latest proposals, ignores the complete divergence between US and European policymakers. It seems that these differences are unlikely to be resolved, and the new Basel revisions may not be implemented by European partners for the first time.

[11] https://www.fdic.gov/news/news/speeches/spnov0916.html
[12] https://www.ft.com/content/f26fd837-3c40-31de-87f8-86dedee532c8]
[13] http://www.politico.eu/event/politico-morning-exchange-live-with-olivier-guersent/