Finance Watch

COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
EUROPEAN PARLIAMENT
Public Hearing on 11 October 2011

CRD IV: The right conclusions from financial turbulences, the proper framework for European Supervision? »

Finance Watch would like to thank the Committee on Economic and Monetary Affairs of the European Parliament for its invitation to participate in this hearing.

In the midst of the latest financial turbulences, Europe's leaders are discussing the possibility of a recapitalisation plan for European banks. The need for building a more resilient banking system could not be more urgent.

Finance Watch’s position on banks’ capital requirements can be summarised as follows:

1. Higher bank capital does not harm banks’ ability to lend to the real economy
2. A simple leverage ratio should be the primary regulatory tool for bank capital
3. Risk weight based ratios should be a secondary tool to enhance bank supervision

Finance Watch is also of the view that when it comes to banks’ resilience, liquidity is as important as capital.

The main conclusion to be drawn from the financial turbulences of the past few years is that we should build a sustainable banking system, i.e. one that is efficient and resilient.

By efficiency we mean the ability of the banking system to serve society and the real economy, and by resilience we mean the ability of the banking system to survive an unexpected shock.

1. <u>What will be the effect of CRD IV on European banks’ efficiency?</u>

A key aspect of efficiency is:

- **Will higher capital requirements increase the cost of funding for banks and impair their ability to lend to the real economy?**

The short answer to this is “no”. Banks’ lending capability is not impaired by their chosen mix of debt and equity funding.

This can be demonstrated from financial theory and from empirical evidence.

Theory tells us that the cost of capital of banks is directly related to the risks that are inherent in banks' asset returns and, therefore, that their chosen mix of debt and equity has no influence on their cost of capital. Empirical evidence shows that there is no link between the cost of bank loans and the level of bank leverage or between bank leverage and GDP growth.

It must also be noted that if banks need to deleverage to comply with CRD IV, they do not have to reduce their loans to the real economy. They can sell other assets instead such as derivatives or trading portfolios, which constitute on average 2/3 of the assets of the largest European banks.

The second question on efficiency is:

- **Will CRD IV enable European banks to serve a diversity of customers?**

An efficient banking system gives banks the freedom to decide which assets to finance. Using risk weights as the front line regulation tool, as CRD IV does, has the mechanical effect of pushing all banks to hold the same assets. Moreover, it gives the illusion that risk assessment can be carved in a piece of legislation and that some assets are forever more (or less) risky than others. This makes the system less diverse and therefore less efficient.

2. What will be the effect of CRD IV on European banks' resilience?

This question can be approached from three angles:

- **Will CRD IV help to build more resilient *standalone* banks?**

The answer is "yes" for the following reasons:

- The quality of Core Equity Tier 1 capital under CRD IV is greatly improved in its loss absorbing capability.
- The amount of capital required from banks goes from 2% of risk weighted assets to at least 4.5% with a strong incentive to go to 7%.
- The liquidity requirements introduced by CRD IV (Liquidity Coverage Ratio and Net Stable Funding Ratio) contribute to making banks less fragile. As demonstrated by Lehman Brothers, Northern Rock, Fortis and Dexia Bank, liquidity is as important as bank capital adequacy and the way CRD IV calibrates the denominators of its liquidity ratios goes in a direction that makes economic sense.
- The introduction of a simple leverage ratio defined as total equity divided by total assets has the merit of being simple and effective. However, in our view it should be a primary tool and not just a back-stop. We will come back to this point later.

- **Does CRD IV *go far enough* in building more resilient standalone banks?**

The answer is “no” for the following reasons:

- Increasing core Tier 1 capital from 2% to 4.5% of RWA may sound like a lot but we started from an absurdly low level. The Basel II requirement of 2% corresponded on average to a capital level smaller than 1% of total assets for European banks. At 4.5% of risk weighted assets, Basel III’s capital requirement is still around a very low 2% of total assets. In comparison, it must be remembered that Lehman Brothers had a Tier 1 capital ratio equal to 11% before it went bankrupt and Dexia had a prospective 2012 Tier 1 Capital ratio of 10.4% (under Basel III definitions) as recently as July 2011.
- The concept of risk weights at the heart of Basel III (and Basel II before), is based on the notion of Value at Risk. This is a major concern as Value at Risk is a method that may have some merits in normal times but that has proved to be totally useless in times of crisis: this means that CRD IV, whose purpose is to ensure sufficient capital in times of crisis, is founded on a methodology that does not work in times of crisis.
- Risk weights are to a large degree the result of internal bank calculations and, as is now well documented, the very same assets can be given very different risk weights by different European banks. This variation means that headline capital ratios can be virtually meaningless figures for investors and regulators.

- **Will CRD IV contribute to building a more resilient *banking system*?**

The question here is to look at the resilience of the system as opposed to the resilience of banks on a standalone basis.

By using risk weights as the primary regulation tool, CRD IV not only does not improve the resilience of the banking system but makes it worse.

The reason for this is that risk weights not only push banks to all hold the same assets (a factor which, everything else being equal, increases systemic risk) but, even more importantly, they act as an incentive for banks to increase their interconnectedness (and a more interconnected system is, by definition, more fragile). Here is how it works: when a bank acquires an asset or makes a loan, it can reduce the amount of capital it must hold by hedging the position away with other firms through the use of derivatives.

The example of AIG is a point in case: in its 2007 Annual Report, AIG wrote that “approximately $ 379 billion…. of the $ 527 billion in notional exposure of AIG Financial Products’ super senior credit default swap portfolio as of December 31, 2007 represents derivatives written for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation”.

There is no reason why arbitraging risk weights should not continue under Basel III / CRD IV.

Conclusion:

A key factor in building a banking system that operates at the optimal balance between efficiency and resilience is governance. Despite its importance, for time reasons we cannot address the governance dimension of CRD IV today but it will be integral to Finance Watch's advocacy.

Our key messages today are (1) that increasing bank equity does not harm the real economy, (2) a simple leverage ratio is without doubt the best tool in CRD IV to combine our two objectives of efficiency and resilience, and (3) risk weights should play only a supporting role to avoid excess risk buildup.

As we have seen, the use of risk weights as the front line mechanism is not only inefficient but also increases systemic risk, total leverage and asset uniformity. At the same time, it must be recognized that a risk based approach is useful for supervisors to engage with banks, to understand their risks and have a ground to intervene when appropriate.

A pure leverage approach could result in banks increasing risk within their leverage constraints, as we saw with Basel 1. We therefore need a combination of pure leverage and risk weights BUT it is indispensable to put simple leverage first in order to limit as much as possible the negative effects of risk weight based capital requirements.

The economically sensible solution is to invert the relationship between leverage and risk weights: a simple leverage cap should become the primary rule and risk weights should become the back stop enabling supervisors to intervene with particular banks when they see unreasonable risks building up in the system.

Last but not least, at 33x, the leverage ratio contemplated by CRD IV is so high that it loses any economic purpose. Finance Watch will make proposals to fix this ratio at a much more economically sensible level. As the current banking situation in Europe demonstrates, this is one of the key topics, along with "too big to fail" and moral hazard, which need to be addressed radically and urgently if we do not want to see banks collapsing more and more frequently at the expense of society.