Finance Watch statement and opinion on the CRD IV / CRR package

FINANZAUSSCHUSS IM DEUTSCHEN BUNDESTAG

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Kurzdarstellung

Das regulatorische Maßnahmenpaket CRD IV / CRR ist nach unserer Ansicht dazu geeignet, die Widerstandsfähigkeit von Banken als alleinstehende Institutionen maßgeblich zu verbessern. Zu seinen als positiv zu bewertenden Elementen gehören höhere Eigenkapitalanforderungen, die Einführung anti-zyklischer Puffer und Verbesserungen in Bezug auf den Umgang mit Verbriefungen.

Trotz dieser als positiv zu bewertenden Punkte beinhaltet das Maßnahmenpaket die gleiche übermäßig komplexe, undurchsichtige und selbst-kalibrierende Methodologie wie sein Vorgänger. Dies führt zu Bedenken in Bezug auf die Robustheit des Maßnahmenpakets und trägt nicht dazu bei, Vertrauen wiederherzustellen.

Die Abwesenheit einer Schuldenbegrenzung (Leverage Cap) im finalen Text stellt zudem eine ungenutzte Möglichkeit dar, denn diese Regel war die zentrale Innovation von Basel III.

Abstract

The CRD IV / CRR package should contribute to improve meaningfully the resilience of banks on a standalone basis. Positive elements include higher capital requirements, the introduction of countercyclical buffers and an improved treatment of securitization.

However the package keeps the same overly complex, opaque and self-calibrating methodology as its predecessor. This raises questions regarding its robustness and does not contribute to restoring confidence.

The absence of a leverage cap in the final text is also a missed opportunity, as this was the key innovation of Basel III.

Finance Watch – AISBL – Square de Meeûs 38/40, 1000 Brussels - www.finance-watch.org
Tel: +32 (0)2 401 87 07 – contact@finance-watch.org

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Preliminary remarks

The G20 Declaration of 2 April 2009 on Strengthening of the Financial System called for internationally consistent efforts aimed at strengthening transparency, accountability and regulation, by improving the quantity and quality of capital in the banking system.
The CRD IV / CRR package that resulted is only a piece of the wider financial reform and is not expected to achieve that objective alone, however it is a critical piece of the puzzle and it is therefore fundamental that it delivers its promises.

We can only support the objectives of strengthening the resilience of banks and the stability of the financial system, given the huge cost of crises for all stakeholders and society at large. We also fully support the related objectives of strengthening transparency and accountability considering the urgent need to restore confidence. Trust is indeed at the core of well-functioning financial systems; without trust there is no lending, there are no shareholders, it is one of the key ingredients that has been severely damaged and must be repaired.

The crisis showed among other things the damage that can be inflicted by solvency concerns on financial institutions. Solvency concerns can be based on actual solvency issues, but also on investors' perception of solvency issues, that can be sometimes excessive or irrational. While the former can be addressed through higher capital requirements, addressing perception issues is more difficult and would require improving transparency, accountability and the credibility of solvency measures.

In this respect, we expect the new CRD IV/CRR package to be a significant reform with a positive impact on the former, but unfortunately a very weak impact on the latter: while bank capital will increase, the same non transparent, overly detailed and complicated methodology as Basel II will be used, and transparency of banks' regulatory capital and solvency will not improve.

An investor trying to assess the soundness of a financial institution would be as lost after Basel III as before. This is a missed opportunity in terms of restoring confidence, improving stability and improving banks' ability to attract new capital.

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I. EXCESSIVE COMPLEXITY, OPACITY AND A MISSED OPPORTUNITY

a. Excessive complexity

The 1600 pages of the final compromise text are a testament to the length, level of detail and complexity of the package.

There is significant evidence that making regulation more risk-sensitive, starting with Basel II and pursued in Basel III, and the related inflation in the size of regulatory proposals may not be the most effective trend.
Very detailed and complex regulations are not only easier to arbitrage, as evidenced by the large discrepancies in risk weights attributed by different banks for similar assets[1], they are also likely to be less effective and less stable over time.

Andrew Haldane from the Bank of England argued in an excellent speech[2] last year that complex and uncertain environments called for simple rules. Simple tools have been found to be superior to more complex ones in most complex environments, from avalanche prediction to heart attacks diagnostics, asset allocation or bank failure prediction.
As an example he analysed a sample of 100 large banks and concluded that a simple leverage ratio was a much better predictor of bank default risk that the complex Tier 1 ratio.

We believe that sound regulations that stand the test of time require simple rules and methodologies, aimed at providing backstops rather than micromanaging. *To quote Mr Haldane: "as you do not fight fire with fire, you do not fight complexity with complexity. (..) If a once-in-a-lifetime crisis is not able to deliver that change, it is not clear what will."*

b. Prominence of the opaque and self-calibrating IRB methodology

While we appreciate the original intention of incentivizing banks to develop internal models, we believe that the main source of complexity and opacity in the CRD IV framework is the internal ratings based approach.
The introduction of this approach led to an explosion of the number of estimated parameters required to determine risk weighted capital, and raises serious questions regarding the robustness of the framework. The thousands of parameters and related underlying assumptions make it extremely difficult to determine the soundness of the results.
The resulting opacity is an issue for all stakeholders, from regulators to investors and to the institutions themselves, insofar as it does not foster trust and appetite for bank shares.

More importantly by enabling banks to use their own internal models, the internal ratings based approach led to a "self calibration" by the industry of its regulatory capital, a related decline in the consistency of the risk weights and an incentive for aggressive institutions to use overly optimistic assumptions.

[1] Cf. chart below
[2] "The dog and the frisbee" - Aug 2012
http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf

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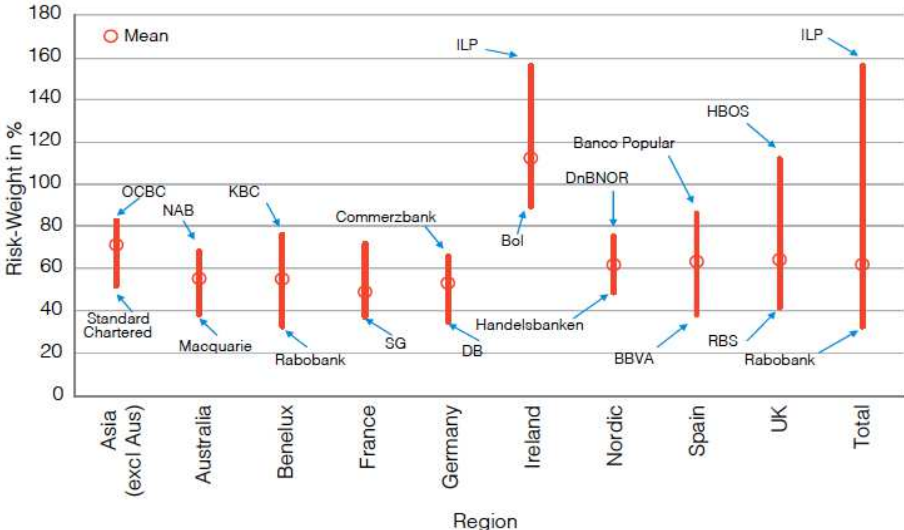
It has been abundantly documented indeed that different banks can give very different risk weights to identical assets. A study by Standard & Poors[3] showed that the risk weights attributed to corporate exposures in 2009 by a sample of banks ranged from less than 40% to almost 160%, depending on the bank; that is a ratio of one to four for similar exposures. Such a discrepancy is a perfect illustration of the consistency and robustness issues associated with this approach.

Corporate exposure risk weight range by country under the IRB approach



Source: S&P (2009)[23]

Finally the Value-at-Risk methodology used to calculate risk weights suffers from a number of well-known flaws, as it does not measure the impact of extreme rare events and introduces procyclicality in the measurement of risks.

The Basel I floor provides an indispensible backstop to address some of the issues mentioned above by ensuring that institutions maintain minimal capital equal or higher than 80% of what would have been required under Basel I; however supervisors must also actively benchmark institutions risk weights against standard portfolios to ensure a minimum consistency.

c. Leverage cap and disclosure: a missed opportunity

The G20 declaration of April 2009 called among other actions for introducing a supplementary non-risk based measure to contain the build-up of the leverage in the banking system.

A leverage ratio addresses many of the issues mentioned earlier: it is simple, robust, does not rely on assumptions and estimations, and several studies found it a much better predictor of bank failure than risk weighted alternatives.
The OECD studied a sample of 94 banks between 2004 and 2011 and concluded that " *The*

[3] S&P Approach to Bank Capital Adequacy - 2009

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Basel Tier 1 ratio found no support as a predictor of default risk. The un-weighted leverage ratio, on the other hand, found strong support."[4] In fact the OECD even concluded that "*the Basel system is excessively complex, rendering it ineffective, and that a simple leverage ratio should be the primary regulatory tool for bank capital.*" A leverage ratio is also much less prone to tinkering and much less procyclical.

A leverage ratio and leverage cap already exist in several countries, most notably in Canada were the leverage cap has been credited for the strong resilience of Canadian banks during the crisis, together with sound supervision and conservative lending practices. This is not surprising as leverage had been identified as one of the key systemic risks long before the crisis.

The introduction of a publicly disclosed leverage ratio and of a leverage cap was the key positive innovation of Basel III / CRD IV, and while we welcome the comprehensiveness of its definition, we strongly regret both the absence of public disclosure and the postponement of the cap to co-decision in the final CRD IV/CRR compromise text. At the very least we would have liked to see a sunrise clause[5] in the package regarding the introduction of this cap.
This is clearly a missed opportunity that significantly weakens the CRD IV framework, and the last minute trade-off for a bonus cap is a pyrrhic victory at best.

This is all the more disappointing and surprising that according the Basel Committee latest monitoring exercise of Basel III, the average leverage ratio of EU banks is already below the proposed cap of 3% at 3.8%[6]. The average Basel III Tier 1 leverage ratio for group 1 banks[7] is 3.7% (or a leverage of 27 times compared to the cap of 33 times) and for group 2 banks is 4.4% (or a leverage of 22.7 times).

Critics argue that such a tool is not risk-sensitive and would constrain bank lending, but it is precisely because it is not risk-sensitive that it is robust, not procyclical and provides such a useful backstop limiting leverage in the banking system.
Regarding the potential impact on bank lending, first as mentioned most banks already comply with the proposed cap, but also if the leverage cap proves more constraining than risk weighted capital, this is merely the indication that it is more robust and less likely to be manipulated.

Critics also sometimes argue that leverage ratios may encourage banks to shift to riskier assets; however putting leverage and capital ratios on more equal footings would avoid that risk, as the leverage cap would limit the level of risk while the risk weighted capital would disincentivize a shift to riskier assets.

[4] "Business models of banks, leverage and the distance to default" - OECD journal n°103
[5] A statutory provision providing that a particular measure will be introduced on a particular future date, unless action is taken by the legislature to disauthorize it.
[6] "Results of the Basel III monitoring exercise as of 30 June 2012" Basel Committee on Banking Supervision
[7] Group 1 banks are those that have Tier 1 capital in excess of € 3 billion and are internationally active. All other banks are considered group 2 banks.

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Lastly we would like to comment on Article 482 of the regulation: it provides that where appropriate the European Commission shall submit a legislative proposal on the introduction of an appropriate number of levels of the leverage ratio that institutions following different business models would be required to meet. We feel that introducing several cap levels not only would go against the simplicity and consistency of this tool, but it would also ignore the fact that all business models can be risky and that we do not know where the next crisis will come from.
Instead we would favour 2 tiered cap of 3% in normal times and 5% in crisis, identical for all banks. The double cap aims at introducing a countercylicality consistent with the countercyclical buffer and would prevent forced deleveraging during downturns. Such an approach already exists in Switzerland.

To conclude these comments, we would have liked to see a very different Basel III / CRD IV, one that:

- is simpler, shorter and more transparent
- gives more prominence to a simplified standardised approach on broad asset class basis over the IRB approach
- includes a public disclosure of the leverage ratio and a leverage cap
- puts leverage cap and capital ratios on equal footings.

II. BUT THERE ARE SOME SIGNIFICANT IMPROVEMENTS

a. Tighter definition of capital, higher capital requirements and focus on CET1

The tightening of the definition of capital instruments, requiring banks to hold higher quality forms of capital with a view to ensure their loss absorbency is a very good development. The higher capital requirements are also a much needed and welcome measure that should contribute significantly to strengthen banks' solvency and resilience. Lastly we strongly welcome the focus of common equity Tier 1 capital as opposed to total capital, as the market is also focussed on this aggregate to assess banks' solvency.

Contrary to what some critics claim, higher capital requirements do not automatically imply a sustained adverse impact on the availability and cost of lending.
First of all banks are already close to meeting the new requirements on average: the Basel Committee on Banking Supervision assessed not long ago that the vast majority of banks already meet the capital standards set out in Basel III, smaller banks being even more ready than large banks[8]. They also concluded that capital shortfalls linked to the common equity Tier 1 requirement of 7% are declining rapidly and represent less than one year of profits after tax for both group 1 and group 2 banks, assuming the full implementation of Basel III as of 30 June 2012[9].

[8] "Basel III: necessary but not sufficient" speech by Wayne Byres, secretary general of the Basel Committee on Banking Supervision - 6 November 2012 http://www.bis.org/speeches/sp121106.pdf
[9] "Results of the Basel III monitoring exercise as of 30 June 2012" Basel Committee on Banking Supervision

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Secondly the deleveraging currently underway may not be all that bad. As explained by EBA chairman Andrea Enria in a speech he gave last year[10]: "*Deleveraging could be both "bad" and "good" (..) For example, deleveraging is welcome when it entails dismissing or writing down troubled assets accumulated by banks before the crisis. (..) This process has no adverse real impact, as it does not change in any way the amount of loans. On the contrary, there is a good amount of evidence that if residual credit risk is not recognised and dealt with, it is likely that the economy remains in a prolonged period of stagnation associated with a failure to address non-performing assets.*"

On the cost of lending, an IMF staff discussion note[11] estimated that average lending rates would rise by 0.17% in Europe, without taking into account the economic benefits of financial reform. An OECD analysis[12] concluded similarly that banks would increase their lending spreads on average by about 0.15%, and this impact could be offset by a delayed rise in monetary policy rates. The expected impact is therefore very limited.

Lastly to quote again Mr Enria, chairman of the European Banking Authority: "*I do not believe that high levels of capital are a deterrent to new lending. On the contrary, banks with low capital levels – or perceived by the market as being so – are those that have had problems in increasing lending. They either face major funding difficulties – which, in turn, do not allow them to grant loans – or focus primarily on preserving their meagre capital. Banks with large capital positions, by contrast, are less sensitive to cyclical shocks and more likely to pursue lending growth strategies.*[13]"

Should some banks choose to deleverage and reduce their lending rather than to increase their capital base or reduce their distributed profits, this would thus only strengthen the case for a supervision of deleveraging as is being done by the European Banking Authority.

b. Countercyclical buffers

The introduction of a capital conservation buffer and a countercyclical buffer are also positive and necessary developments: the provision of credit and financial markets are both subjects to procyclical bubbles, and we have witnessed the dramatic impact of procyclical deleveraging and the related vicious circles of fire sales of assets triggering more asset price declines and deleveraging.
Incidentally this is why Finance Watch proposed that a future leverage cap also includes a countercyclical dimension through a flexible cap.

[10] "Supervisory policies and bank deleveraging: a European perspective" Andrea Enria - *21st Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies Debt, Deficits and Financial Instability 11th April 2012*
[11] IMF staff discussion note "Estimating the costs of financial regulation" http://www.imf.org/external/pubs/ft/sdn/2012/sdn1211.pdf
[12] "OECD working papers n°844 "Macroeconomic Impact of Basel III"
[13] "Supervisory policies and bank deleveraging: a European perspective" Andrea Enria - *21st Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies Debt, Deficits and Financial Instability 11th April 2012*

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We regret however that the risk assessments and regulatory capital remain based on a methodology and risk metrics that are procyclical, even though the use of stressed scenarios mitigates the issue.

c. Treatment of securitization

Even though very few securitizations defaulted in Europe, securitization is the tool that enabled the emergence of the originate and distribute model with the related disastrous consequences in terms decline in lending standards, reduced accountability and sometimes increased interconnectedness. Securitization is also the tool that was used for regulatory arbitrage and the related weakening of the implementation of prudential regulation. While it is not a bad tool per se, it is therefore essential to address the related issues, some of which are linked to banks.

Significant progress has been made on the treatment of securitization. The recognition of significant risk transfer in particular was long overdue, since cases of securitization with flawed risk transfer or without risk transfer have been well documented.[14] The different treatment of synthetic securitizations and resecuritizations is also a very welcome development.

We regret however the low level of the retention requirement at 5%. We believe indeed that such a level is too low to meaningfully address potential conflicts of interests and promote a necessary return to accountability and sound lending standards. As an example, we are not convinced that such a requirement would prevent another Abacus case.[15]

On a related topic as securitization seems to be perceived as one of the key tools to promote long term financing, it is important to ensure that securitization does not come back in its pre-crisis form but rather without leverage, maturity transformation, conflicts of interests, excessive complexity, overreliance on ratings and quantitative risk assessments, and with flexibility provisions for borrowers. It is also important to remember that there is a qualitative difference for borrowers between bank lending and market financing and that the development of the latter might not be entirely desirable.

[14] "Securitization without risk transfer" Acharya et al. 2010

[15] Abacus is the name of a synthetic CDO of subprime mortgages specifically picked to perform poorly. It was issued at the request of one client willing to bet on a crash of the property market and sold to German bank IKB. However the issuer misled IKB through not disclosing that another client had taken the opposite position and had a role in which mortgages were selected. As the result the issuing bank was fined $550 million by the SEC. http://sevenpillarsinstitute.org/case-studies/goldman-sachs-and-the-abacus-deal
http://www.guardian.co.uk/business/2010/jul/16/goldman-sachs-record-abacus-fine

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Conclusion

We expect the CRD IV / CRR package to improve the resilience of banks on a standalone basis and in a non-procyclical manner. The package should also reduce to some extent interconnectedness, even though it still allows for risk exposure mitigation techniques such as hedging and netting.

The impact on the cost and availability of lending should be limited and is very linked to how banks will choose to respond to the regulation, whether by reducing their expected return on equity, limiting profit distribution, raising new capital, reducing their trading book or by reducing their lending activities[16].
Regarding the impact on SMEs, while a reduction of the risk weight of retail exposures will be positive, the overall impact will depend again much on banks' response to this regulation and choice of deleveraging: whether they choose to reduce market activities or lending.

The overly complex, non-transparent and self-calibrating methodology raises some concerns regarding the robustness of the framework and is not expected to contribute positively to restoring confidence, a much needed ingredient of a well-functioning financial system.

The absence of a leverage cap is a big missed opportunity, since this tool was the key innovation of Basel III.

Lastly we believe that additional measures outside the scope of this regulation such as a regulation of shadow banking are urgently needed to avoid regulatory arbitrage undermining the effectiveness of this package and we urge policy makers to act quickly on this matter.

Zusammenfassung

Wir erwarten, dass das CRD IV / CRR Maßnahmenpaket die Widerstandsfähigkeit von Banken als alleinstehende Institutionen und in nicht-prozyklischer Weise verbessern wird. Das Maßnahmenpaket sollte zudem Probleme der Interkonnektivität bis zu einem gewissen Grad reduzieren, obgleich es immer noch Methoden der Risikominderung wie z.B. Sicherungsgeschäfte und Saldierungen (netting) zulässt.

Es ist zu erwarten, dass das Maßnahmenpaket nur begrenzt Auswirkungen auf die Bereitstellung von Kapital haben wird und dass diese stark davon abhängen werden, auf welche Weise Banken auf die neuen Regeln reagieren werden: ob sie Erwartungen in Bezug auf Kapitalrenditen senken werden, ihre Gewinnverteilungen begrenzen werden, neues

[16] Banks' loans to non-financial companies and households represent only 28% of their total assets, according to the High Level Expert Group on reforming the structure of the EU banking sector. Therefore a reduction of bank assets could also concern the remaining 72%.

Kapital aufnehmen werden, Bestand und Umfang ihrer Handelsbücher verkleinern werden, oder ihre Kreditgeschäfte verringern werden.17

Die Auswirkungen auf KMUs werden – während Reduktionen in Bezug auf die Risikogewichtung von Handelsrisiken positive Effekte haben werden – insgesamt zu einem Großteil davon abhängen, wie die Banken auf die neuen Regeln reagieren und auf welche Weise sie ihre Entschuldungsprozesse gestalten werden, sprich: ob sie Handels- oder Finanzierungsaktivitäten reduzieren werden.

Die übermäßig komplexe, undurchsichtige und selbst-kalibrierende Methodologie des Maßnahmenpakets wirft Bedenken in Bezug auf dessen Robustheit auf und ist aller Wahrscheinlichkeit nach nicht dazu geeignet, einen positiven Beitrag in Bezug auf die Zurückgewinnung von Vertrauen zu leisten, einem fundamental wichtigen Bestandteil wohl funktionierender Finanzsysteme.

Die Abwesenheit einer Schuldenbegrenzung (Leverage Cap) im finalen Text stellt zudem eine ungenutzte Möglichkeit dar; denn diese Regel war die zentrale Innovation von Basel III.

Abschließend sind wir der Überzeugung, dass zusätzliche Maßnahmen jenseits des Geltungsbereichs der vorliegenden Regulierung wie z.B. Regulierungen des Schattenbankensystems unbedingt notwendig sind, damit die Wirksamkeit des vorliegenden Maßnahmenpakets nicht durch regulatorische Arbitrage ausgehöhlt wird. Wir fordern die zuständigen Politiker deshalb auf, rasch in diesem Kontext zu handeln.

[17] Bank-Kredite an nicht-Finanzfirmen und Haushalte umfassen im Durchschnitt lediglich 28% von Banken-Aktiva nach Einschätzungen der EU-*High-Level Expert Group (Liikanen*-Gruppe) zu Reformüberlegungen des EU-Bankensektors. Eine Verringerung der Aktiva könnte daher auch im Rahmen der übrigen 72% stattfinden.

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