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Last Exit Basel III

As Regulation of Bank Capital Comes to a Close, Stability Concerns Risk Taking a Backseat

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Following the global financial crisis, in 2009 the world's major economies (G20) quickly agreed on stricter rules for financial markets. Heads of government tasked the Basel Committee on Banking Supervision (BCBS) with developing a new framework for the capitalisation and liquidity of globally active financial institutions and the agreement (Basel III) was signed in December 2010. A crucial area that was left to be finalized later were final rules on the use of banks' internal risk models. While it has been the US government's intention to restrict risk models the EU made it clear that it would not agree to additional rules leading to increased regulatory capital requirements. After a long stalemate in the negotiations, chances now seem to increase for an agreement in fall 2017 between European and US representatives in the Basel Committee. The Trump administration might be willing to meet the EU halfway and grant Europe's ailing banks greater freedom in calculating risk. But the price could be high: the US wants more leeway in national interpretations of the Basel framework. The European Commission, which will have to give its agreement in Basel, needs to be aware of the risks this poses to the stability of its own banking market.

Ten years after the financial crisis hit the US, attempts to regulate global banks are increasingly characterised by nations going it alone instead of seeking cooperative solutions that would benefit all countries in the long term. At first glance, the regulation of banks and capitalisation of globally active institutions have indeed been noticeably improved (see Chart 1, p. 2). But closer inspection reveals that consumer protection and measures that contribute to the stability of the global financial system are being sidelined in favour of the vested interests of banks and financial companies. These processes unfolding in the BCBS and other fora of financial-market regulation began well before Donald Trump was elected US president. But concern is now growing that, under Trump, the US could withdraw entirely from the international regulatory framework on financial markets. Following the Trump administration's first few months in office, the impression is hard to avoid that the odds of an internationally agreed regulation of financial markets have been reduced. Shortly after Trump assumed

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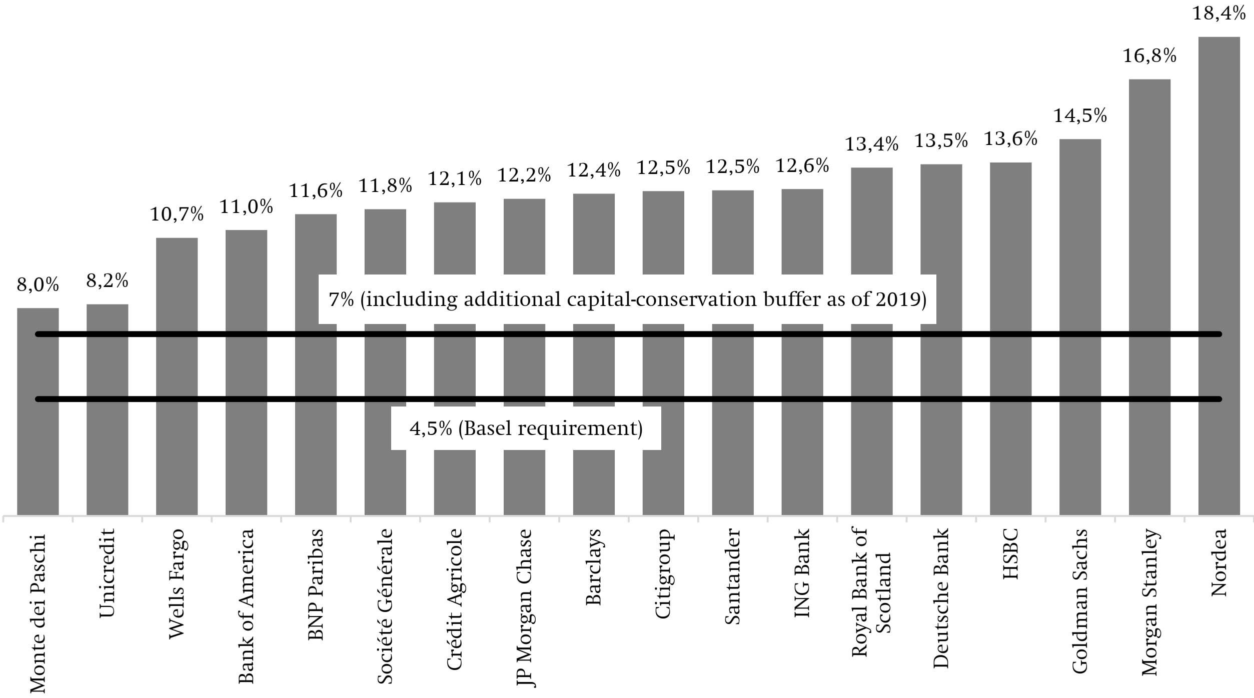
Chart 1
Risk-Weighted Common Equity Tier (CET 1/RWA)



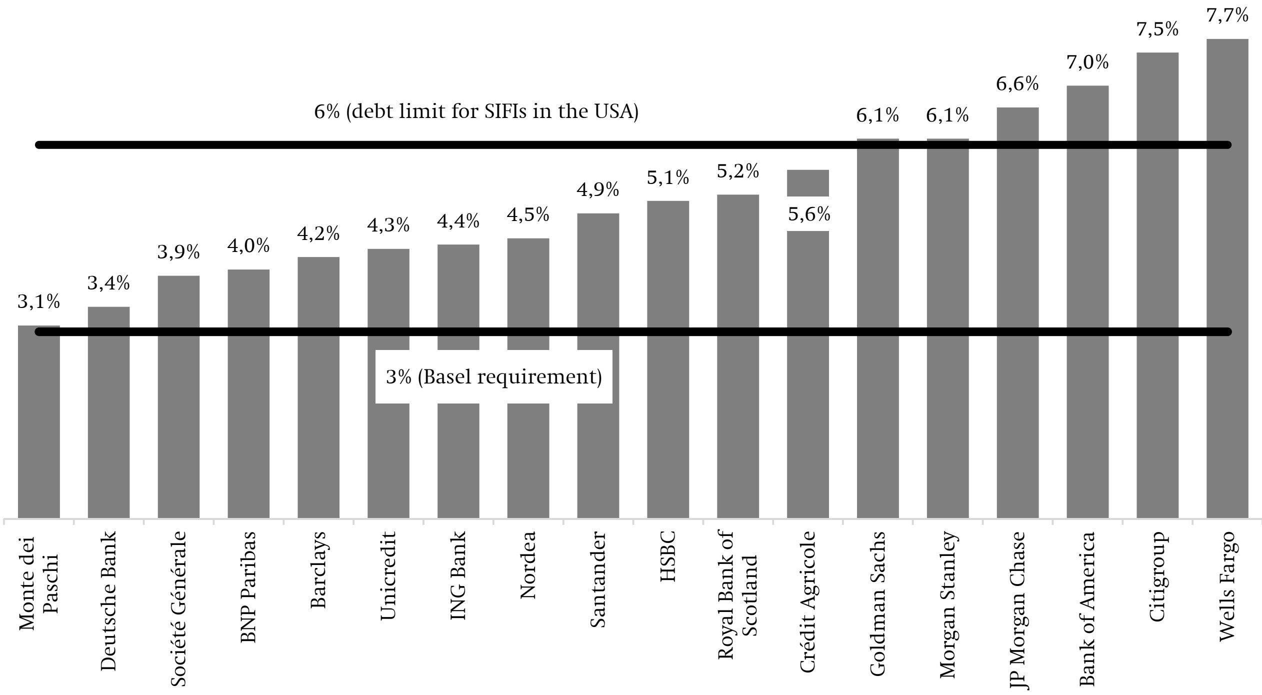
Source: Federal Reserve Board, *Global Capital Index*, June 2016.

office, senior Republican politicians criticised the rules issued by the Basel Committee for excessively curtailing Washington's sovereignty. Via executive order, the president has already revoked certain areas of consumer protection regarding financial-services provisions. Republican draft legislation, the Financial Choice Act, could also retract important areas of regulation covered by the Dodd-Frank Act (see Table, p. 6). It is furthermore conceivable that the UK might withdraw from international cooperation on financial-market regulation in the coming years. Over the past decade, the UK has made an important contribution to the stability and transparency of the financial system alongside the US. Following the Brexit decision, however, its continued involvement is not at all guaranteed.

Stringent Regulation under Obama

Immediately after the crisis, the US pursued a regulatory approach that was implemented in less time and went considerably further in crucial areas than the EU's. First, Washington was much quicker to regulate the financial markets. As early as July 2010, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which intervened substantially in the freedoms of the large banks. In July 2013 the US Federal Reserve Board published a complementary package of measures, the US Basel III Final Rule. Second, the US government used specific regulations – such as the Collins Amendment, the Volcker Rule and new rules on risk classification in securitisation – to check the financial sector precisely in those areas where it had taken the greatest risks before the crisis: in the investment business. Third, the US did not only

Chart 2
Basel III Leverage Ratio



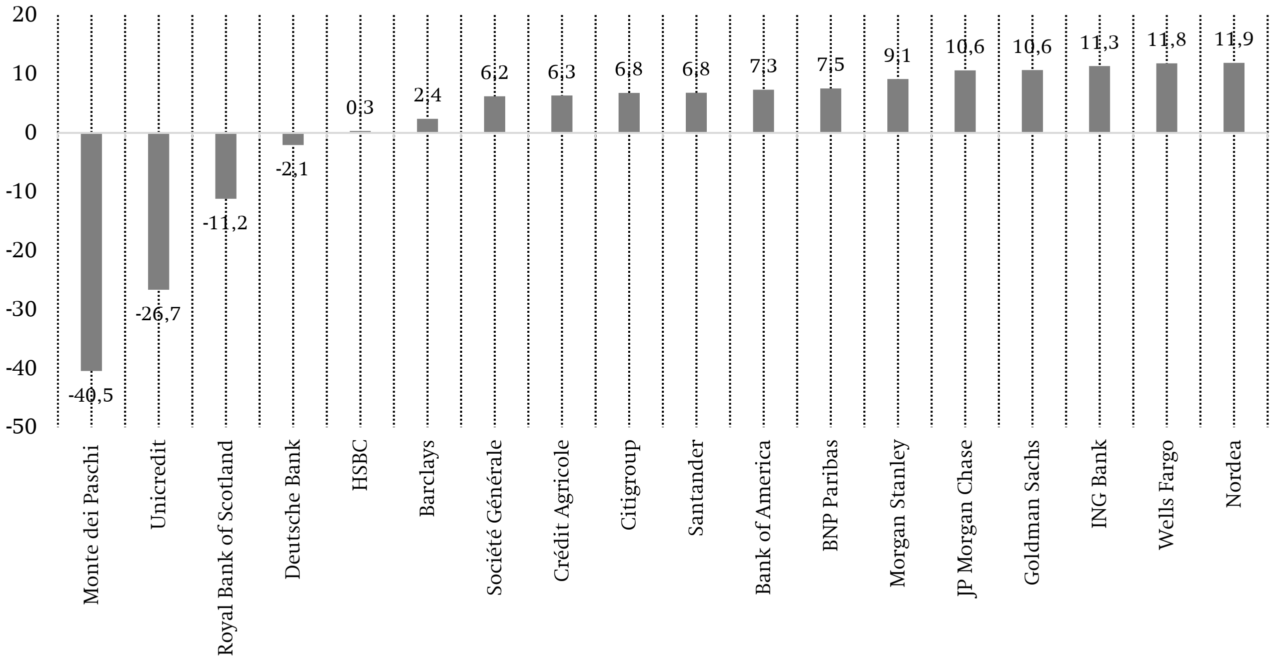
Source: Federal Reserve Board, *Global Capital Index*, June 2016.

focus its regulatory measures on banks, but decided to extend new standards to non-bank financial companies (e.g. private equity funds, wealth funds). Moreover, as of 2014 the government also compelled foreign-bank subsidiaries active in the US to implement the new US standards (in a departure from the principle of Home Country Rule).

A possible explanation for the US government's regulatory approach can be found in the structure of the domestic financial market. But, more importantly, the administration took a deliberate decision to prioritise the stability of the financial system over the short-term business interests of the financial industry. In order to guarantee that financial institutions on US soil remained competitive, the Obama administration then tried to extend its own financial-market rules internationally. As part of this, Washington pushed for the Basel standards for banking regulation to be tightened. The UK, whose financial system and institutions resemble the US's, also reacted quickly to the financial crisis, taking similar regulatory steps from 2009 onwards: separating commercial and investment banking activities (ring-fencing), and establishing an adjustable leverage ratio and restrictions on derivatives.

In both cases, the US and the UK, tighter regulation did little damage to the financial companies active there. It actually allowed profits to increase. As the data shows, returns of US-UK banks are now markedly higher than those of banks in continental Europe (see Chart 3, p. 4).

Chart 3
Return on Equity (RoE) % (TTM)



Source: *Morningstar*, 5 May 2017.

Europe as Regulatory Laggard

The EU took longer to develop regulatory responses to the crisis without proceeding any more rigorously than the US or UK. This can be seen, for example, in the way non-performing loans (NPL) are treated. Not only do NPLs remain in bank balance sheets in several EU member states, posing significant risks to the respective national finance systems but they also have a destabilising effect on the euro zone as a whole. While the European Central Bank has recently established guidelines for banks on how to resolve NPLs further action is necessary. What is needed are binding rules for member states on tackling banks that ignore the guidelines. Beyond these, national regulators and banks need further support, enabling the latter to finally sell toxic assets on a new market and to take necessary balance sheet adjustments.

Another area where the EU has been slow to fulfil its regulatory promises is the implementation of Basel III capital and liquidity rules. The European Commission has in fact attempted to embed the new international standards set out by the Basel agreement EU-wide, by promulgating a Capital Requirements Regulation (CRR) and the reworked Capital Requirements Directive (CRD IV). However, to this day national exceptions allow banks to circumvent parts of the Basel standards. These include the quality of a bank's equity, the use of bank internal risk models to reduce costs of regulatory capital, and the approach to sovereign risk. Not only has the Basel Committee pointed this out in three published progress reports. But independent voices outside of the BCBS have also frequently condemned the reluctance of EU states to apply firmly agreed international rules consistently.

Looking for explanations, an obvious factor seems to be the lack of institutional capacity to reign in financial risks, at least at the beginning of the Global Financial

Crisis. The EU did not commence its step-by-step introduction of a banking union until 2014. Moreover, at the EU level the decision-making process in banking policy (much as in trade policy) does not yet operate smoothly. But leaving aside these constraints, the EU's negotiation strategy in the BCBS, together with its slow implementation record, begs the question of whether the European Commission has in fact consistently prioritised its stability objective over the business interests of the euro-zone banks.

Regulator's Dilemma

Amplified by the EU's lasting economic weakness, European policy makers have been facing a difficult trade-off in regulating financial institutions. On the one hand, they can privilege the profits of banks headquartered in the EU in the hope of kick-starting economic growth. On the other hand, they need to place tighter restrictions on the banks' riskiest business activities to improve the stability of the financial system. There are no simple solutions, and the focus now tends to be on who will bear the costs of the decisions made by the European Commission and EU member states in the Basel Committee. The most recent dispute in the BCBS over rules on banks' internal risk calculation illustrates this. On the one hand, the EU member states are determined to protect the competitive interests of the banks headquartered there compared to rivals in the US (and in future potentially in the UK as well). The European Commission and Germany's Central Bank and Federal Financial Supervisory Authority (BaFin) are therefore battling for flexible regulations and defending special conditions for European banks. On the other hand, citizens demand stable markets and reduced risks. In a world of globally active banks and financial companies, stability depends on stringent international rules. Since governments can still not credibly distance themselves from bank bailouts, the concern is that taxpayers will once more carry the main burden of future crises. If that happened, the dissolution of the euro zone would be almost impossible to avoid, and even the future of the EU would be threatened. Europe clearly needs a debate on the financial-markets policy pursued by the European Commission – and by important EU countries such as Germany and France – in international fora including the Basel Committee, and on the far-reaching consequences of that policy.

European Commission to the Rescue?

Against the tense political backdrop within the G20, the EU needs to ask itself what role it intends to play in future banking and financial market regulation. Could the current uncertainty make the European Commission, of all parties, the preserver of financial-market stability when it has recently been more of an obstruction to establishing stricter rules for banks? That seems doubtful – but in case the Commission does indeed shoulder the responsibility for stabilising financial markets, it should concentrate on three objectives.

First, it should settle its dispute with the US over regulatory restrictions of internal bank risk models, and use the German presidency of the G20 in 2017 to wrap up this still-unfinished chapter of Basel III. Under the current proposal of a mandatory output floor on bank internal risk calculation, banks within the EU would still be allowed to give their lending a risk weighting of up to 25 percent lower than standard models. In return, however, the US banks are asking for more flexible standard models, allowing for national interpretations of Basel rules. While this may seem like an agreeable solution from the European banks' perspective, the European Commission now has to gauge very carefully what the future risks may be for its own financial system, in particular if the largest banks are given more leeway again.

Second, the Commission should make the leverage ratio binding as of 2019, as provided by Basel III. Banks in the EU could then be penalised for letting equity drop

Table
Will there be a U-Turn in Financial Regulation under Trump?

Suspension of the Fiduciary Rule	probable to certain	The Fiduciary Rule, issued by Obama, obliges financial advisors to recommend only retirement investments that are in the best interests of their customers. On taking office, Trump used an executive order to suspend the rule until June 2016. It now risks being abolished.
Hanging the Consumer Financial Protection Bureau (CFPB) out to dry	probable to certain	The Republicans want to put this important and hitherto independent new consumer-protection agency under congressional oversight. With this financial leverage, they could remove significant CFPB powers. Since March, an ongoing court case has also tried to settle whether Trump can dismiss the agency's director, appointed by Obama, without justification.
Raising the threshold for designation as a systemically important bank	probable to certain	There is bipartisan consensus on reducing the number of banks that are designated systemically important because of the size of their balance sheet and their interconnectedness. That would exclude more institutions from the strictest monitoring and regulation.
Relaxed equity requirements for banks' derivatives trade	probable to certain	The Obama administration did not lay down stricter standards for the high-risk derivatives trade until late 2016. Trump could now relax these provisions without the approval of Congress, on the basis of the Congressional Review Act (CRA). The CRA authorises him to unilaterally rescind all decrees issued during the last six months of the predecessor government.
Abolishing bank stress tests for the largest banks	possible	This would release large systemically important banks and other financial institutions (SIFIs) from compulsory critical review by the US regulators as long as they make a one-off declaration of their willingness to meet higher equity requirements. The abolition may be confirmed by Congress as part of a Republican draft law, the Financial Choice Act (FCA), drawn up by Republican Jeb Hensarling. In early June 2016, the proposal already obtained a majority in the House of Representatives in a vote along party lines. However, in the Senate it will be much harder to obtain vital Democrats' votes.
Abolishing the Orderly Liquidation Authority (OLA)	possible	Using the FCA, control over the liquidation of ailing banks and SIFIs could be removed from the FDIC's jurisdiction. Its budgets required for orderly liquidation proceedings would then be cut.
Abolishing obligatory living wills for SIFIs	possible	Under the FCA, SIFIs would no longer have to present extensive plans for potential liquidation proceedings.
Reducing the leverage ratio requirements for SIFIs	possible	The FCA stipulates a higher leverage ratio for large banks that take higher risks. However, Finance Minister Steven Mnuchin's position is still unclear. Financial analysts expect profit increases of up to 10 percent per bank share for the eight biggest US banks if the requirements are lowered.
Better liquidity assessments for Fannie-Mae and Freddie-Mac mortgages	possible	This would reduce the costs to the state-funded mortgage banks of providing high-quality regulatory liquid assets (HQLA).
Abolishing the Volcker Rule	unlikely	To abolish the Volcker Rule completely, both Houses of Congress would have to pass the FCA. It is currently unlikely to obtain a majority in the Senate. However, it is also possible to water down the Rule without changing the law, namely via the authorities (personnel is politics).

Source: author's own presentation.

below 3 percent of their overall balance. Under Basel III, the Commission should also introduce a higher leverage ratio of 6 percent for systemically important banks as of 2019. To improve the equity base lastingly, the Commission will also have to push ahead with resolving non-performing loans in the EU, which make up over 1,000 billion euros or 7 percent of the EU's GDP. NPLs are an indicator of future losses and associated equity losses. If the Commission managed to solve this problem it would not only increase the stability of its own financial market, but also its standing as a relevant actor in the international financial system. Moreover, it could also simplify the Brexit negotiations with the UK, since both sides could then draw on an international standard. In the best scenario, the EU would learn from the UK's experience with a flexible ratio and work with the UK on an equity ratio that reacts even better to emerging systemic risks in the financial system (macroprudential risk).

Third, the Commission needs to keep pushing banks to meet the new liquidity standards (liquidity coverage ratio, net stable funding ratio). Important steps have already been taken in that direction, and Europe's banks have now largely reached the provisional targets. However, the requirements stipulated as of 2019 are far from being met by all banks The capital shortfall of these institutions should not be underestimated. After all, the G20 primarily blamed the lack of liquid capital held by financial institutions for the rapid spread of the crisis following the insolvency of the US investment bank Lehman Brothers in 2008. Finally, the EU should continue to reach out to the US and UK in all the appropriate fora (Basel Committee, Financial Stability Board, US-EU Financial Markets Regulatory Dialogue). Only if the EU maintains its dialogue with other financial centres can it draw Washington's and London's attention to any negative effects of the new financial-markets policy and continue to work towards cooperative political solutions.

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