EU banks at a difficult crossroads

*Gonzalo Gasós**

The reform of the international prudential framework that started in 2010 with the Basel III package is arriving at its final stage. Global policy makers are committed to putting an end to the overhaul of the standards that have kept the regulatory environment in a state of flux for six years. But the final destination is not entirely clear for all. At this point, it is an imperative to evaluate the progress made and shift the focus to improving profitability and developing technology.

What has been accomplished?

With hindsight, the EU banking system has significantly strengthened its resilience on all fronts. First, banks have enhanced their core equity capital ratios up to the current 13% mainly by raising fresh capital in the market and retaining earnings. This improvement has resulted in a boost to the leverage ratio of banks from less than 3% to the current 5%. Also importantly, new liquidity metrics are being monitored regularly across EU banks and many of them already comply with the Basel III targets. In addition, more than a hundred of the largest banks have prepared recovery plans and are currently in the process of presenting and reviewing those plans with their supervisors.

The implementation of the global Basel III standards in Europe has coincided with two relevant changes, namely the deployment of a Single Rulebook in the EU and the Banking Union project. The former has placed more emphasis in EU regulation leaving less room for national discretion. The latter has posed a major challenge to the euro area banks as the new regulation had to be implemented by a newly created Single Supervisory Mechanism. In sum, it has been a daunting task that could only be completed thanks to the strong determination shown by regulators, supervisors and banks.

What is still ongoing?

In the EU regulatory landscape, the review of the Capital Requirements Regulation (CRR) and Directive (CRD) is meant to reduce risk, promote finance and improve existing rules. Global Systemically Important Banks (G-SIB) are also committed to complying with the Total Loss Absorbing Capacity (TLAC) requirements in two steps, the first step in 2019 and the second one in 2022. But Europe has once more extended the global minimum scope by applying the Minimum Requirement for own funds and Eligible Liabilities (MREL), a European version of the Total Loss Absorbing Capacity (TLAC) standard, to a much broader range of EU banks.

To top it all, the Basel Committee on Banking Supervision (BCBS) has put forward several proposals which are currently underway and should be finalised by the end of 2016, namely the revision to the standardised approaches (SA) to credit risk and to operational risk, the changes to the rules of internal rating based (IRB) models and the floors to IRB models based on SA results. This is the most controversial part of the reform because it was not envisaged in the original Basel III package. For this reason the industry has unofficially named it Basel IV.

Why is it crucial for Europe?

One of the messages of the Hangzhou summit of the leaders of G20 in September 2016 is that the Basel Committee should finalise the refinements of the Basel III framework bearing in mind that capital requirements must not be significantly increased in any of the major regions of the world. This commitment is crucial knowing that a further significant increase in overall capital requirements would most likely hit Europe harsher than other jurisdictions, in particular the US, due to three relevant factors. First, residential mortgage loans remain on the balance sheet of EU banks until maturity; given that it is the largest and highest credit quality portfolio, it pulls down the risk profile of EU banks leaving them more exposed to the effect of too high capital floors. This is not the case in the US because the bulk of the mortgage portfolio is transferred out of the banking system to government-sponsored entities like Fannie Mae. Secondly, EU supervisors have long used Pillar 2 of the Basel Accord to demand additional capital requirements which currently represent more than one third of the total requirements. Third, EU banks will have to make important IT investments to comply with the regulations and to compete with FinTech companies.

All in all, the fact that the European economy is highly dependent on bank financing means that any increase in regulatory requirements exacerbates the effects over the wider economy.

A new era of transformation

Against this background, the EU banking system is entering into an era of transformation featured by three conditions: heavy regulation, subdued profitability and increased competition. Successful banks will have to navigate through a deluge of regulatory requirements, use vanguard technology to become more efficient and deliver a competitive return to shareholders. A formidable challenge.

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