Reforming of prudential rules

Position of French banks with regard to current proposals

General comments

Summary

Under the impetus of the G20, the Basel Committee began a complete revision of the prudential framework applicable to banks. This revision process started last summer with a paper on enhancements to market risks and continued in December with the publication of two consultative documents issued for public comments on capital requirements and liquidity risk management. Other works are planned in 2010 on impact studies, measure calibration and potential additional measures. The European Commission services published in February 2010 their proposal to amend the CRD.

The stakes involved in this reform are considerable, not only for the banking sector and the stability of the financial markets, but also for the economy as a whole. The set of measures that will be finally adopted at the end of 2010 should in fact reconcile several imperatives. The first aim is to strengthen prudential supervision, while maintaining a financial system and a banking industry able to support a robust and sustained recovery, and therefore a fall in unemployment. The markets and banks must also be able to play their role of financing the economy so that Governments and central banks can implement exit strategies and turn around their public finances.

The impact of the Eurozone Economy of the Basel Committee Proposals has been conducted by economists and leads to the following conclusion:

- Assuming an immediate and strict implementation of these two proposed standards, Eurozone credit institutions would face (at the aggregate level):
    - a 40% shortfall in their capital ratio, resulting into a €360bn deficit in core Tier 1 capital (under the assumption that investors would keep unchanged their target capital ratio requirements, and excluding the proposed capital charge for mark-to-market losses due to credit value adjustments) ;
    - a shortage of stable funding estimated between €2trn and €3.5trn (depending on the required funding factor assigned to the “remaining assets”, especially financial derivatives with a positive mark-to-market value).

The main findings of this impact study are attached.

As central players in the financing of the economy and the market's operation, French banks therefore wish to actively participate in discussions on the content of this reform, particularly by maintaining close coordination with the public authorities represented in the decision-making bodies. French cooperative banks specify they have sent a full answer about the application of the criteria on cooperative banks through “Groupement National de la Coopération” (GNC).

With this in mind, the purpose of this document is to present an overview of the measures proposed and their impact, if they were all implemented, and to suggest amendments to the Commission's proposals.

The first part of our general comments provides figures on the impact of the measures on French banks. These show that as matters stand, the measures proposed would have a disproportionate impact, incompatible with what the sector is able to absorb without jeopardising its ability to finance the economy:

- ⇨ For French banks, the liquidity ratios would require the raising of non market absorbable amounts of medium-term debt.
- ⇨ For French banks, the capital adequacy rules would impose the raising of very large additional amount of capital. The worst case scenario would request French banks to build up another equivalent amount of the Core Tier 1 capital that they have raised or accumulated since their creation within a very short timeframe.

The second part focus on the most questionable proposed measures and suggest which proposals should be given priority: it is to vital to select the measures that are truly effective in terms of financial stability from the many measures proposed, and amend or abandon the others. The priorities (although other important issues are addressed in the detailed answers) are:

- ⇨ A more realistic definition of liquidity ratios.
- ⇨ The limiting of the leverage ratio to Pillar 2.
- ⇨ Amendments to the proposed risk-based capital deductions, particularly those applicable to minority interests, insurance companies and deferred tax assets.
- ⇨ The complete revision of the so-called "CVA" technical measure, whose impact as it stands would be as significant as that of all the other measures.

Finally, the third part will look at the priorities in terms of impact studies and calibration, with a view to the Basel Committee's upcoming works.

Given the above, the document suggests abandoning requirements proposed in addition to these measures, as they are based on concepts that are particularly vague and debatable: countercyclical capital buffers (which serve no purpose given the possibility of booking forward-looking provisions based on expected losses) and macroprudential overlays. The Industry clearly favors building up available reserves through prospective provisions, the main obstacle, so far, being their acceptability by the accounting standards setters.

It above all suggests safeguarding the economy's interests through impact studies and taking these into account in the calibration of measures: excessive capital and liquidity requirements would bring the economic recovery to a screeching halt. The impact of the measures cannot be fully assessed until more clarity is brought on the critical subject of calibration. In this regard, French banks would consider it unduly penalising if both capital requirements were to be substantially increased through better capture of risks and minimum prudential ratios significantly raised at the same time.

Considering that the on going QIS should not only contribute to the determination of the first tentative calibration but also to choosing among multiple alternative rules and eventually to reviewing some ill conceived propositions, the French banks believe it indispensable to plan a second round of consultation, probably in the autumn, in order to fully assess the likely impact on the Industry and on the economy as well as to fine tune any remaining inadequacies in the supervisory proposals.

French Banks do share the concern expressed by the Basel committee that the timing of the implementation of the proposed measures should be set in order not to jeopardise the economic recovery process. Given this important objective, it remains in our view to be demonstrated whether end 2012 is the appropriate target date for a full implementation of the revised framework. Careful consideration should be given to the fact that banks will need to raise liquidity or equity or take decision in respect of balance sheet management well in advance of the target date, i.e. potentially in the critical phase of exit from the current economic crisis. It is therefore of utmost importance that no final decision be taken in respect of the implementation date(s) before comprehensive macroeconomic studies can be conducted to assess the impact of the measures on the return to economic growth in the various regions.

Finally, we would like also to emphasise that French banks remain very mindful of the level playing field principle, not only in terms of the definition but also in terms of its implementation of the revised framework, in particular as regards the situation in the United States vs. Europe. The primary objective of improving the resilience of the banking industry as a whole cannot be achieved unless the revised framework is applied consistently and simultaneously across the major financial markets.

1. **The calculated impact of the measures proposed as they stand is much greater than the banks, the economy and the markets are able to withstand.**

   a. ***The revising of the capital adequacy ratio rules implies very large capital requirements to maintain current ratios***

The proposals of the Basel Committee amend the rules for calculating the capital adequacy ratio:

⇨ In terms of the numerator, the definition of risk-based capital is made more restrictive (reduction of Core Tier 1 ratio).

⇨ In terms of the denominator, the risk-weighting of balance sheet assets is increased (increase in "risk-weighted assets").

The figures incorporating the impact of these measures have been calculated for the top 5 French banks. As things stand, and leaving aside the specific "CVA" measure (see below), this revision of the calculation would be equivalent to **halving the current ratios**:

In absolute figures, to offset this fall in their Core Tier 1 ratio, French banks would have to **raise very significant amount of additional capital** (compared with Core Tier 1 capital) that would probably not be accepted by the market because of the subsequent dilution and fall of the return under the usual expectations.

This impact does not include the measure proposed by the Basel Committee regarding **Credit Value Adjustments**. This apparently technical and fairly complex issue has a disproportionate impact: this measure alone would cost French banks a very large **additional amount of capital** (almost as much as all of the other measures).

   b. ***The liquidity rules would imply raising medium term debt amounts that are unrealistic in the known market conditions***

The Commission paper introduces two supervisory ratios:

⇨ a short-term ratio known as the **Liquidity Coverage Ratio (LCR)** aimed at obliging banks to constantly maintain sufficient liquid assets to withstand an acute crisis for 30 days.

⇨ a one year ratio known as the **Net Stable Funding Ratio (NSFR)** that compares the available amount of stable funding with the required amount of stable funding.

According to the calculations made for the top 5 French banks, the second ratio (NSFR), as it is currently defined, would imply **raising a huge amount of funding in the medium-term**.

Nevertheless we appreciate the proposals of the Commission regarding the inclusion of various financial instruments in the liquidity buffer and allowing lower percentage of funding for commercial lending. On the other hand, the scope of supervision should be limited and banks should not be submitted at a combination of two requirements (solo + consolidated level).

c. *The Leverage Ratio produces a figure of around 1% and seems to be of little use to the supervisors*

The Basel paper provides a definition of the leverage ratio, with two variations depending on the numerator used either the Core Tier 1 ratio or the Tier 1 ratio.

According to this definition, the average ratio for French banks totals around **1.1% in the first instance and around 1.5% in the second instance**. It is difficult to see how these figures could be of use to the market or even the regulator. On the other hand, any arbitrary requirement to raise this ratio would clearly lead to considerable additional capital requirements (or more likely a **reduction of loans** to reduce balance sheets).

2. Focus on the most questionable proposed measures

a. *Priority amendments to the definition of the capital adequacy ratio*

The objectives aimed at by the Basel Committee, i.e. a uniform and consistent definition of capital and more effective consideration of market and counterparty risks, must be upheld.

To this end, **the French banks are supporting a large number of the measures proposed** by the Basel Committee: the reinforcement of (market and counterparty) Risk-Weighted Assets (RWA) (subject to the amendments described below), the deduction of risk-based capital from unrealised capital losses, goodwill and assets linked to pension plans, etc.

On the other hand, several amendments are vital, both to limit the unwithstandable impact of the measures proposed and to make them more relevant from a technical viewpoint. The priorities are as follows (detailed comments in the annex attached):

- ⇨ **Minority interests**: the deduction of minority interests from the Predominant Tier 1 capital is only possible if the RWAs corresponding to the minority interests' share are equally deducted from the Predominant Tier 1 ratio's denominator. It is logical (and legally applicable) to consider that minority interests assume their share of the risk borne by the subsidiaries in which they have invested. Equivalent methods are possible involving simply earmarking the amount to be deducted (see detailed comments in the annex attached).
- ⇨ **DTAs**: the deduction of deferred tax assets is only justified for part of these assets. This would mean, for instance, only considering a deduction above a threshold expressed as a 10% of capital (see detailed comments in the annex attached).
- ⇨ **Insurance**: we consider the proposals of the Basel Committee, which call the existing framework into question and impose an inappropriate deduction from Core Tier 1 capital, to be completely unacceptable. Remember that the issue of double counting of capital is already dealt with in Europe through regulations on financial conglomerates (see detailed comments in the annex attached).

⇨ **CVAs**: the measure proposed has a completely disproportionate impact, while overlapping with other provisions. These value adjustments already directly alter the capital, through the profit and loss account, and have the same protective aim as the capital required to cover counterparty risk. Imposing a specific charge for CVA variations necessarily leads to redundancies that should be avoided. This issue should be completely reworked by the Basel Committee (see detailed comments in the annex attached).

b. *Priority amendments to liquidity ratios*

French banks support stricter supervision of liquidity risks: the reckless risk-taking and excessive maturity transformation of some players were a major cause of the crisis.

The two ratios proposed, however, have two major failings.

⇨ The approach, consisting of basing this rule above all on two ratios defined in the same way for all players, is debatable. The rule should rely more on internal models, reviewed by the supervisors, which firstly would take into account the specific characteristics of the various banking models more effectively, and secondly would favour better measuring and better supervision of liquidity risks.

⇨ The ratios proposed are defined using an excessively conservative approach, both in terms of sources of funding and the forecast funding required.

If the principle of general ratios, rather than a rule based on internal models, was still preferred, it would be all the more vital to amend the definition of the two ratios, with the following priorities:

i. Short-term ratio (LCR)

⇨ Liquid assets: their definition must be widened. Specifically, it is unreasonable in a situation of systemic crisis to work under the assumption that central bank-eligible assets are no longer liquid. This property is the very essence of their liquidity; it is not inconceivable for the markets to close in the event of massive and concomitant sales of government securities. Similarly, it is completely unwarranted to rule out asset classes that remained liquid throughout the last crisis (equities). The exclusion in principle of instruments issued by financial institutions denies the possibility of the existence of an inter-bank market.

⇨ Cash outflow assumptions: these must be reviewed in greater detail as they are too conservative as they stand.

ii. Medium-term ratio (NSFR)

The definition of this ratio is particularly excessive in its conservatism, as is shown by the impact analysis. By setting the ratio between sources of funding with a maturity of more than 1 year and funding needs lasting more than 1 year at 100%, the Committee is already introducing a major change in the very role of the banking sector, whose traditional role has always been one of maturity transformation. This is therefore tantamount to reacting to the excessive transformation observed during the crisis by completely banning transformation, which is excessive.

However, according to the definitions adopted, the ratio proposed goes even further: assuming that funding needs lasting less one year will be automatically renewed and therefore included in the calculation of the required amount of stable funding, banks will in fact be performing a reverse transformation (i.e. lending over a longer term than they borrow): such a provision negates the very purpose of banks and poses a major threat to economies where bank intermediation is the main driver of financing.

It is therefore vital to review the definition of this ratio in line with the proposals in the annex attached.

Finally, it is crucial that the rules are applied at consolidated group level rather than per subsidiary, to maintain the possibility of optimum capital allocation and not go back on the very principles of free circulation of capital in Europe.

c. *Maintaining opposition to the leverage ratio, particularly in Pillar 1*

The definition proposed by the Basel Committee is probably the least harmful possible, as by including gross off-balance sheet items and prohibiting the netting of derivative positions, it prevents the distortion of competition with the US and the risk of regulatory arbitrage.

Nevertheless, this ratio serves no purpose from a prudential viewpoint and could incite banks to greatly reduce their loans to the economy if precise targets were given.

It is therefore essential, aside from reiterating the criticisms of this ratio, to absolutely avoid its migration to Pillar 1 of the Basel regulations. In actual fact, such a change would simply be aimed at justifying a substitution for the capital adequacy ratio and would therefore undermine the whole construction of the Basel 2 framework.

3. The scope of these measures calls for the abandoning of additional overlays and reasonable calibration

a. *The concepts of "countercyclical buffers" and "macroprudential overlays" are unjustified and excessive*

i. <u>Countercyclical buffers</u>

The December 2009 paper introduces the as yet unclarified concept of countercyclical buffers.

The idea is to protect banks against variations in their capital requirements and to allow the supervisors to restrict banks in the use of their profits to build up a "capital buffer" and maintain their ability to keep to their minimum ratios in times of trouble.

This idea is vague in its justification, its objectives and its principles. The procyclicality of capital requirements has not been proven, particularly when applying properly the Basel Committee's framework. This measure comes on top of an unprecedented increase in regulatory minimum requirements. It is completely utopian, as neither the regulators nor the markets would accept the fall of capital adequacy ratios in times of crisis. Finally, the intervening of the regulator in the free disposal of a company's profits poses many problems in terms of principles and rights.

We are calling for the abandoning of this idea and instead recommend booking real forward-looking provisions based on expected loss

ii. Macroprudential overlays

The FSB and the Basel Committee are continuing to work on the idea of additional layers of capital for "systemic" institutions.

We believe that this provision would be harmful as it would promote regulatory arbitrage (some institutions would be less regulated than others with identical activities) and would be excessive given the scope of the planned strengthening of capital requirements. Healthy institutions that observe the strengthened capital and management rules cannot create a systemic risk in themselves. This risk is presented by interlocking systems (such as clearing systems) and global supervision structures. Many initiatives have already been taken to this end. These must be promoted and particular attention must be paid to instances of excessive influence over the markets (dominant position in a single direction), which is a key factor in destabilisation. It would therefore be far more effective to create a reliable and comprehensive observatory of the positions taken by market players, in order to avoid unmanageable imbalances, than to try to penalise still further institutions that are "too big to fail".

b. The impact studies and calibration must take into account the economic interest

Aside from the proposed amendments to the Basel Committee's draft measures, it is important that the public authorities ensure that the impact studies take full account of the consequences of the measures proposed for the economy as a whole.

Given the considerable strengthening by banks of their capital bases in 2009, the measures should be calibrated to consolidate the strengthening achieved, rather than to produce a new wave of increases in capital requirements.

The effects of such an approach could in fact only be absorbed through additional fund raising (the market's depth is limited and capital investors require a return on investment that it would be difficult to provide under the proposed rules as they stand), as well as by reducing balance sheets, and particularly loan outstandings.

The same conclusion may be drawn for liquidity requirements, as the long-term funding required as a result of the proposals could not be absorbed by the markets, the more so as the unfavourable treatment of bonds, particularly for bank issuers, would restrict liquidity and therefore the bond market's depth.

The impact of these measures would be larger and more penalizing in Europe than the United States due to the differences of refinancing between the two areas.

Legislation and reforms proposals need to be coordinated to global implementation of new rules to ensure a level playing field and to address market fragmentation concerns.

Impact on the Eurozone Economy of the Basel Committee Proposals

Introduction and Summary

- A Group of French economists has focused on the impact of two of the new proposed standards: the revised Tier 1 Capital Ratio and the new Net Stable Funding Ratio (NSFR).

- Assuming an immediate and strict implementation of these two proposed standards, Eurozone credit institutions would face (at the aggregate level):

  - a 40% shortfall in their capital ratio, resulting into a €360bn deficit in core Tier 1 capital (under the assumption that investors would keep unchanged their target capital ratio requirements, and excluding the proposed capital charge for mark-to-market losses due to credit value adjustments) ;

  - a shortage of stable funding estimated between €2trn and €3.5trn (depending on the required funding factor assigned to the "remaining assets", especially financial derivatives with a positive mark-to-market value).

- Since banks would not be able to raise such massive amounts of capital (common shares) and medium-to-long term debt, loans to the nonfinancial sector would become not only costlier but also and foremost much scarcer. This contraction in bank credit supply would result into a negative cumulative impact on the Eurozone real GDP estimated at 1.5% in the short term and above 6% in the longer term (relative to a "no regulatory change" baseline scenario).

- The timing of this regulatory change would be particularly inappropriate if implemented when the economic outlook in the Eurozone is still weak and frail. It would significantly increase the risk of a L-shaped recovery, relative to the U-shaped recovery currently forecast by the consensus. Note also that government debt can no longer be used to compensate a crunch in bank credit supply, since fiscal policies are already on an unsustainable path in most Eurozone countries and have to be drastically adjusted over the next coming years.

- The Working Group has not assessed the impact of these regulatory changes on the US economy. However, this impact is likely to be significantly milder in the US than in the Eurozone for at least two reasons: (i) the Basel Committee proposals would not apply to the whole US banking system but only to the so called "core banks"; (ii) the nonfinancial sector is much less dependent upon bank credit in the US than in the Eurozone (bank loans amount to less than 50% of GDP in the US, against to close to 130% of GDP in the Eurozone).

Estimating the capital shortfall

- On the basis of brokers' bottom-up research on panels of European banks, we estimate that the proposed rules would cut the average core Tier 1 ratio to 5% from 8.5% (2009 data). In other words, the capital adequacy ratio would be reduced by 40%. Note that this estimate excludes the proposed capital charge for mark-to-market losses due to credit value adjustments (CVA), which would further reduce the capital ratio.

- By extrapolating sample estimates to the aggregated balance sheet of Eurozone credit institutions, we obtain a core Tier 1 capital shortfall of €360bn if banks maintain unchanged their target ratio. This is equivalent to the total amount of capital raised since the beginning of the financial crisis, but whose a substantial part took the form of hybrid instruments.

Estimating the stable funding shortfall

- In order to estimate the "available stable funding" (ASF) and the "required stable funding" (RSF) of Eurozone credit institutions, we have used the aggregated balance sheet data published by the ECB (supplemented by some other sources to get more detailed information). According to the latest data, the aggregated balance sheet of Eurozone credit institutions was close to €30 000bn in January 2010. We have also estimated from other sources off-balance sheet obligations (undrawn amount of committed credit and liquidity facilities).

- In these aggregated data, the main source of uncertainty comes from the lines "remaining assets" and "remaining liabilities", which amount to about 10% of the total balance sheet. They are residual categories which include financial derivatives and encumbered securities. On the ASF side, we have assigned a 0% factor to all the "remaining liabilities". On the RSF side, we have produced estimates under two different hypothesises:
    - under the 1st hypothesis (H1), we have assigned a 0% RSF factor to all the "remaining assets"; remaining assets and liabilities have then a neutral impact on the NSFR;
    - under the 2nd hypothesis (H2), we have assigned a 100% RSF factor to half of the "remaining assets" (and 0% to the other half); this increases the required stable funding by a very substantial amount (€1 300bn).

Eurozone Credit Institutions (aggregated balance sheet)

		Hyp. 1	Hyp. 2
Required stable funding (in €bn)	(1)	16560	17860
Available stable funding (in €bn)	(2)	14460	14460
Stable funding deficit (in €bn)	(1)-(2)	2100	3400
Net stable funding ratio (%)	(2)/(1)	87%	81%

- As detailed in the above table, the aggregated stable funding deficit of Eurozone banks is estimated at close to €3 500bn if we assume that part of the "remaining assets" (including financial derivatives with a positive mark-to-market value) require stable funding, and at just above €2 000bn if we do not.

- This deficit in stable funding is considerable. For the sake of comparison, the outstanding amount of debt securities issued by Eurozone banks with a maturity exceeding one year is currently worth €4 500bn. This amount would thus have to be increased by a percentage between 45% and 75%, triggering a steepening in the yield curve at the macro level. Note also that banks will not be able to fully substitute medium-to-long term debt to short-term debt: outstanding bank debt securities with a maturity below one year amount to less than €1bn. However, if medium-to-long term debt issuance substitutes to other sources of stable funding, the impact on the NSFR would be much reduced. For instance, if 1€ of debt issuance is funded, at the macro level, by a decline of 1€ in deposits (70% weighted if "less stable"), the available stable funding will increase by only 30 cents.

- It would be not only very costly but also very difficult for banks to issue such amounts of medium-to-long term debt. As a consequence, they would also have to cut their lending. Note however that the *ex post* decline in loans would have be very large. Since at the macro level loans create deposits, the reverse process would shrink deposits and thus available stable funding (through a sot of reverse credit multiplier mechanism).

- On the asset side, banks would also have a strong incentive to substitute government bonds and - in a lesser extent - nonfinancial corporate bonds to loans. SMEs, which are very dependent upon bank loans, would be the most severely impacted.

Assessing the impact on the Eurozone real GDP

- In order to assess the impact of these regulatory changes on the economy, we have used models incorporating a bank lending channel of transmission, distinct from the traditional interest rate channel. The specific role of bank lending has two causes:

  - on the banking sector's side: imperfect substitutability among their liabilities;

  - on the nonfinancial sector's side: imperfect substitutability between bank loans and debt securities.

- Indeed, we have applied a two-step approach, similar to the one used by the European Commission[1] and the IMF[2] to quantify the impact on Eurozone GDP of subprime related losses:

  - in the first step, we estimate the impact of the capital and stable funding shortages on bank credit supply to the nonfinancial sector ;

  - in the second step, we estimate the impact of this credit supply shrinkage on real GDP[3].

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[1] European Commission : « *Quarterly Report on the Euro Area* », p26-31, N°4 (2008).

[2] IMF Working Paper # 69 (2009):"*From subprime loans to subprime growth? Evidence for the euro area*".

[3] We have relied on the elasticities calculated by ECB's economists Cappiello-Kadaraja-Sorensen-Protopapa in : « *Do Bank Loans and Credit Standards have an Effect on Output? A Panel Approach for the Euro Area*", ECB

- In the first step, we estimate that the proposed regulatory changes would translate into a 20% in bank loan supply (relative to baseline). In the second step, this results into a negative impact on the Eurozone GDP close to 1.5% in the short term and cumulating to nearly 6.5% in the longer term.

- These estimates are of course subject to many assumptions, and must be interpreted very carefully. Nevertheless, they show that an immediate and strict application of the proposed regulatory standards could significantly put at risk the economic recovery in the Eurozone.

Working Paper Series, N°1150 (2010). According to this study, a 10% decrease in bank credit results into a real GDP decline (relative to the baseline) of 0.8% in the short term and 3.2% in the longer term. Note that these elasticities are smaller than the ones used in the EC study mentioned above in footnote 1.