Position of the Association of German Banks on the Basel Committee on Banking Supervision proposals on the capital and liquidity of banks

The financial crisis has highlighted shortcomings in the global banking system. Banks have recognised this and independently launched initiatives to address these shortcomings in order to make the system more crisis-resilient. This is documented in detail in, for example, the Institute of International Finance (IIF) report of December 2009[1].

Nevertheless, we welcome in principle the efforts made by regulators to improve the stability of the international financial services industry. The Basel Committee on Banking Supervision unveiled on 17 December 2009 reform packages for tighter regulation of the banking sector (Basel III): *Strengthening the resilience of the banking sector* (bcbs 164) and *International framework for liquidity risk measurement, standards and monitoring* (bcbs 165). The focus of the individual reform packages is on:

- improving the structural quality and quantity of regulatory capital
- improving the capture and coverage of counterparty credit risk
- introducing a leverage ratio
- reducing procyclicity and building up countercyclical capital buffers
- outlining ideas on how to deal with systemic risk and the phenomenon of interconnectedness
- introducing a global standard for measuring and limiting liquidity risk.

In addition, various rules have already been issued by the Basel Committee and are being implemented at European and national level, e.g. tighter capital requirements for trading book positions and (re)securitisations.

The Association of German Banks supports the efforts made by the international supervisory authorities to introduce higher capital requirements in those areas in which the crisis has revealed that requirements are too low. The condition for any adjustments to the regulatory framework must, however, be that the basic concept behind Basel II – gearing capital requirements to the individual risks incurred by an institution – is not unintentionally undermined or nullified. Some of the current regulatory proposals do not yet fulfil this key condition in our view.

[1] *IIF: Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*, December 2009 (http://www.iif.com/press/press+125.php).

Implications of the proposals for the banking sector and bank customers

A general capital backing requirement, e.g. in the form of a newly introduced overarching leverage ratio, creates scope for capital arbitrage and thus produces wrong incentives which run counter to the risk-sensitive rules of Basel II. It increases capital needs and thus the cost of credit for low-risk exposures particularly in customer loan business. The consequence is that such loans are made much more expensive and there is an incentive for higher-risk investment in order to offset the reduced return prospects. Banks with low-risk portfolios and their customers are therefore punished, which flies in the face of the experience gathered during the financial crisis.

The planned tightening of the definition of capital and the increase in minimum capital requirements are, on their own, so dramatic that compliance by banks will not be easy, particularly in the short term, and will need to be spread over a period of several years. According to expert estimates, the current proposals are expected to generate total additional capital requirements of € 98 billion in Germany (see attached Table 1). This is equivalent to more than seven times the average annual increase in capital among German institutions over the past ten years. It should be noted that this figure does not yet take the effects of a leverage ratio into account[2]. This means that, even in optimistic scenarios, the numerous capital increases required on the stock market, by public-sector owners and by cooperative shareholders would only be possible over a period of many years. Moreover, investors are expecting only moderate returns in the banking sector in the future, so that most institutions will have to turn to building up capital by ploughing back future profits. This will further increase the time needed for raising capital levels. Banks with low-risk portfolios and correspondingly limited return prospects also run the risk of not being able to earn their cost of capital any longer (in connection with the return prospects, see the business lines set out by way of example in Table 2).

As a consequence of the foreseeable capital formation squeeze, banks will have to respond by cutting back their lendings and other assets. A marked shortage of credit would be the result, as the cutback required to comply with the regulatory ratios would be considerable. For example, as shown in Table 2, the additional capital required would be equivalent to a cutback in the volume of housing finance of around € 2 trillion. According to the Bundesbank, this is almost double the existing volume of private housing finance in Germany[3].

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[2] See in this connection the study on the implications of a leverage ratio commissioned by the Association of German Banks (http://www.bankenverband.de/themen/fachinformationen/bankenaufsicht).

[3] Deutsche Bundesbank, Monthly Report – as per 12.2.2010

The introduction for the first time of internationally binding liquidity requirements as a second element of Basel III – alongside capital rules – must be welcomed in principle. The requirement to comply with liquidity ratios at all times may, however, lead in stress scenarios such as the financial crisis to market collapse. In a crisis, all institutions would have to sell their securities simultaneously to ensure compliance with the ratios. But the current regulatory proposals would also cause problems in a "regular" market environment. The narrow definition of eligible securities leads to aligned behaviour by market participants in a narrow market segment, i.e. to "monocultures". However, these are particularly vulnerable to market disruption and may lead to destabilisation of the banking sector and ultimately to higher systemic risk (current example: Greece). As, moreover, the securities called for by regulators to cover liquidity requirements yield a relatively low rate of interest and the funds tied up as a result are no longer available for lending purposes, the scope for lending – like under the tighter capital rules – is further restricted and the cost of credit further increased.

Macroeconomic implications of the proposals

Banks' high additional capital needs make the supply of credit more expensive and tighter for all sectors. There will be a marked increase in the interest charged on loans, particularly low-risk loans, because the respective capital backing requirements (as called for by regulators) are an integral part of computation of interest. As a result, an adequate and stable supply of credit to private households, businesses and the public sector is endangered. Sustained negative macroeconomic effects (adverse impact on macroeconomic growth due to less consumer and investor demand, higher unemployment, less public revenue, etc.) are the consequence. What is more, systemic risk will increase since banks will operate closer to minimum capital levels and the strictly imposed liquidity buffers cause monocultures.

Conclusion

Because of their overall impact and their planned short-term implementation, the current proposals are unsuited to achieving the declared aim of stabilising the financial sector. In our opinion, they would do exactly the opposite. The large number of new rules with cumulative effects (e.g. definition of Tier 1 capital and a leverage ratio taking Tier 1 capital as a benchmark) on the one hand and contradictory effects (e.g. the requirement to hold government bonds as a liquidity buffer in relation to the leverage ratio) on the other hand need to be adjusted accordingly in our view. Regulation must be geared more strongly to areas and products which, as the experience gathered during the crisis shows, are subject to capital requirements that are too low. Generally raising capital requirements should, in contrast, be avoided so as not to unintentionally handicap low-risk business. Overall, the proposed measures harbour a serious threat of undesirable developments and unwanted market distortion, particularly if they are introduced simultaneously.

In addition to the necessary regulatory adjustments, their sound, phased introduction over a period of several years, based on impact assessments conducted beforehand, is required. This will allow banks to respond to the new requirements in a controlled manner and in this way limit the negative macroeconomic impact.

Berlin, 14 April 2010

Enclosure

Impact of the Basel Committee proposals on German banks' aggregate capital resources – prior to a leverage ratio and liquidity rules

Table 1: Increase in core Tier 1 capital requirements

Area of regulation addressed by Basel Committee	€ billion
Higher capital quality[1]	44
Higher risk weights for exposures to financial institutions[2]	4
Higher capital requirements for trading book	36
Minimum Tier 1 capital ratio: 10 % (assumed)	14
Total	**98**

[1] Abandonment of currently recognised capital components and tighter deduction rules ("prudential filter").

[2] Adjustment of asset correlation in risk-weighting function for users of IRB approach under Basel II – assumption: 20% increase in capital requirements.

Table 2: Scope for offsetting increased Tier 1 capital requirements

Risk-reducing or capital-raising measure	Reduction in total lendings	Capital increase	Expected return[3]
Capital increase		€ 98 bn	15 %
Private housing finance if given 50 % risk weight[4]	€ 1 960 bn		7-12 %
SME finance if given 70 % risk weight[4]	€ 1 400 bn		3-7 %

[3] If capital is increased: investors' expectations; if risk is reduced: rough estimates of average post-tax returns based on selected banks.

[4] Assuming that compliance with Tier 1 capital ratio of 10 % is required.