THE BASEL ACCORDS AND THEIR CONSEQUENCES FOR THE ECONOMY
What are the Basel Committee and the Basel Accords?

How do regulations ensure the stability of the financial system?

What impacts can the finalisation of Basel III have on the funding of the economy?
Created in 1974, the Basel Committee is an international committee based in Switzerland tasked with establishing international banking rules. Its members are central bank governors and representatives of the national competent authorities of the 28 member states and jurisdictions\(^1\).

Although the Basel Committee holds no legally binding power, its recommendations are nevertheless enacted by its members.

The aim of the rules proposed by the Committee, known as the “Basel Accords” is to ensure the stability of the global banking system, establish effective supervision of the world’s banks, and promote cooperation between banking supervisors.

The Basel Accords are founded on the principle to set a minimum capital ratio for banks. This capital ratio is a requirement to hold a certain amount of own funds and profits allocated to reserves and is calculated in accordance with loans and commitments bank has granted. This capital is blocked and must remain in the bank.

(1) Argentina, Australia, Belgium, Brasil, Canada, China, France, Hong Kong SAR, Germany, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, Netherland, Russia, Saudi Arabia, Singapour, South Africa, Sweden, Switzerland, Turkey, United, Kingdom, United States and European Union.
FROM BASEL I TO BASEL III…

Basel I: the Cooke ratio

The first Basel Accord, completed in 1988, established a minimum ratio between a bank’s own funds and the risks it takes when it grants loans to customers (credit risk). This ratio, i.e. the capital ratio, was set at 8% minimum.

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\text{CAPITAL RATIO} = \frac{\text{OWN FUNDS}}{\text{CREDIT RISK}} = 8\%
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In 1996, it was revised to include both credit risk and market risk (risk of losses arising from movements in market prices, including exchange rates).

Basel II: the risk-based approach

In 2004, a new accord put forward stronger standards aimed at covering new risks and improving the management of these risks by banks, primarily by encouraging them to develop internal risk assessment methods.

This included operational risk (risk of loss resulting from inadequate or failed internal processes, from people and systems or from external events).

It also introduced a more detailed supervisory review process overseen by the banking supervision authority and introduced measures to promote market transparency.

Basel II Accord rested on three complementary pillars:
➤ **Pillar 1**: minimum capital requirements for credit, market and operational risks, allowing banks to cover their risks and absorb exceptional losses or withstand potential crises.

➤ **Pillar 2**: oversight of banks by the supervisor, resulting in additional capital requirements where applicable. This pillar is based in particular on **stress tests designed to test a bank’s resilience in an adverse economic scenario**.

➤ **Pillar 3**: transparency (increased disclosure obligations) and market discipline, with the aim of keeping the market informed while facilitating comparisons between banks.

However, this system, which took effect in France on 12/31/2006, has never been applied by the United States.

The financial crisis that erupted in 2008 highlighted a number of regulatory failings, particularly in addressing liquidity risk or losses stemming from a major economic crisis.

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**CAPITAL RATIO (CET1)**(1) OF MAJOR FRENCH BANKS: CAPITAL HAS DOUBLED

Source: Banque de France - ACPR

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(1) Common Equity Tier 1 (CET1) is considered to be the highest-quality Tier 1 capital and is the focal point of analysts and investors.
Basel III: enhanced capital requirements

The Basel Accord published at the end of 2010 established new, more restrictive standards in the form of additional capital requirements aimed at:

- strengthening the level and quality of bank capital (with several additional “buffers” added to the capital ratio),
- improving and harmonising the management of liquidity risk (the possibility that over a specific horizon the bank will become unable to settle immediate obligations),
- reducing bank leverage (i.e. limiting their debt-to-equity ratio).

In Europe, the Basel III Accord was transposed by Capital Requirements Directive 4 (CRD4) and the Capital Requirements Regulation (CRR), in application since 2014.
In France, to date, banks have doubled their capital as a result of the Basel III reform.

The new Basel agreement of 7 December 2017 finalises the international prudential reforms except the Fundamental Review of the Trading Book (FRTB), expected to be completed in late 2018.

The finalisation of Basel III aims to harmonise risk measurement methods worldwide, without significantly increasing capital or discriminating between banking models, as mandated by the G20.

However, this work results in even stronger capital requirements in relation to loans issued, in contradiction with the G20 mandate. The consequences are so significant for European banks that the finalisation of Basel III is sometimes called “Basel IV.”

**An approach dominated by the Anglo-Saxon model**

Global regulatory harmonisation efforts are largely influenced by the dominant sector and thus by the US approach.

However, the structural differences between the US and European banking systems are substantial, so much so that the same rules do not generate the same effects on bank balance sheets and the funding of the economy on both sides of the Atlantic.

In the US, corporations predominantly obtain funding on the markets (70%), turning to banks for only 30% of their financing needs. Furthermore, US banks do not record loans on their balance sheets. Instead, they are massively sold off on the securitisation markets, which is especially true for real estate loans. They do, however, keep more complex, higher-risk loans that cannot be sold on their balance sheets.
In Europe, the opposite is true: corporations predominantly obtain funding (80%) from bank loans (intermediation) and banks record loans on their balance sheets, without relying on massive securitisation like the United States.

Real estate loans currently account for nearly €1,000 bn on French bank balance sheets.

There are two adverse effects of directly or indirectly placing restrictions on a bank’s balance sheet size: a much stronger impact on the funding of the European economy and on European banks.

Because they record loans on their balance sheets, European (and particularly French) banks have developed a responsible lending culture and a rigorous risk management approach: risk is assessed for each customer, based on creditworthiness (ability to repay the loan over time), and not the value of the real estate asset.

UNDERSTANDING THE DIFFERENCES BETWEEN THE FRENCH AND ANGLO-SAXON BANKING SYSTEMS: REAL ESTATE LENDING

- **Fixed-rate loan**
- **Guarantee system**
- **Assessment of the borrower’s solvency (loan-to-income)**
- **Loans recorded on bank balance sheets**

- **Variable-rate loan**
- **Backed by mortgage**
- **Assessment of the real estate asset’s value (loan-to-value)**
- **Securitised loans (removed from bank balance sheet)**

Regulatory developments could jeopardise the French lending model. The market could shift from fixed rate loans to variable rate loans. The volume of loans granted could also be impacted because the regulator is planning on capping leverage (ratio of capital to balance sheet size), which determines banks’ ability to make loans. Guarantees could also be called into question. All of this would have stronger consequences on financing for first-time home buyers and rental investments.

Efforts made by the French Senate, the National Assembly, the government and the Governor of the Banque de France must be continued to avoid penalising the French system.
An inappropriate change in method

At the supervisor’s request, European banks have developed internal risk assessment models to manage their risks as closely in line with their commitments as possible.

The Accord signed on 7 December 2017, however, aims to promote a global standard method that no longer analyses risks on a customer-by-customer basis, but instead sets requirements according to globally observed averages.

This text also introduces a link between this standard method and internal models. The idea is to define a floor, i.e. a minimum level of capital to establish to cover risks (The 7 December 2017 agreement sets the floor at 72.5%).

Internal models are penalised in their actual assessment of risk. The higher the floor, the greater the constraint on the banks using these models, forcing banks to increase their capital levels, with no basis on the actual level of risks, thus limiting their ability to fund the economy.

In reality, this Accord undermines the sound risk-based capital management approach that has proved so effective for French banks during the financial crisis.

Is the French and European model under threat?

The transposing of the latest Basel agreement in the EU might jeopardise the European, and especially the French financing model.

As a result, the volume of loans on bank balance sheets would decline and their capital would increase substantially.

The principle of loan distribution based on borrower creditworthiness (rather than the value of the asset) and on fixed vs. variable rates (which expose customers to interest rate risk) would also be placed at risk.

Ultimately, French and European banks would be at a particular disadvantage, when in fact their risk management and loan distribution are prudent.

Consequently, European banks would either have to set aside several hundred billion euros in additional capital or reduce their lending commitments by several hundred billion, which would negatively impact their funding of the European economy.
Setting uniform regulations would have a material impact on French and European banks, limiting their capacity to finance individual customers, corporations and major strategic plans such as motorway infrastructures, the naval or the aviation industry.

It makes no sense whatsoever for the US model, the root of the 2008 crisis, to impose a set of rules on Europe without taking the specific characteristics of its banking model into consideration.

The crucial objective for France and Europe is to maintain robust and powerful banks in order to preserve their financial independence and control over decisions relating to the funding of the economy.

This is why the prudential regulation of banks directly concerns other business sectors and represents a key political issue.

**Mobilisation on all fronts**

Representatives from a variety of industries, associations and European institutions have mobilised as never before against the work of the Basel Committee, shedding light on the major risk hanging over the European economy.

Despite the lack of an impact or transparency study on the reform, evaluations conducted by banks point to potentially undesirable consequences on certain categories of financing.
A strong stance
by the European institutions

European institutions have agreed that regulatory provisions should not penalise European banks.

► In July 2016, the Economic and Financial Affairs Council (ECOFIN) noted that the reform package would not be expected to result in a significant increase in the overall capital requirements for the banking sector.

► In mid-November 2016, the European Parliament stressed that the revision should respect the principle stated by the Basel Committee of not significantly increasing overall capital requirements, while mitigating the differences between jurisdictions and banking models, and by not unduly penalising the EU banking model.

► At the end of January 2017, the Vice-President of the European Commission stated that he would not recommend transposing the Basel Accord into European law if it did not respect the interests of the European Union.

Mobilisation of industries
and associations

Voices outside the banking industry itself were being raised in a bid to avoid the harmful consequences of the Basel Committee’s decisions.

► BusinessEurope, a European association made up of national business organisations, including MEDEF, made its position clear by highlighting the risks of detrimental impacts on the cost and availability of trade and export finance, given that European banks fund 80% of the European economy. BusinessEurope argued against increasing capital requirements for banks and also requested an overall impact study of the reforms on European businesses before any new rules are approved.
Other associations have conveyed similar messages, such as the Association française des trésoriers d’entreprise (AFTE) or the construction sector via the European Construction Industry Federation, and the Fédération française du Bâtiment.

The real estate sector is completely on-board to preserve fixed-rate real estate lending and to avoid the adverse impact of the reform on first-time home buyers and rental properties.

The aviation sector also has a stake to defend, as aviation finance could be significantly impacted by the reforms.

**WITH A FLOOR AT 72.5%, THE AMOUNTS OF CAPITAL IMMOBILIZED BY THE BANKS FACING CERTAIN KEY FUNDING WILL CONSIDERABLY INCREASE**

- **2x** FOR UNRATED CORPORATE BUT INVESTMENT GRADE QUALITY FINANCING
- **2.6x** FOR RESIDENTIAL REAL ESTATE FINANCING
- **2.8x** FOR MOTORWAY FINANCING
- **4x** FOR AIRPLANE FINANCING
An appropriate transposition in the EU

The prudential measures already implemented all had the same objective: to preserve the stability of the global banking system and establish effective banking supervision. Mission accomplished. The Basel III reform has already made European banks stronger than ever before.

The French Banking Federation acknowledges the December 2017 agreement finalising the Basel III reform. It stabilises and clarifies, on the long term, the rules on bank capital.

The implementation of the measures in the EU must take the characteristics of different funding models into account while maintaining a level playing field between banking sectors in the interest of ensuring the effective funding of the economy.

The banking industry is paying close attention to the implementation of the Basel rules which will be launched by the European Commission.

A need for an impact study

The FBF welcomed the European Commission announcement to proceed with the impact study of the consequences of the Basel agreement on the European economy.

This study will ensure that implementation takes into account the characteristics of European funding models, especially regarding the prudential treatment of certain assets such as real estate financing, specialised financing, and non-rated companies financing (which constitutes 3/4 of the companies in Europe). As a matter of fact, Basel measures are based on American standards and don’t take into account the diversity and specificities of European situations, nor the different level of risks.
Preserving the efficiency of the French financing models

A European Central Bank survey published in September 2015(1) showed that France is one of the rare countries in the euro zone where the banking crisis did not have a material impact on the deficit or public debt. This is evidence, if any were needed, of the resilience of the French banking model.

In France, banking is a strategic, solid, innovative and dynamic industry that funds the economy - businesses and individuals alike. It is considered by the OECD to be one of the six key strengths of the French economy: four out of nine major banks in the euro zone are French(2). Protecting its competitiveness and appeal is critical for the economic sovereignty of our country, because without banking there is no economy.

It is therefore essential to watch over the regulatory and competitive environment in order to maintain a competitive and innovative banking industry in France and Europe capable of funding the economy.

(3) Illustration by Gabs.