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2015.10.07

FBF RESPONSE TO EUROPEAN COMMISSION ON THE POSSIBLE IMPACT OF THE CRR AND CRD IV ON BANK FINANCING OF THE ECONOMY

I- General comments

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the European Commission consultation on the possible impact of the CRR and CRD IV on bank financing of the economy. We note that the consultation focuses only on capital requirements when leverage and liquidity requirements have already become binding constraints for banks through market pressure and internal planning process. Given the interactions between various metrics (including MREL and TLAC) it is essential to have a comprehensive picture of the impact of regulations, which we aim at providing through this document. Our response to the Commission's online questionnaire will be also submitted through the dedicated website. The annexes to the online submission are available below.

II- Online questionnaire

Capitalisation

1.1 What role has been played by the CRR and CRD IV requirements in the recapitalisation process, in terms of the timing and overall effect on the levels and quality of capital held by banks?

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Basel 3 and, in Europe, the CRR/CRD IV requirements, have been a major incentive to increasing the capital of the banking industry. Investors have followed the evolution of prudential rules, in terms of increased quality of capital instruments and the evolution of capital requirements including CET1 buffers. Rating agencies have adapted their measurement of equity to CRR/CRD4 requirements. This has accelerated the renewal of ineligible capital. The renewal timing was sharp since capital markets have reacted sometimes in anticipation on prudential draft legislations that were not finalized and simply did not take into account any phasing or transition period in their analysis. This made the regulatory burden even more challenging for banks to comply with. CRR/CRDIV have also pushed banks to significantly contract their balance sheet –deleveraging strategies were public and massive. **Please see Annex A for additional quantitative information.**

1.2 How have market, supervisory and regulatory capitalisation demands interacted to make banks adjust the level of capital they hold to the current level?

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Capital markets have put pressure on banks at a very early stage of the regulatory process, since they take into account all available information in the share valuation. In this respect, each evolution of any draft prudential text led to a potential change in the market valuation of banks, and also in the ability/price to find new resources on the market. Regulatory uncertainty is very detrimental for bank activities. After all the efforts made by EU banks to be Basel 3 compliant, we believe that a stable regulatory framework would be beneficial for banks and the whole economical system. Market, supervisory and regulatory capitalisation demands have significantly reshaped banks' balance sheet.

Trading book has been strongly reduced and banking book suffered a sharp contraction of both bank lending and long term financing. **Please see Annex A for additional quantitative information.**

1.3 Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role?

- ☐ **Yes, it is possible**
- ☐ No, it is not possible
- ☐ I do not know

1.3.1 Please rank these three factors in accordance to their importance:

	3 Most important	2 Important	1 Less important
Market demands		**X**	
Supervisory Demands			**X**
Regulatory capital	**X**		

1.4 Please explain you answer to whether it is possible to identify which has/have played the most important role?

1000 character(s) maximum

The main driver was regulatory capital requirements that have been followed by other actors in the market, such as rating agencies or institutional investors. The market was the source of the strongest pressure on banks, measuring and challenging their ability to respect the new regulatory requirements.

2. If you consider that capital levels go significantly beyond what is necessary in light of the level of risk incurred and posed by banking activities in certain areas, please specify those areas and back up your view with specific evidence.

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Proposals to move away from the risk-based approach in favour of “simplified” approaches would create a significant detriment to not only the accuracy of determining the risks that banks carry (which capital requirements should be based on), but also by making banks’ key performance measures and strategic decision-making less sensitive to their underlying risk, with potential behavioural and market outcomes. **Please see Annex A for specific evidence.**

3.1 What role have the additional capital requirements and buffers exceeding the harmonised requirements set out in the CRR played in the capitalisation process?

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The additional capital requirements a bank is expected to meet are scrutinized by investors notably shareholders and, ultimately, regulatory capital providers, both on a transitional and fully loaded basis. Since the distributions of CET1 and AT1 instruments are highly constrained by Pillar 1 requirements (including buffers), equity valuation or AT1 pricing are heavily influenced by capital requirements. As market participants closely look at fully loaded ratios, banks are under pressure to comply with those future requirements earlier than provided for by the regulatory deadlines. To some extent, rating agencies have also contributed to this process since they have developed methodologies mirroring regulatory approaches.

As a result:

- Banks have had to build up capital cushions above current regulatory minimums to anticipate future regulations;
- Banks must also build up capital cushions to maintain a management buffer to reassure investors, rating agencies, etc.

Please see Annex A for additional quantitative information.

3.2 Are such additional micro- and macro-prudential capital requirements and buffers commensurate to the level of risk incurred and posed by banks?

- ☐ Yes
- ☐ **No**
- ☐ I do not know

3.3 Please back up your view with specific evidence.

1000 character(s) maximum

The principle underpinning the Basel 2 framework is a capital requirement consistent with a Value at Risk at 99.9%. More specifically, when a bank’s RWAs are covered by 8% of going-concern loss-absorbing capital (CET1 and AT1), the expected default rate should be 0.1% or less. Basel Committee capital buffers such as systemic or contracyclical may be to a certain extent theoretically founded as basic capital requirements. However there are other regulatory initiatives dealing with counterparties’ probabilities of default today. To some extent capital cushions overlap with other measures whose purpose is to deal with cyclicality or systemicity:

- Systemicity will be addressed by MREL/TLAC requirements.

- Banks have had to meet micro- and macro-prudential capital requirements and buffers beyond level of risk incurred and posed. As a result, several activities had to be reduced or discontinued.

Please see Annex A for additional quantitative information.

Regulation – a cause of the fall in corporate lending?

4.1 Have increased capital requirements influenced the overall capacity of banks to lend?

- ☐ <u>Yes</u>
- ☐ No
- ☐ I do not know

4.2 Please explain your answer on whether increased capital requirements have influenced the overall capacity of banks to lend?

1000 character(s) maximum

The new capital requirements have resulted in higher break-even for most transactions, lower profitability for the banking business and higher costs for clients. Given capital requirements anticipation, the long-term structural impact is barely smoothed over time, without taking into account the impact of other regulations (liquidity, market risks…).

The new regulatory framework clearly incentivizes a move from an intermediation model to an originate-to-distribute model and lower liquidity and higher volatility of secondary markets. For instance, cost of capital and regulations restraining market-making hamper the holding of significant bonds inventories; as a consequence issuers must pay higher spreads and price volatility has increased as banks cannot act as counterparties as they used to do.

Please see Annex A for additional quantitative information.

4.3 Which factors, including demand-side factors, regulatory changes and other supply-side factors (such as the volatility of interbank and capital markets), contributed most significantly to the change in the volume of loans?

1000 character(s) maximum

We would like to highlight the impact of the NSFR, which strongly penalizes short-term financing activities and notably Factoring and Trade Finance business.

As the NSFR reduces the capacity of banks to enact maturity transformation, it generates additional liquidity costs which cannot be passed onto clients. In addition, QE results in artificially inflated NSFR levels; it ends up short-circuiting inter-bank lending. The significant increase in ST liquidity costs (<1y) results in a loss of competitiveness for EU Investment banks compared to Asian and US competitors, as well as for Retail Banks which benefit from lower funding costs thanks to retail deposits. As a matter of fact, the NSFR constraint would generate a steep decrease in business volumes and significant NBI shortfall.

The Commission should bear in mind that NSFR, once finalised, may have the same consequences as the 2011 announcement of new capital requirements and LCR (massive deleveraging by EU banks).

4.4 How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?

1000 character(s) maximum

An increase in capital requirements inevitably has an adverse effect on the capacity of banks to increase loans.

On a short-term basis, this effect was limited because of weak demand from customer base. On a long-term basis, the financing of the economy is modified: some types of transactions may become too costly which means that the way the economy is financed is altered. With CRR/CRD IV banks have experienced a substitution of loans by issuance of securities for large corporate. The credit risk that was concentrated on banks will now be also borne by other economic actors through the issuance of securities. Thus we may see in the future some contagion effects on other economic actors.

Without regulatory changes, banks would have been in a position to fully support a strong demand from customers.

5.1 What are the effects of increased capital requirements, such as they are?

- ☐ Generally temporary and transitional
- ☐ Structural
- ☐ **Both temporary transitional, but also long-term structural**
- ☐ I do not know

5.2 Please explain your answer on the effects of capital requirements:

1000 character(s) maximum

Please refer to the answers to section 4 above.

5.3 Has the requirement to hold higher levels of capital increased the cost of funding banks?

- ☐ **Yes**
- ☐ No
- ☐ I do not know

5.4 Has the per-unit cost of bank capital decreased as banks have become less risky?

- ☐ Yes
- ☐ **No**
- ☐ I do not know

5.5 Please justify your answers to questions 5.3 and 5.4?

1000 character(s) maximum

The overall cost of funding has increased due to higher T2 and AT1 requirements and stringent liquidity constraints (longer funding, HQLA stocks). Assuming the same cost of each funding/capital component, the new regulatory framework now requires a more costly capital mix. From a per-unit cost of capital perspective, we see no significant decline in the cost of CET1 in spite of the massive deleveraging of the banking industry. Though banks are less risky, the high risk premium they must pay is explained by the high cost of equity. Regulation-related risks have replaced business-related risks. We see no decline in the AT1 spreads since the pre-crisis regulation due to higher structural risk of AT1s vs. old style hybrid Tier Ones. This is the consequence of the conjunction of various regulations: capital, liquidity and TLAC/MREL requirements.

6.1 Have increased capital requirements affected the market for some categories of assets more than others?

- ☐ **Yes**
- ☐ No
- ☐ I do not know

6.2 Which are these categories of assets and how have their markets been affected?

1000 character(s) maximum

- Structured finance
- Complex products
- Securitisation
- Derivatives trading
- Capital Market assets globally (*)
- Local administration (*)
- Real estate markets (*)
- Corporate bonds (*)

Please see Annex A for more details on categories marked with an asterisk (*)

6.3 Which of the provisions contained in the CRR, apart from those establishing capital ratios, are likely to have created the effects experienced by specific markets and/or exposures?

1000 character(s) maximum

The leverage ratio will lead to crowding out good quality assets. It should remain as a back stop measure, and not a binding one, hence its requirement for banks should be defined and capped in order to remove regulatory uncertainty which is very detrimental for bank activities.

Another major concern is the Basel NSFR Standard of 2014, which will have a significant impact on capital market activities. Derivative activities are penalized by the 20% Stable Funding Requirement on Derivative Liabilities. Repo markets are penalized by the asymmetry between repo Available Stable Funding and reverse repo Required Stable Funding, which will most likely reduce liquidity on securities markets.

In addition, the stable funding requirements for securitization conduits are not clear as per the Basel Framework or the CRR. As securitizations of trade receivables will soon receive higher funding requirements (100% as encumbered) than corporate loans, this will quickly create a significant burden on trade receivables conduits activity.

7. Do you think the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions?

- ☐ **Yes**
- ☐ No
- ☐ I do not know

7.1 Please explain how, according to you, the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions?

1000 character(s) maximum

No comment

Lending to SMEs

8.1 To what extent has this provision been effective in supporting lending to SMEs?

- ☐ Very effective
- ☐ **Effective**
- ☐ Slightly effective
- ☐ Not effective
- ☐ I do not know

8.2 Could you provide any evidence, preferably quantitative, of the change in lending to SMEs due to the introduction of the supporting factor as from 2014?

1000 character(s) maximum

From our perspective, the Supporting Factor has played a key role in allowing French banks to support and finance SMEs. Therefore we strongly advocate for maintaining the regime provided for by article 501 of the CRR.

Access to bank financing for SMEs has improved in 2015 compared to previous years. The ECB in its survey (SAFE) published in June 2015 points out that for the period from October 2014 to March 2015, small enterprises reported a "*sizeable improvement in net terms*" of bank financing (loans and overdrafts). According to the same survey, the indicator of financing obstacles declined from 16% in the previous survey to 13%. The external financing gap has been reduced to zero (from 3% in the previous survey) for SMEs in the euro area. The steady improvement of access to bank financing for SMEs since 2014 would not have happened so rapidly without the relief provided by the supporting factor. **Please see Annex B for our detailed study on lending to SMEs.**

9.1 What specific difficulties do banks face when lending to SMEs, compared to when lending to larger corporates? Are they related to the CRR?

1000 character(s) maximum

Please see Annex B for our detailed study on lending to SMEs.

9.2 How could the CRR and other prudential regulations contribute to addressing some of these difficulties in other ways than by adjusting rules for SMEs?

1000 character(s) maximum

Please see Annex B for our detailed study on lending to SMEs.

9.3 Do these difficulties need to be resolved by some other means?

- ☐ Yes
- ☐ **No**
- ☐ I do not know

9.4 If these difficulties need to be resolved by some other means, what other means would be adequate?

1000 character(s) maximum

Please see Annex B for our detailed study on lending to SMEs.

Lending to infrastructure

10.1 Has the CRR influenced the capacity of banks to provide loans to infrastructure projects?

- ☐ <u>**Yes**</u>
- ☐ No
- ☐ I do not know

10.2 Which provisions are most relevant?

1000 character(s) maximum

Please see answers in section 11 below. The flexibility to lend to infrastructure projects could be jeopardized by the Basel Committee's proposals for a global floor between IRBA and standardized approach. This would lead banks to calculate the capital relative to infrastructure financings based on borrowers' turnover and leverage. Neither the quality of income (long-term commitments with governments or local authorities), nor the quality of the contracts (commitments with big corporations) or of the financing conditions would be taken into account. Moreover, all specialized lending, including infrastructure projects, could be subject to a high floor of 120% RWA. These measures would multiply bank capital linked to these projects and reduce the amount that banks are able to commit to these projects.

11.1 What are the specific difficulties that banks face when lending to infrastructure projects? Are they related to the CRR?

1000 character(s) maximum

Thanks to the latest Basel regulations, the European financial sector has been reinforced and therefore uncertainty has been reduced. However, these new requirements have resulted in a huge consumption of resources (capital, liquidity …) for European banks. These efforts have been absorbed thanks to the dramatic collapse of interest rates, the development of alternative financings (bond market) and huge cost-cutting policies, including a reduction in IT investments. Any further regulatory constraint will certainly not be sustainable for the banking sector when interest rates are back to more usual levels and alternative financings are withdrawn from the market.

11.2 How could the CRR and other prudential regulations contribute to addressing some of these difficulties?

1000 character(s) maximum

It is essential to slow down the constant modification of prudential requirements, which 1/ limits the visibility on the environment, 2/ dampens investment strategy, 3/ restrains actors (investors and banks) from making long term investment decisions. Furthermore, to meet its long term infrastructure needs, Europe should keep its independent financing capacity. Therefore, any additional regulatory requirement on lending activities (capital floor, TLAC, MREL, revised IRB) will jeopardize the competitive position of the European banking sector, which is among the worldwide leaders in long term infrastructure lending. This will reduce its ability to support the Juncker Plan and more generally to contribute to sustainable long term investments programs. For example, the lending capacity of banks using IRBA model will be reduced in a range comprised from 4 – 8 if the BCBS proposal to introduce a capital floor based on a revised standard approach were implemented.

11.3 Do these difficulties need to be resolved by some other means?

- ☐ **Yes**
- ☐ No
- ☐ I do not know

11.4 If these difficulties need to be resolved by some other means, what other means would be adequate?

1000 character(s) maximum

The Basel 2 framework has contributed to a better risk sensitive capital framework. Preserving the IRB risk sensitive approach is fundamental to meet the challenges of infrastructure financing and answer efficiently to market demands. Only risk sensitive approaches are able to select the most suitable lending activities, contributing to the stability of the banking sector. For credit risk, the implementation of simplistic risk drivers, as proposed in the BCBS's revised standardized approach, will render the approach less risk sensitive and new capital requirements will materially increase for low risk and good quality portfolios; contrary to its goals, the reform will lead to increasing risk and uncertainty on banks' balance-sheets. Preserving the IRB risk sensitive approach and stabilizing the regulatory framework are likely the main cornerstones of current discussions. Additionally, Leverage Ratio constraints should remain a backstop measure and the requirement should not increase.

12 Should infrastructure projects continue to be treated as loans to corporate borrowers?

- ☐ Yes
- ☐ **No**
- ☐ I do not know

12.1 Please specify why you think infrastructure projects should not continue to be treated as loans to corporate borrowers.

1000 character(s) maximum

Given their low risk profile in nature, infrastructure specialized lending (such as projects and object finance) are typically the financing tools useful in supporting productive investment and infrastructure financing. Infrastructure investments are substantial (in 2014: 259 billion dollars worldwide and 70 billion in Europe, source: Project Finance International, 14/01/2015). They require a dedicated prudential treatment maintaining this risk sensitive approach and the particular characteristics of their financing structure. It is fundamental that the new regulations reflect the underlying risk profile of the specialized lending exposures, and do not increase their risk weight.

12.2 What common features of infrastructure projects or their subsets would justify a separate treatment from loans to corporate borrowers?

1000 character(s) maximum

While corporate financing has a short to medium time horizon, infrastructure financings, thanks to the long asset life and their strategic nature for the economic growth are considered over the long term. Their specific features need an expertise to coordinate the various stakeholders involved (contractors, public parties, operators, suppliers, off takers) and to assess the technological and economical complexity. It should be noted that while corporate financing largely relies on historical financials and perspectives, infrastructure project risk analysis is based on contractual structure, cash flow projections and assets value as appropriate.

Proportionality

13.1 Should the provisions contained in the CRR allow for more differentiation in how they are applied to banks of different sizes or with different risk-profiles?

- ☐ Yes
- ☐ **No**
- ☐ I do not know

13.2 How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market?

1000 character(s) maximum

As per our answer to question 13.1 above, we believe differentiation is best appreciated through variety in risk profiles rather than through banks' size.

- Proportionality is necessary in order to account for different risk profiles
- The diversity of business models and markets across the EU ("one size does not fit all") is the best defence against contagion and concentration risks –such diversity supports financial stability rather than compromise it.

13.3 Are there any provisions that could potentially be applied with greater differentiation?

- ☐ **Yes**
- ☐ No
- ☐ I do not know

13.4 If there are any provisions that could potentially be applied with greater differentiation, what are these provisions?

1000 character(s) maximum

There is a need for an overall assessment of the CRR-CRD4 package against initial objectives; same rationale should apply to the forthcoming "Basel 4" package. For example:

- The increased complexity brought by the Basel revised standardised approach is contrary to the proportionality principle.
- The BCBS NSFR standard (*)
- Remuneration (*)

Please see Annex A for more details on categories marked with an asterisk (*)

13.5 Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application?

1000 character(s) maximum

There is a necessity to take a step back and to underscore universal models banks' valuable role

- Universal banks were not the trigger for the global crisis:
  - Northern Rock, Spanish Cajas and Lehman Brothers were all specialized banks (most casualties were also specialised banks)
- They demonstrated resilience throughout the crisis (risk mitigation for the financial stability):
  - Canadian, Australian, French and even Italian universal banks better resisted to the crisis

    - Thanks to structural risk diversification and good risk management (maybe also because being universal requires a wider risk culture)
- Last but not least, they continued to extend credit (real economy support):
    - In particular, French banks were the only one to increase lending activities every years since the crisis (ex 2010)

13.6 Are any concrete changes desirable in this context?

- ☐ <u>Yes</u>
- ☐ No
- ☐ I do not know

13.7 If any concrete changes are desirable in this context, what are these changes and the associated costs and benefits?

1000 character(s) maximum

We are concerned that the introduction of TLAC may amplify the effects of the backstop leverage ratio, particularly as it will be based on a multiple of either the leverage ratio or the capital ratio, whichever is higher. A non-risk sensitive leverage ratio coupled with a largely non-risk sensitive capital framework may call into doubt the extent to which institutions are willing to improve risk measurement and management. In addition, with a TLAC set as a multiple of the LR, authorities will have to calibrate them at the same time while keeping their individual consistency. We believe TLAC and leverage requirements should be set independently.

We are also concerned about changes to the current treatment of insurance participations. Upon supervisors' review and on the basis of the Financial Conglomerates Directive, conglomerates can deduct insurance participation. This creates a diversification benefit which clearly strengthens financial stability.

Scope for simplification

14.1 Which areas of the CRR could be simplified without compromising the Regulation's objective of ensuring prudence, legal certainty and a level playing field?

1000 character(s) maximum

Overall when putting together all the requirements and parameters, the level of complexity is such that it has become quite difficult to both comply with the legislation and do our job. And this is likely to increase as the CRR-CRD4 continues to be implemented.

Yet banks have taken initiatives to adapt to the CRR and to manage this complex new framework. Our major concern now relates to the Basel 4 package. While CRR has not been fully applied yet, adding another layer of requirements would make the regulatory framework all the more complex. What is now needed is regulatory stability. Regulatory uncertainty is a main issue, for investors, for the banks' business planning and for financial stability.

Examples:

- The multiplicity of ratios is a source of complexity
- The own funds definition does not properly fit the EU

14.2 Are there areas that could be simplified, but only for specific types of bank or business models?

1000 character(s) maximum

The first step for simplification would be to freeze (for a while) the upcoming regulation propositions and take time to assess the current overall framework as well as the necessity to go further. There are still several workstreams underway at international level that go beyond the reform agenda and are likely to result in further, fundamental change to the capital framework. These include the FRTB, a new framework for IRRBB, the introduction of non-risk sensitive restrictions on the IRB approach, capital floor proposals and revised standardised approaches for the main risk categories. Each of these appears likely to increase capital further and to reduce the level of risk sensitivity. This will hamper bank lending and appropriate capital allocation. As Bank lending is (3 times) more necessary in EU than in the US so far, EU must be more involved in shaping international regulatory agenda and priorities.

Please refer to answer 13.5

14.3 Would it be useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations?

- ☐ Yes
- ☐ **No**
- ☐ I do not know

14.4 Please explain your answer on whether it is useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations?

1000 character(s) maximum

It is not useful. We support reporting and transparency as necessary and as a critical part of the level playing field.

The EU must have a close look to the calibration of the capital floor and the leverage ratio that are still to be finalised. Such simplification schemes are indeed justified as common backstop for the industry but would be highly detrimental if they become the binding constraint for the majority of the system.

14.5 What would be the risks with such an approach (where banks that are capitalised well above minimum requirements or that are less exposed to certain risks are subject to simplified obligations)?

1000 character(s) maximum

Nobody can predict which risk will be the trigger of the next crisis. It is of the utmost importance to keep a risk sensitivity approach rather than elaborate derogations based on assumptions which will lead to arbitrage and misguided behaviours. Regulatory pressure has already pushed EU banks to exit or reduce some activities (market making, project finance, etc.) which are however necessary to EU economy and growth. It would not be appropriated to increase discrimination further.

In addition, such approach should not advantage foreign groups that may be in a better position to adapt their subsidiaries' structures than European banks.

Single rulebook

15.1 What additional measures could be taken in the area of prudential regulation to further promote integration and enhance a level playing field?

1000 character(s) maximum

Banking regulation must acknowledge the existence of SSM and SRM

- The SSM implementation should be reflected and EU legislation and ensure a level playing field across Member states, as well as between Banking Union members and non-BU members
- The Resolution Framework should not add additional requirements on top of existing prudential ones
- G-SIIs identification methodology should exclude claims and liabilities within the Banking Union (SSM / SRM). EU G-SII scores are artificially inflated due to intra-EU exposures, therefore systemical buffers may be disproportionate
- There should be no double counting between G-SII buffers and SREP /Pillar2 requirements, as the SREP aims at identifying risks not already account for into Pillar 1

The Banking Structural Reforms may also hamper fair competition if it will be applicable only to a short list of European continental banks –any derogation to BSR must be subject to reciprocity conditions, especially with the US.

Please see Annex A for additional quantitative information.

15.2 Can you indicate specific examples and evidence of discretions that affect the cost and availability of bank lending?

1000 character(s) maximum

No comment

III- Annexes to the online questionnaire

ANNEX A: Additional quantitative information complementing the survey questions

1.1

As of December 2012, for 19 EU banks, the targets for active deleveraging amounted to EUR 1400 bn (Deutsche Bank calculation):

- EUR 1361 bn
- USD 704 bn in the United States

According to PwC (November 2014), from 2008 to 2013, across 24 banks studied:

- Assets have fallen by 12% (a reduction of EUR 3.6 tn)
- European banks have outperformed their US peers with regards to asset reduction, and have cut total assets by 19%

In addition, PwC noted the following impact on RWA / asset ratio evolution between Pre-Basel 2.5 (2011) and Basel 3 (2014) and consequences in terms of deleveraging (reduction in assets):

- Credit: from 40% to 160% => high deleveraging between 2011 and 2014 with – 70% in assets
- Commodities: from 100% to 270% => high deleveraging between 2011 and 2014 with – 50% in assets
- Rates: from 10% to 30% => high deleveraging between 2011 and 2014 with – 50% in assets
- Securitization: from 40% to 150%% => high deleveraging between 2011 and 2014 with – 20% in assets
- Equities: from 50% to 40% => increase of assets by + 70% between 2011 and 2014
- FX: from 180% to 240% => slight increase of assets by + 10%

Morgan Stanley & Oliver Wyman (March 2015) noted that since 2010, wholesale banking balance sheets supporting traded markets have decreased by:

- 40% in RWA (de-risking)
- 20% in total balance sheet (de-leveraging)
- Such deleveraging actions have generated widespread authorities' attention, most notably by the EBA in its "Overview of the potential implications of regulatory measures for banks' business models" report, published last February.

1.2

Bank trading portfolios have declined since the crisis by 40% (BOAML, April 2015)

- The size of the primary dealer repo market has already shrunk by 51% since its peak 2008, while primary dealer trading volumes have declined 34% over the same period
- Reforms also contributed to subduing market-making and repo activities, reflected in reduced trading activity (IMF report, October 2014)

Banking book suffered a sharp contraction of both bank lending and long term financing:

- From December 2011 to December 2014: Bank's balance sheet in the euro area decline of -7% or EUR -2 400 bn derived from the contraction in the banks' deposits (due to the LTRO payback but also from a contraction in loans to euro area customers: EUR -588 bn)
- Liquidity rules leads to a lengthening of the average maturity of liabilities and/or a shortening of the average maturity of lending
- Some banks decided to put overly regulated activities in run-off.

2

Capital: the deduction of all minority interests when the entity is not a bank (or not eligible) is particularly unfair as the consolidating entity bears all the risk. A minimum level of minority interests should at least be included in the capital ratio of the consolidating entity. This situation can be very penalizing for partnerships with non-banking financial entities, e.g. consumer finance.

Leverage ratio: this is not a risk measure and it strongly penalizes activities with low risk weights e.g. residential real estate mortgages.

Securitisation: the current framework allows only the securitisation of the less risky assets; large assets pools cannot be securitised anymore, which resulted in a sharp reduction in business volumes to the detriment of economy financing. With the forthcoming "Basel 4" securitisation framework, AA-securitisation transactions will cost about 4 times more than unsecured corporate bonds (30% vs 6.6%).

'Qualifying securitisations' will only reduce capital charge increase (20% vs 6.6%), for an addressable short-term securitisation market reduced by over 50%. This needs to be revised at EU level to be aligned with the Commission's objective to relaunch the securitisation market.

Please see also the EBA's "Overview of the potential implications of regulatory measures for banks' business models" (9 February 2015) for a comprehensive overview of the impact of regulation on banks' business lines.

3.1

Moreover, as a result of additional capital requirements and buffers, banks today are much more resilient. The regulatory reforms have ensured a much better-capitalized banking sector:

- The world's top 10 banks now have USD 470.3 bn more capital than they had at the end of 2007 (Citi/FT, 30 March 2015)
- 24 large banks have increased their Tier 1 capital by 80% from 2006 to 2013 (PwC report, Nov 2014) despite a stricter definition of capital.
- EU banks have increased their Tier 1 capital more than US competitors (EBA report, February 2015)

The financial system is safer but return on equity has fallen:

- IMF report (October 2014): " Bank return-on-equity has fallen to a historically low level, excluding the peak of the financial crisis, because underlying profitability (return on assets) has declined and the capital base has increased "
- KPMG study (April 2015): "Balance sheet restructuring has not increased the very low returns on equity of many European banks (…) 85% of the banks included in the Comprehensive Assessment were not covering the cost of their equity"
- ***Return on equity (RoE) still lower than Cost of Capital (CoE)*** Generally, the deleveraging and the increase in equity have resulted in a considerable reduction in profitability, as measured by the Return on Equity (The RoE averaged 3.2% from 2008 to 2014 against 15.1% from 2003 to 2007). It remains still far from pre-crisis levels and from viable returns. In the US, the decline has not occurred to the same extent (form 14.9% to 5.5%). Such RoE levels contrast with banks' Cost of Equity (CoE), which is in an 8%-12% range in 2015. As a result, only around 35% of European banks are in a position to cover their CoE by currents earnings. To restore the sustainability of returns, banks should be constrained to continue to cut costs and to exit activities whose capital requirements are excessive with regards to the expected profitability.

Business models have been strongly impacted, leading to large-scale adjustments, refocusing on "core" activities:

- IMF report (October 2014): "Now large banks are entering the third phase they have become stronger and are emerging from post crisis balance sheet repair, but need to adjust their business models to new economic realities"
- EBA report (February 2015): "Banks are likely to refocus on core (home currency) businesses and local funding (host currency) for subsidiaries due to the new liquidity rules and the reforms of banking structures which will toughen the conditions for intragroup flows (cross-border and non-cross-border)".

3.3

Global banks have already begun their transition to new business models (IMF report, October 2014) "Many global banks are shrinking or exiting from capital market activities", which is not in line with the EU's Capital Markets Union project. In addition, structural changes in the industry may exacerbate illiquidity in times of stress. Combined, these trends will likely magnify market shocks and liquidity risks and provide additional challenges to the execution of a smooth exit for monetary policy.

Large number of global banks are retrenching selectively from international markets and refocusing on commercial banking activities in home markets and regional markets where they enjoy a leading presence. A notable exception is infrastructure finance, where many global banks are reducing their presence or exiting.

New regulation and structural adjustments may disturb banks' ability to support the recovery:

- Contraction of bank lending and long term financing
- Obstruction in the funding of the real economy through the interbank market:
    - Substitution of the unsecured interbank market by the repo market due to LCR treatment of unsecured funding
    - But the repo market is also in danger as the looming NSFR could in turn very well taper the repo market off

- Retail lending seems to be negatively impacted by the collective implementation of the new regulatory measures
    - “This is mainly due to the potential implications of the leverage ratio (given the low risk weights in retail banking) and the liquidity coverage ratio which does not take retail loans into account in the liquidity buffer” (EBA report, February 2015)
    - Money multiplier decreases with the setting up of the LCR, this decrease was compensated by the ECB accommodating monetary policy. Bank lending remains stable only due to current QE environment.
- In addition, “New regulation may severely affect local funding and local market liquidity within emerging markets countries” (Agustin Carstens, Governor of the Bank of Mexico, Financial Stability Review, April 2015)

4.2

PwC’s corporate bond turnover ratios (average daily volumes/outstanding volumes) between 2010 and 2014 show the following:

- US: from 0.36% to 0.28%, turnover ratio divided by 1.3
- Asia: from 0.15% to 0.05%, turnover ratio divided by 3
- Europe: from 0.15% to 0.10%, turnover ratio divided by 1.5

There are clear imbalances between financial regulation and economic growth.

There is a mismatch between regulatory liquidity standards and banks’ traditional role in liquidity and maturity transformation:

- LCR (and NSFR soon) limits the banks’ ability to transform maturities which is crucial in the EU given market structures
- The Capital Market Union is a shared goal which may be jeopardized by NSFR consequences on access to liquidity
- In its March 2015 report, the EBA states : “the SLR (proportion of liquid assets to total deposits) will limit the overall lending capacity of the banks”

Prolonged imbalance could deeply undermine both financial stability and economic growth prospects

- Emerging market countries may be collateral victims (“at best higher cost, at worst large international banks withdrawal”, IMF report, October 2014)
- Also in the October 2014 IMF report: “(…) when binding, the leverage ratio could make it uneconomical to hold or acquire lower-risk assets.”
- Moreover “Regulatory reforms … have decreased bank’s lending capacity and therefore their contribution to growth” (Barbara Novick, vice chairman, BlackRock, Financial Stability Review, April 2015)
- Last but not least, the EU economy is affected 3 times more than the US due to the significant role of the banks vs. markets in the EU compared to the US.

Greater attention is required for a well-designed final calibration, best suited to the multi-faceted banking landscape:

- The leverage ratio should be a binding constraint only for banks with more aggressive modelling approaches
- Should the leverage ratio become a binding constraint for the majority of banks, these will have an incentive to pursue risker transactions
- Combined with the LCR's HQLA requirements, this will drive banks to pursue high yield to offset low return, away from IG corporate…
- Risk sensitivity should be preserved with the leverage ratio only used as a backstop
- TLAC: further clarification is expected to allow an appropriate tailoring to fit different business models and the various banking structures
    - KPMG report (April 2015, Part 1): "this (TLAC) may be expensive and have a significant impact on a large bank's cost of funding (…) some banks may struggle to raise additional long-term debt".

Some unintended consequences:

- Christine Lagarde, Managing Director, IMF: « (…) risks are migrating from banks to non-banks, from solvency to market liquidity risks, and from advanced to emerging economies », International Conference on Policy Challenges for the Financial Sector (June 4th 2015)
- Bank of England Governor Mark Carney (June 2015): « (…) the possibility of sharp, unpredictable changes in market liquidity poses a clear risk to financial stability »
- According to BOAML (April 2015), clearinghouses are becoming too big to fail. CCPs have indeed increased capital by >50% since 2010 (Morgan Stanley & Oliver Wyman, 2015). Also, risky products with daily redemptions could face increased pressure, particularly given the reduction in liquidity (BOAML, April 2015)
- More generally, notable reductions observed in trading volumes raise the question of banks' ability to act as shock- absorbers in times of volatility

Banks abilities' to deliver return is impaired and may result in inappropriate behaviour:

- IMF report (October 2014): "Banks have raised capital, they have also worked in other areas, including running off portfolios, selling noncore businesses, and cutting operating costs. But there may be only limited room left for further gains in these areas and more needs to be done (…) Banks with low risk-weights are likely to shift to higher-risk activities until regulatory capital constraints are hit."
- Economists already demonstrated that the tightening of regulatory capital constraints –among others- may, against regulators' expectations, increase portfolio risks and banks' failures (Kim and Santomero, 1988)
- EBA report (June 2015): "RoE remains thus subdued and insufficient to cover the cost of equity for many banks, which may encourage disproportionate risk taking…"
- Lower returns may also lead to underinvestment at the expense of longer-term viability (Yves Mersch's speech, the Economist Future of Banking Summit, March 2015)
- At the end of the day, banks will have to price in regulatory costs in order to restore return on equity.

Please refer also to the "Rapport annuel 2014 du Haut Comité de Stabilité Financière », pages 48-53.

6.2

- Capital Market assets globally: the new regulatory environment imposes constraints on trading / market making activities, which reduces the liquidity on capital market to an extent which observers are now starting to be quite concerned about.
- Local administration: this category has lost its preferred risk weight and is penalised by liquidity measures. Since the margins on such transactions are very thin, the volume of transactions has been affected.
- Real estate markets are very much penalized by the leverage ratio and the upcoming Basel 4 IRRBB rule that will increase their risk weight. A shift to a variable rate business model would tighten credit conditions, increase credit risks for the customer and increase market risks for banks. It would mean a complete reconsideration of the real estate lending business model.
- Corporate bonds: by requiring banks to cut repos activities, the leverage ratio framework has contributed to further affecting the corporate bond markets, already impacted by macro-economic factor (also see 4.2). Since the collapse of Lehman Brothers, the secondary market liquidity in corporate bond markets in the US and Japan has dropped around 45% and 63% respectively, with the turnover ratio reaching 0.7 in the US and just over 0.05 in Japan in 2013. In the sovereign bonds markets, where liquidity is higher due to their standardized issuance procedures and their popularities as 'safe haven', the turnover ratio has been reducing as well.

13.4

- The BCBS NSFR standard applies on a consolidated basis exclusively. However, CRR introduces liquidity requirements both on an individual and consolidated basis. As NSFR requirements are far more restrictive for capital markets and corporate banking than they are for retail banking, an EU transposition at entity level would have very serious impacts on corporate and investment bank subsidiaries. This would impact EU efficiency and attractiveness and would be in contradiction with the objectives of the Capital Markets Union of promoting market-based financing.
- Remuneration: level 2 measures should respect level 1 framework. The EBA-proposed deletion of thresholds at individual level and company level would disproportionally increase the scope of persons whom the remuneration rules should apply to, although they have little to do with the level of risk of the bank.

15.1

The BCBS included a cross jurisdictional activity criteria in BCBS methodology to identify G-SII with a rational based on resolution.

> 1. Cross-jurisdictional activity: 21. Given the focus on G-SIBs, the objective of this indicator is to capture banks' global footprint. Two indicators in this category measure the importance of the bank's activities outside its home (headquarter) jurisdiction relative to overall activity of other banks in the sample: (i) cross-jurisdictional claims; and (ii) cross-jurisdictional liabilities. The idea is that the international impact of a bank's distress or failure would vary in line with its share of cross-jurisdictional assets and liabilities. The greater a bank's global reach, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure."

Resolution therefore clearly appears to be the key concern behind the cross border indicator.

The benefits of the SSM / SRM must thus be reflected in the way G-SII methodology considers cross-border activity:

- The European Union is a single market, which financial sector now benefits from a common prudential regulatory framework, including the Bank Recovery and Resolution Directive (BRRD) adopted in April 2014 which provides a single rulebook for the resolution of banks and large investment firms in all EU Member States.
- Furthermore, within the European Union, the majority of European Union Member States (Euro Area and other Member States opting to participate) are part of the Banking Union which provides a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM):
    - Within the Banking Union, all large institutions are under the supervision of the European Central Bank since November 4th, 2014.
    - From January 1st, 2016 onwards, a common resolution framework will apply to all banks subject to the SSM, based on a single resolution authority and a common resolution fund.

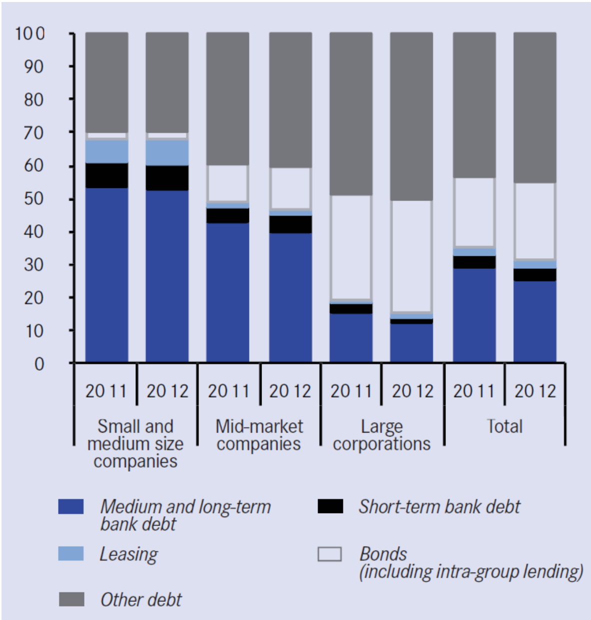
ANNEX B –review by French banks economists on the impact of regulation on SMEs' financing

1. The importance of measuring the impact of bank regulation and capital requirements legislation on SME lending

1.1. SMEs play a crucial role in the economic growth and job creation. In France, SMEs accounted for more than 99% of companies and 43.9% of the economic value added in 2011, and employed nearly half of the total workforce (48.7%).[1]

1.2. SMEs are specific in their financing structure. As a result of organizational features and business strategies that are rarely publicly disclosed, capital market funding is seldom an option for SMEs which largely rely on bank loans for funding.

FRENCH COMPANIES: BREAKDOWN OF FINANCIAL DEBT BY SIZE OF COMPANY, IN PERCENTAGE



Source: Cailloux, Jacques, Augustin Landier, and Guillaume Plantin, 2014. Lending to SMEs: Identifying Difficulties and Recommending Targeted Measures. Les Notes du CAE 18.

1.3. It is therefore of importance to measure the impact of banking regulation and capital requirements on SME lending.

2. Some difficulties to disentangle the effects of regulatory changes on bank financing of the economy

2.1. The impact of CRR and CRD IV on bank financing the economy has attracted a relative small interest in the academic and institutional organization literatures. This lack of empirical evidence should encourage greater prudence: only a few studies (conducted by BIS, BCBS, IIF, IMF, FSB, and OECD)[2] try to analyse and assess the benefits and costs of regulatory reforms.

[1] See: République française, *Annexe au projet de loi de finances pour 2015. Effort financier de l'Etat en faveur des petites et moyennes entreprises*, 2015.

[2] Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity* Requirements, August 2010; Financial Stability Board and Basel Committee on Banking Supervision, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, December

Furthermore, predictions on the impact of banking regulation and capital requirements legislation are conclusive but contradictory on the overall net economic impact. Papers converge on the existence of additional costs reforms that may be imposed on banks and lending volumes. However, while some studies suggest that the total benefits of regulatory reforms outweigh the additional cost, other studies report a positive impact on lending spreads and a small but negative impact on GDP growth. The assessment of the contribution of prudential reform to financial stability is quite artificial and raises serious methodological issues. For example, the Long-Term Economic Impact Group (LEI Group, BIS) considers that the arithmetic product of the fall in the annual probability of financial crisis and the median long-term cost of a financial crisis (a cumulative 63% of GDP) gives the mathematical expectation of the annual GDP loss avoided. Controversially, the LEI group then assimilates the latter to supplementary points of GDP growth. All in all, the LEI experts put the benefits of a 7%-to-10% increase in the average common equity ratio at between 1.98% and 2.10% of GDP per year under their baseline assumptions, depending on whether liquidity requirements are respected or not. Furthermore, the BIS incorporates monetary policy *via* a Taylor rule. This tends to compensate for the restrictive impact of Basel III on the creation of money and significantly reduces the impact on economic activity but is not necessarily relevant through the economic cycle. Contradictory predictions abound, it is necessary to conduct empirical studies to try to disentangle the link between CRR and CRD IV and bank financing of the economy.

2.2. European banks are clearly on the way to achieving the adaptation to the new regulatory standards, at least for those which have been already finalized. This process has already impacted the European economy. In future, the ongoing regulation tightening could weigh on the financing of non-financial corporations – widely relying on banks' lending – and could hamper banks' ability to accompany the upturn of the credit demand from enterprises when economic growth will pick up again.

The decrease in the euro area banking system aggregated balance sheet between its peak in May 2012 (€34,855bn) and July 2015 (€31,514bn, corresponding to a variation rate over the period of -9.6%) has been, to a certain extent, attributable to the contraction in loans to euro area customers (-1.3%). However, this shrinkage in euro area banks' aggregated balance sheet was mostly due to the fall in "remaining assets" (-4.2%), mainly derivatives. Another reason of the reduction in balance sheets has come from the fall in banks' deposits with the Eurosystem (-3.4%), which has been only very modestly offset by the positive contribution from interbank loans (0.5%). Last but not least, the banking sector's deleveraging in the Eurozone has been noticeable in all countries but to a greater or lesser degree.

2.3. Analysing the *ex post* impact of banking regulation and capital requirements legislation is problematic. First, there is a lack of tangible data to observe any consequences of regulatory reforms. With most regulatory reforms still at an early stage of implementation, it remains too early to fully

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2010; Institute of International Finance, *The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework,* September 2011; Financial Stability Board and Basel Committee on Banking Supervision, *Assessment of the Macroeconomic Impact of Higher Loss Absorbency For Global Systematically Important Banks*, October 2011; OECD (Patrick Slovik and Boris Cournède), *Macroeconomic Impact of Basel III*, Working paper, 2011; IMF (Douglas Elliott, Suzanne Salloy and André Oliveira Santos), *Assessing the Cost of Financial Regulation*, 2012; Financial Stability Board, *Update on Financial Regulatory Factors Affecting the Supply of Long-Term Investment Finance*, September 2014.

assess their impact on bank financing of the economy.[3] Second, it is difficult to disentangle the effects of regulatory changes from other economic factors that impact the supply and demand of credit.

2.4. The usual regression framework to assess the *ex post* impact of increased capital requirements on corporate lending should involve linking credit growth to SMEs as a dependent variable to regulation/legislation proxies and other bank and macroeconomic variables as explanatory variables, using the following specification:[4]

$$\Delta Loans_t = \alpha_t + \beta_0 B_t + \beta_1 H_t + \beta_2 R_t + \varepsilon_t$$

Where the dependent variable is the real credit growth to SMEs in time *t*; B_t represents the variables controlling for the bank characteristics including lagged credit growth, profitability, liquidity and solvency; H_t is the set of macroeconomic variables (such as GDP growth and inflation rate) reflecting the attractiveness of expanding credit to SMEs; and R_t refers to a regulation dummy taking the value of one for years in which regulation began, and zero otherwise.

However, given the lack of tangible data and the early stage of implementation of regulatory reforms, establishing a cause-and-effect relationship is by no means a perfect solution.

2.5. The monetary policy bias

Among other factors, new liquidity rules have certainly led the European Central Bank to do much more than what it would have done without them. To some extent at least, the LCR may be viewed as a mandatory reserve requirement, where commercial banks have to constitute reserves at the central bank in proportion to their deposits, and on which academic literature abounds.

The first effect of an increase in the reserve requirement is an arithmetic decline in the credit (or money) multiplier. The impact of this decline on bank lending has been hidden so far by the exceptionally accommodative stance of the monetary policy, which has allowed a huge increase in banks reserves with the ECB (from €378bn in December 2010 to €626bn as of 11 September 2015).

Moreover, non-conventional monetary policy measures artificially inflate euro area banks' stable resources (LTRO, TLTRO, bank deposits of securities sellers to the ECB under the QE) and help lower loan-to-deposit ratios. As a result, current NSFR and LCR, as measured in the last Monitoring exercise published by the EBA, are probably significantly higher than their "natural" levels that the monetary policy normalization may reveal in the coming years. In addition, the disintermediation process is likely to bring a transfer of banks' liabilities from retail deposits to corporate deposits. Since retail deposits are weighted between 90% and 95% in the "available stable funding" of the NSFR and between 3% and 10% in the "cash outflows" of the LCR whereas corporate deposits are weighted at 20% in the "cash outflows" of the LCR and at only 40% in "available stable funding", the disintermediation trend is likely to depress the future levels of both the LCR and the NSFR.

[3] See: Barut, Marie Laure, Nathalie Rouillé and Marion Sanchez, 2015, *L'impact du nouveau paradigme réglementaire sur le rôle des banques dans le financement de l'économie,* Revue de la stabilité financière 19.

[4] Allen, Franklin, Krzysztof Jackowicz, Oskar Kowalewski and Lukasz Kozlowski, 2015. Bank Lending, Crises and Changing Ownership Structure in Central and Eastern European Countries. *Working Paper*; Blaise Pua Tan, Tatum, 2012. Determinants of Credit Growth and Interest Margins in the Philippines and Asia. *IMF Working Paper*.

3. Preliminary findings on the impact of financial regulatory reforms on bank financing of the economy in France

3.1. French companies' stands out by both a strong increase of market sources of credit and a relative good performance of bank credit. Since 2009, market finance has more than offset the decline in bank loans to companies in the Eurozone as a whole. However, this conceals substantial disparities between countries. And France corporate lending stands out on both fronts.

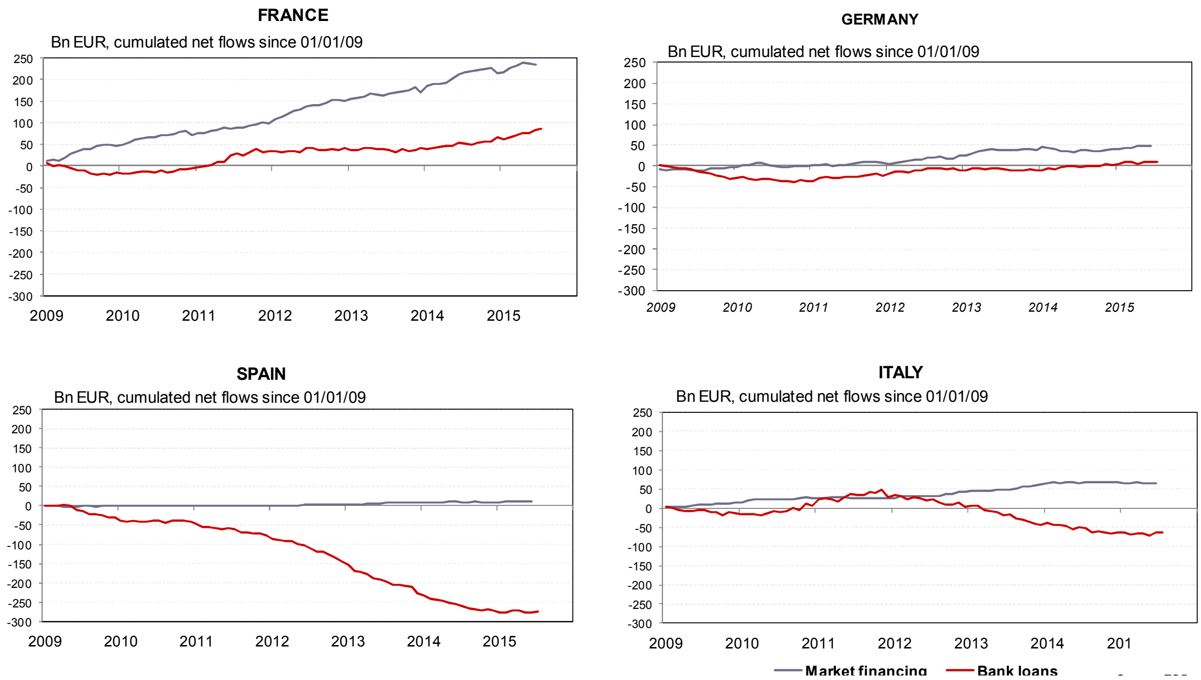
Indeed, in France, bank lending has proved resilient (no "credit crunch" has been observed): since 2009, outstanding loans have continued to grow slightly. Surveys on bank lending conditions suggest that – apart from during the height of the financial crisis in 2008/beginning of 2009 – sluggish growth in bank lending stems more from weak demand than restricted supply.

In parallel, France also stands out with regard to non-financial corporate market debt: the cumulative increase since 2009 is above €240bn in France. The disintermediation trend therefore seems to be more important in France (where market financing now represents 38% of total non-financial corporations' debt vs. 26% at the beginning of 2009; total Eurozone: 21%). Two factors may contribute to explain this French particularity:

- A corporate structural factor: the preponderance in France of major multinational groups, which are more likely to resort to market financing, whereas other major Eurozone economies are characterized by a substantial number of medium-to-small sized companies, which continue to resist to resort to bank financing;
- A bank strategic reallocation: the French banking sector is composed mainly of big universal entities. In reaction to the new economic and regulatory environment, they have strategically accompanied their big clients towards market financing, in order to keep RWA capacities for SMEs.

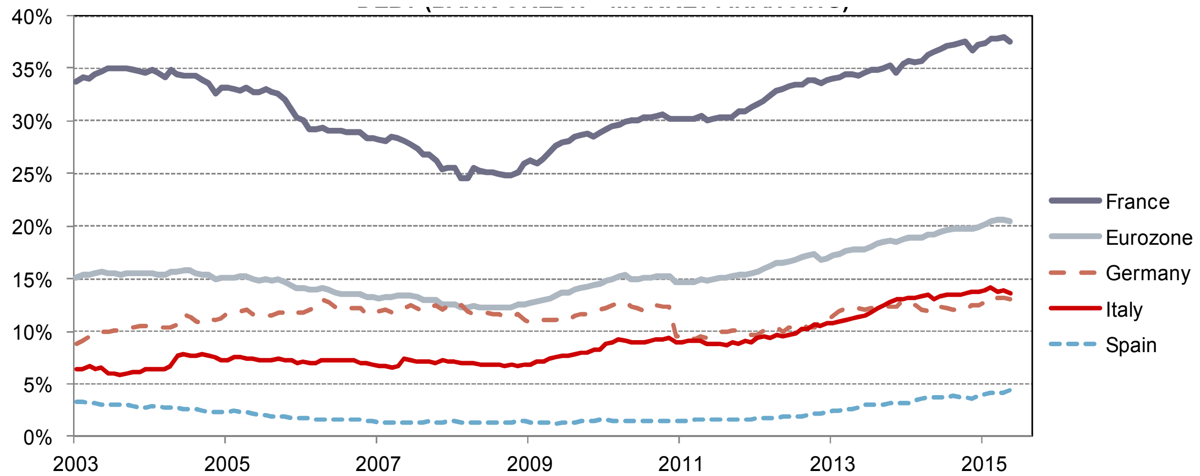
This disintermediation process has been possible thanks to very accommodative market conditions. Then, a normalization of interest rates could partially call into question the process. Moreover, the euro area does not currently have the same capacities as the U.S. to attract foreign capital (positive vs. negative current account) and the development of markets involves lengthening of the maturity of domestic savings, which is a long term process.

DEBT OF THE NON-FINANCIAL CORPORATE SECTOR



Source: European Central Bank

NON-FINANCIAL CORPORATE SECTOR: SHARE OF MARKET FINANCING IN TOTAL DEBT (BANK CREDIT + MARKET FINANCING)



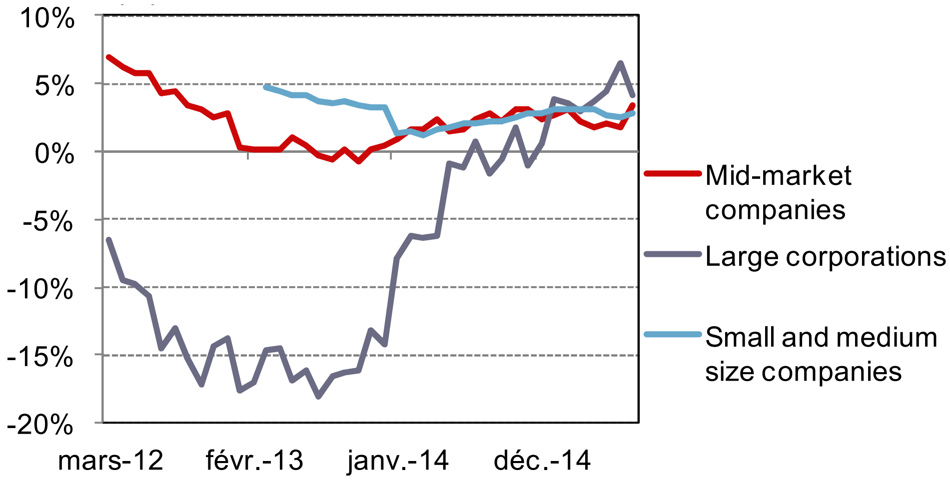
Source: European Central Bank

3.2. SMEs

More detailed data on French non-financial corporations show that over the period, bank lending has been declining for large companies and intermediate-sized enterprises (ETI, *Entreprises de Taille Intermédiaire*[5]), whereas it has continued to increase for SMEs. Disintermediation therefore appears to operate for companies having a size that allows them easier access to markets, whereas SMEs continue to obtain financing *via* the banks.

[5] An intermediate-sized enterprise is a company with between 250 and 4,999 employees, and a turnover which does not exceed 1.5 billion euros or a balance sheet which does not exceed 2 billion euros. ETIs represent an intermediate category between small and medium companies and large companies.

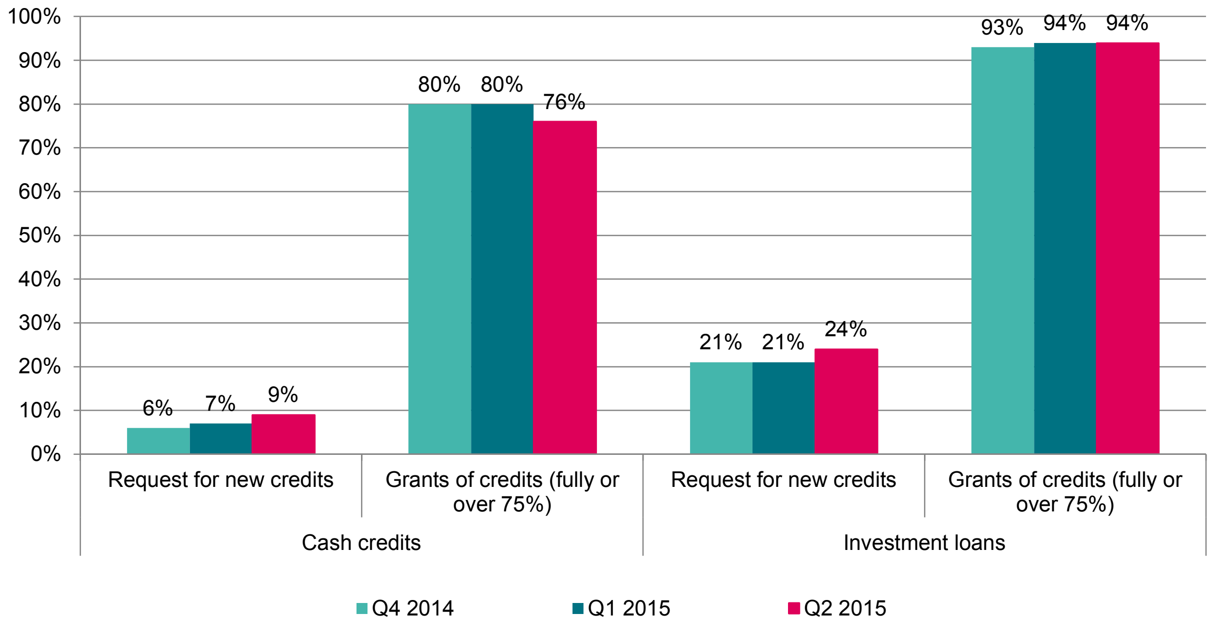
BANK CREDIT TO THE FRENCH NON-FINANCIAL CORPORATE SECTOR, IN PERCENTAGE, YEAR-OVER-YEAR



Source: Banque de France

In particular, lending to SMEs has remained but growth rates remain at low levels (yearly growth of +2.5% in June 2015). Access to investment loans remains easy: 94% of SMEs were fully or substantially granted. Weaker bank lending is likely to reflect a tightening in the demand for credit: over the second quarter of 2015, only 24% of SMEs requested for new investment loans.

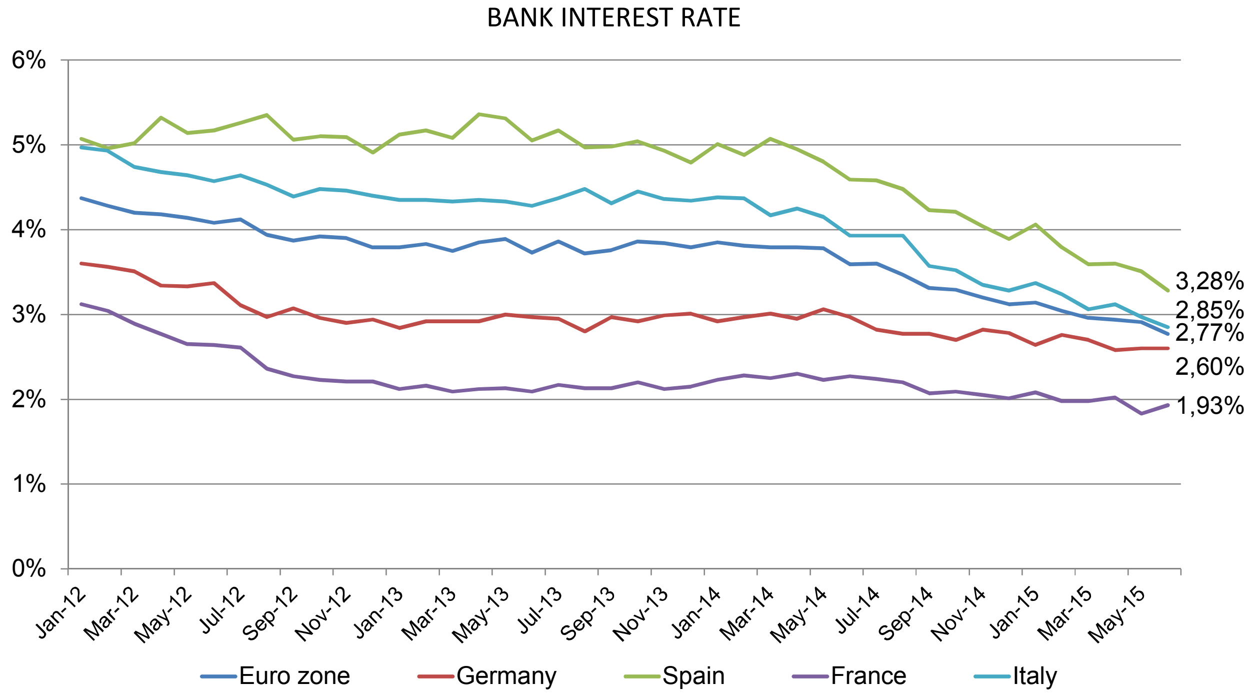
ACCESS TO BANK FINANCING FOR FRENCH SMEs



Source: Banque de France

Bank interest rates have been exceptionally and persistently low. This low interest rate environment is challenging for banks.[6] The ECB's quantitative easing program, which began in March 2015, maintains these low interest rates. When rates finally rise, credit could be negatively impacted.

[6] See: Banque de France and ACPR, July 2015, "Evaluation des risques du système financier français"; Bank for International Settlements, "85th Annual Report, 2014/15"; ACPR, May 2015, "French banks' performance in 2014", *Analyses et Synthèses* 46.



Source: European Central Bank. Loans up to EUR 1 million at floating rate and up to 1 year initial rate fixation.

3.3. European banks are much better capitalized today than prior to the crisis. The level of CET1 capital has increased by almost 50% between June 2011 and December 2014 for large internationally active European banks[7], in response to regulatory requirements and market pressure. However, the cost of equity required by investors (10-12%) has not decreased accordingly and does not reflect the fact that the industry has strengthened its balance sheet. This means that higher capital requirements are not neutral and create additional costs for banks and the economy as a whole.

European banks have adapted swiftly to higher regulatory costs in order to limit the pass-through into lending interest rates. This has contributed to the erosion of European banks' profitability. While the profitability of French banks appears to have been recovering faster than at other European banks, they are still less profitable than American banks, where the return on equity reached 6.8% in 2014 (vs. 4.5% in France)[8]. The average return on equity of the European banking industry has been standing below its cost of equity since 2009.

(1) Efforts from European banks to streamline their cost base were an important factor that helped to stabilize cost-to-income ratios. From 2008 to 2014, the number of euro area branches declined by 14% and the number of bank employees by 10% (-5% and -3% in France respectively, according to ECB statistics).
(2) Many global banks have shrunk or exited from activities like fixed income, currencies, and commodities. Most of them have rebalanced their business models away from capital-intensive activities to more fee-based activities (M&A, underwriting) and/or have refocused on commercial banking in home markets.
(3) As already mentioned before, higher capital requirements would have made credit to enterprises much more expensive without an exceptionally benign monetary policy.

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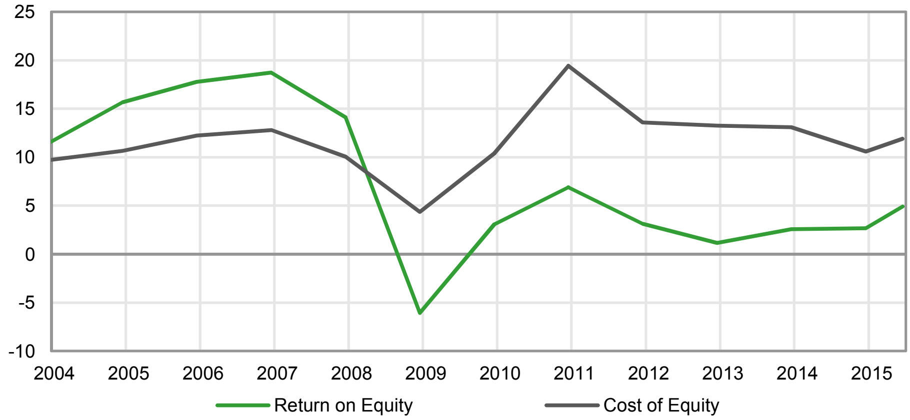
[7] See: EBA, *CRD IV–CRR/Basel III monitoring exercise report*, September 15, 2015.
[8] See: IMF, October 2014, "Risk Taking, Liquidity, and Shadow Banking: Curbing Excess While Promoting Growth", *Global Financial Stability Report*; ACPR, May 2015, "French banks' performance in 2014", *Analyses et Synthèses* 46.

But there may be limited room left both in cost-cutting efforts and further loosening of monetary policy. Additional constraints are likely to lead to a significant credit repricing which could undermine the competitiveness of SMEs, which rely heavily on bank lending. It could also lead to more deleveraging when repricing is not possible due to international competition, especially in capital markets activities.[9] This raises concerns about the ability of European banks to support the international expansion of the European corporate sector.

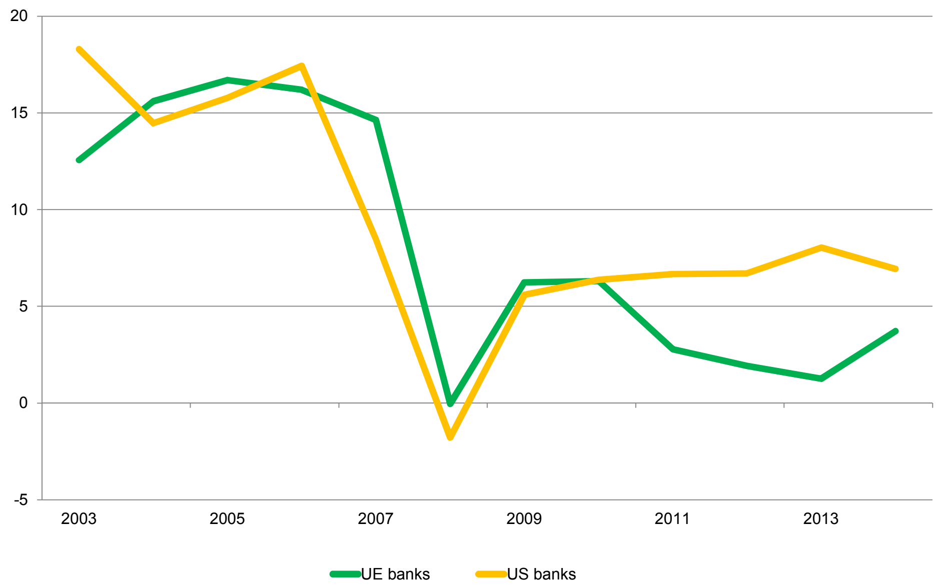
RETURN ON EQUITY AND COST OF EQUITY, IN PERCENTAGE[10]

Sample of 29 European banking groups



Source: Bloomberg, Crédit Agricole S.A.

COMPARISON OF BANK ROE, IN PERCENTAGE



Source: Bankscope, calculations by BNP Paribas

[9] According to the IMF, 46% of euro area banks would not be able to deliver more than 5% annual credit growth due to balance sheet constraints; 40% would need to increase lending margins by at least 50 bps on their entire loan books in order to preserve capital buffers. See *Global Financial Stability Report*, October 2014.

[10] The last two graphs are based on different samples.

ANNEX C: Illustrative examples

The decision to invest in one asset class over another is not only based on the performance of this investment and the risk policy relevant to each bank but also depends on the amount of capital and liquidity tied up against risks and as required by prudential regulation.

Current prudent regulations implemented after the financial crisis already considerably strengthened banks' capital requirements for banks and limited their investment capacity in the securities and debt issued by corporates, as well as their ability to finance these same counterparties through loans. The charts enclosed illustrate synthetically and in a simple fashion the impacts of new regulation implemented as of 1 January 2014 and new developments anticipated as from 2018 in relation to solvency requirements.

Indeed, three main measures which are already implemented, impact strongly on the capacity of banks to invest / finance the corporate portfolio:

- **The strengthening of banks' global solvency requirements** which impacts on the whole range of banks' activities, including investing in the corporate portfolio,
- **The increase in the capital charge for this particular kind of investment**
- **A framing of liquidity in particular over the short-term with the introduction of the LCR**, which incentivises banks to constitute reserves of High Quality Liquid Assets thereby unduly putting at a disadvantage investments in corporates.

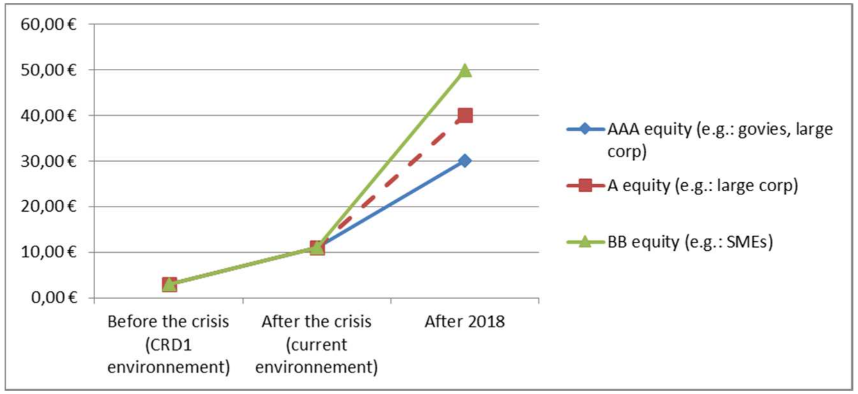
The prudential regulations currently under negotiations at the Basel and European level will add on this already penalising base and could compromise the capacity of banks to play their investor's role while overly framing their role of financier of the economy. It is of utmost importance that all stakeholders bear in mind the importance of a properly calibrated regulation while designing the "Basel IV" framework in order not to hinder the economy recovery in the EU and not to counter the objectives of the CMU proposals.

Assumptions underpinning our illustrative charts:

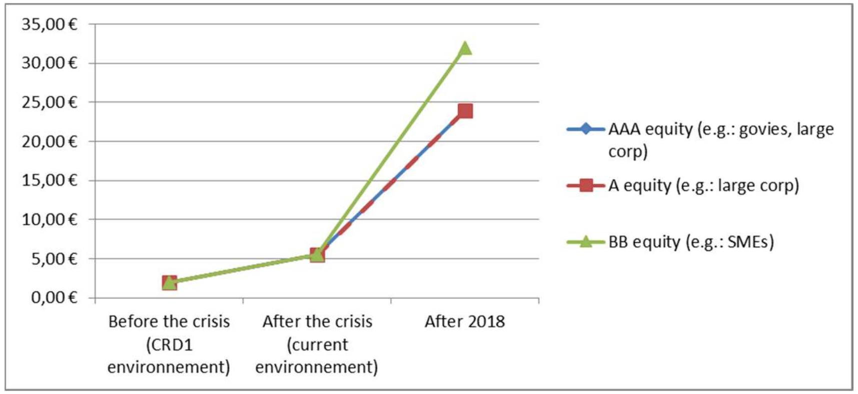
- Equity and debt
  - We aim at showing the cost in capital of holding on a bank's balance sheet a 100 € security (equity or debt), over the short term (trading book) and over the long term (banking book)
  - Debt calculations do not take into account portfolio diversification effects as we assume only one security is held at the time –as a result, the capital charge will be higher in our stylised example
- Credit exposure
  - We aim at showing the cost in capital for a 100 € credit exposure to a SME, a large corporate (A and BB), and a project finance transaction, before the crisis (CRD regulatory environment), after the crisis (current CRR1 / Basel 3 regulatory environment), and tomorrow (after 2018, under the "Basel 4" framework as anticipated);
  - All credit exposures are supposed to be held by the bank into its banking book for financing purposes (no trading activities);
  - All calculations are made under the Standardised methodology.

EQUITY - Cost in capital of a 100 euros equity purchased by the bank and held on its balance sheet

Over the short term (Trading book)

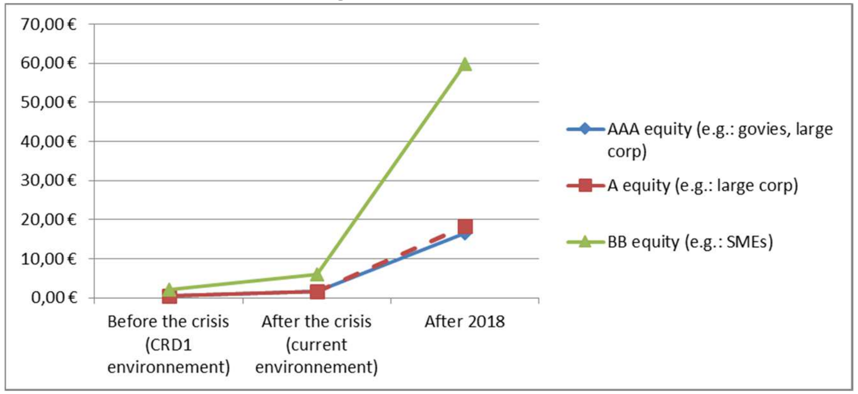


Over the medium/long term (Banking book)

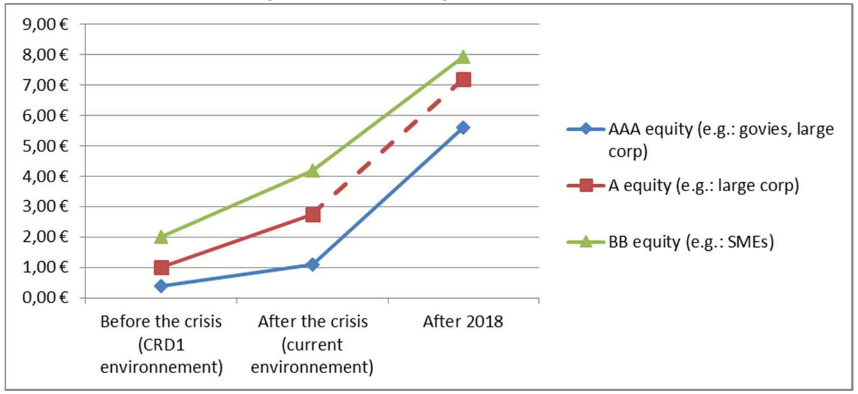


DEBT - Cost in capital of a 100 euros bond purchased by the bank and held on its balance sheet

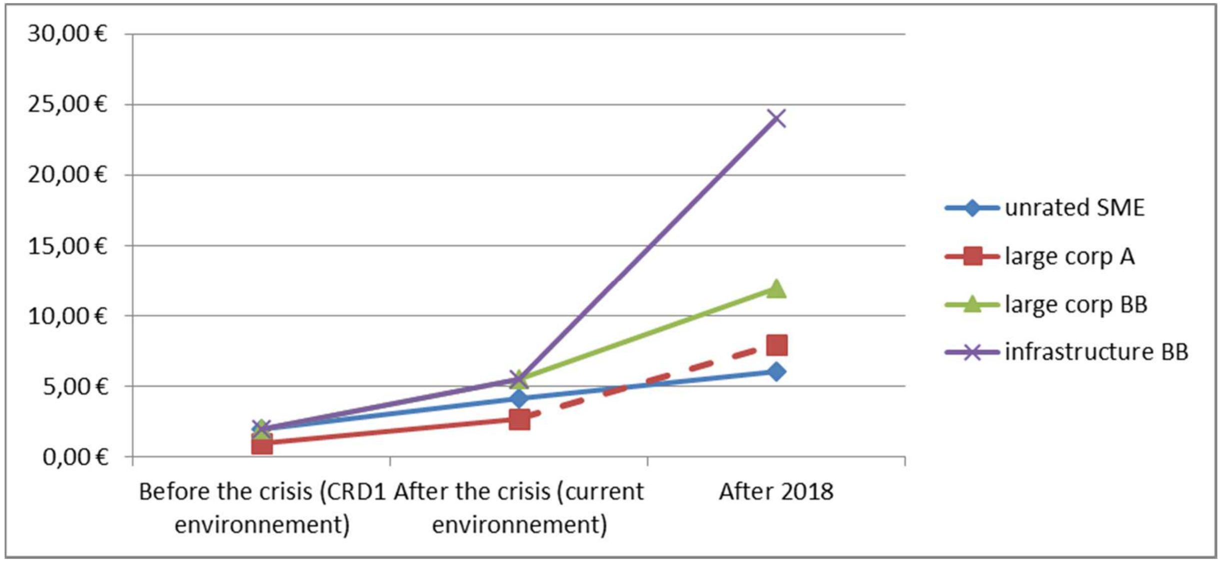
Over the short term (Trading book)



Over the medium/long term (Banking book)



LOAN - Cost in capital of a 100 euros credit exposure held on the bank's balance sheet (banking book only)



* As far as unrated SME exposures are concerned, we have included in our calculations the SME supporting factor on the "After the crisis" and "After 2018" scenarios. It is worth noting that removing the supporting factor would lead to mathematically increasing by 30% the cost in capital on those exposures, all things being equal.