MEMO
N°04

THE BASEL ACCORDS AND THEIR CONSEQUENCES FOR THE ECONOMY

FÉDÉRATION
BANCAIRE
FRANÇAISE

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?

01

WHAT IS THE BASEL COMMITTEE?

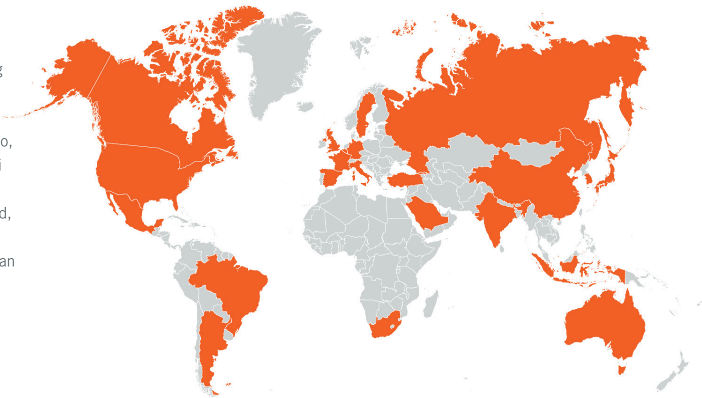
Created in 1974, the Basel Committee is an international committee based in Switzerland tasked with establishing international banking rules. **Its members are central bank governors and representatives of the national competent authorities of the 28 member states and jurisdictions**[1].

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, Switerland, Turkey, United, Kingdom, United States and European Union.



02

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.

CAPITAL RATIO

$$\frac{\text{OWN FUNDS}}{\text{CREDIT RISK}} = 8\%$$

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.**

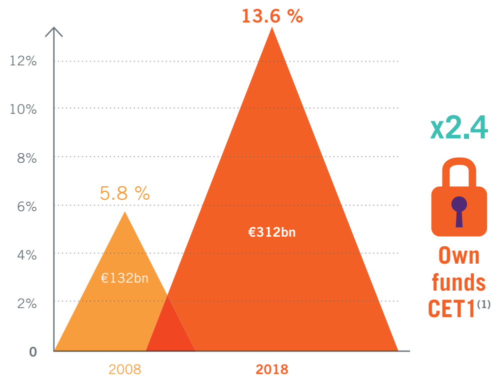
➤ **Pillar 3:** transparency (increased disclosure obligations) and market discipline, with the aim of keeping the market informed while facilitating comparisons between banks.

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.

EVOLUTION OF THE CAPITAL RATIO OF MAJOR FRENCH BANKS: CAPITAL HAS DOUBLED

Source: Banque de France - ACPR



(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 immediat 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 and supplemented by new texts adopted in 2018 (CRD5-CRR2).

03

FINALISATION OF BASEL III: BACK TO A STANDARD APPROACH?

In France, to date, banks have **more than 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), completed in january 2019.

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."

According to impact studies from the Basel Committee (March 2019) and the European Banking Authority (August 2019), the average increase in capital requirements is **more than 24% for European banks** (up to 28% for very large banks and about 25% for French banks), **compared to 1.5% for American banks**.

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 banking system still makes up 75% of the financing of the economy, although alternatives have developed (access to markets for large corporations, easing of long-term investment rules for insurers).

The role of banks remains paramount in the EU and France, specifically for financing the development of the economy – whether for individuals, SMEs, corporations, or government and local authorities – and ensuring economic and financial sovereignty.

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 funding model under threat?

If the banks are to withstand such an increase in their capital requirements, they will have only two levers:

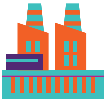
- **increase their capital:** they would have to set aside all of their undistributed profit for five years, and would, effectively, lose any capacity for additional investment and thus for financing economic growth;

- **and/or reduce their exposure:** the lending capacity of French banks would be reduced over time by several hundred billion euros, which is a very substantial amount in comparison to outstanding loans to individuals (€1.2 trillion) or businesses (€1 trillion).

Certain types of financing would be especially affected, such as aircraft financing, real estate financing, and financing of unrated companies. It would affect the banks' ability to continue serving their customers under optimal conditions and supporting them with the energy transition and the growth of their business.

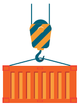
THE AMOUNTS OF CAPITAL IMMOBILIZED BY THE BANKS FACING CERTAIN KEY FUNDING WILL CONSIDERABLY INCREASE

2x FOR UNRATED **CORPORATE BUT INVESTMENT GRADE QUALITY FINANCING**

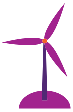


2.6x FOR RESIDENTIAL **REAL ESTATE FINANCING**

2.5x FOR **EXPORT** FINANCING



3x FOR PROJECTS **SUCH AS WIND TURBINES FINANCING**



4x FOR **AIRPLANE FINANCING**

04

A QUESTION OF ECONOMIC AND FINANCIAL SOVEREIGNTY FOR EUROPE

Setting uniform regulations would have a material impact on French and European banks, limiting their capacity to finance individual customers, corporations and major strategic projects 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**.

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.

Indeed, the reform would have a major impact on growth: according to Copenhagen Economics[1], the impact of the agreement would reduce European growth by 0.4%.

(1) Copenhagen Economics, EU implementation of the final Basel III framework, November 2019

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.

Mobilising at the highest national level

- In early July 2019, the French Prime Minister told Paris Europlace players that France will ensure "the development of healthy and fair competition with financial institutions located outside the Union" and pay "careful attention […] to the accurate assessment of the consequences on the European economy of the final Basel III agreement, as well as its […] procedures for enactment in Europe."
- On 27 August 2019, at the Conference of Ambassadors, the French President called for "a greater integration of financial markets of the Euro Area and stakeholders, and a capacity to build everything that truly establishes financial and monetary sovereignty."

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.

05

OUR PRIORITIES

For appropriate transposition in the European Union

Transposition should not be undertaken without the European legislature's assurance that it will preserve the specific nature of our financing: fixed-rate housing loans, financing for quality companies that do not have an external rating, and specialised financing to build our future and broaden the coverage of our industrial champions.

Transposition should promote greater risk awareness. Any increase in regulatory requirements should be the consequence of a higher risk, not of an overly simplified approach.

Transposition should avoid any increase in the fragmentation of the Banking Union, which would be detrimental to the free movement of capital.

Transposition should preserve the conditions of fair competition with US banks. If it does not, the profitability of French banks (6.7% in 2018) would erode further, widening the gap with American banks, which are much more profitable (10%). European corporate and investment banks have lost a 10% market share in 10 years in the EU, which raises the question of whether the EU is in control of its financing sources.

Transposition must not result in a reduced offering, nor an increase in financing costs or financial risks for businesses or consumers. Financing terms for smaller suppliers and specialised financing (aviation, project finance, etc.) are a key issue. Likewise, financial operations that make international sales easier and more secure must be preserved. Lastly, special handling of market risks is needed for the Capital Markets Union's development.

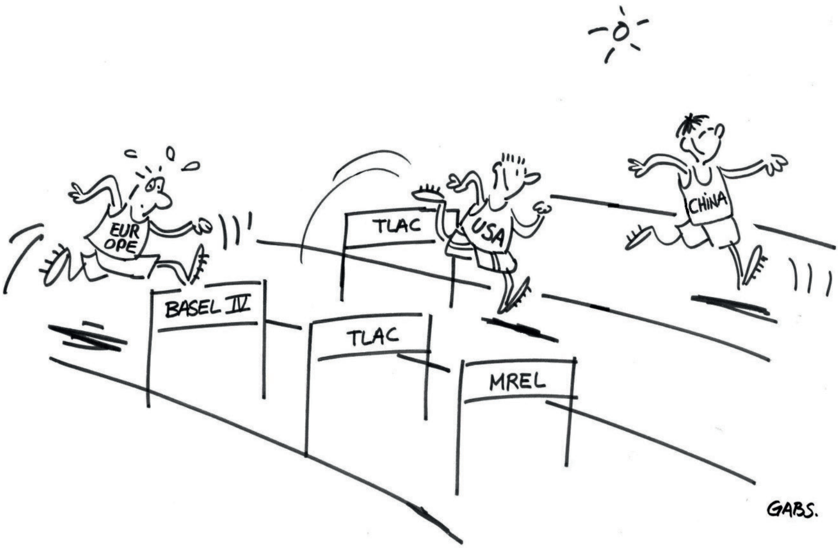
Preserving the efficiency of the French financing models

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[2] to be one of the six key strengths of the French economy: five out of ten major banks in the euro zone are French[3]. **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.

(1) ECB survey published on 17 September 2015 on the fiscal impact of financial sector support during the crisis (2008-2014).
(2) OECD, "OECD Economic Surveys: France 2015", April 2015.
(3) S&P Global Market Intelligence, 2018



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November 2019

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