Finance Watch response to DG FISMA consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy

Brussels, 7 October 2015

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are relevant to Finance Watch are reproduced here.

We agree to the publication of this response.

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Finance Watch welcomes this consultation. We strongly support the objective of ensuring that the CRD IV / CRR package provides the right incentives and refocuses banks on their core mission to lend to non-financial corporations and households.

We note however that some of the questions seem to focus disproportionately on the possible costs of regulation for banks and not much on its longer term benefits for all stakeholders.

Question 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? How have market, supervisory and regulatory capitalisation demands interacted to make banks adjust the level of capital they hold to the current level? Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role?

CRR and CRD IV requirements have played a major role in pushing banks to increase both the levels and the quality of capital.
The stress tests and ECB asset quality review were also a major contributing factor.

Market pressure further compounded the impact of the previous factors and incentivised banks to comply quickly for fear of being perceived as less solvent than competitors.

Market players have however been quick to realise that regulatory capital under CRR and CRD IV relied on internal models that could be manipulated and was a very weak predictor of bank default. As a consequence it could be argued that market discipline had a bigger impact on banks' leverage ratio.

Question 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.

We do not consider that capital levels go significantly beyond what is necessary in any area.

However, talking about capital levels alone undermines the relevance of the question: the question should also consider the known flaws of the Internal Ratings Based approach and the planned changes in the standardised approach.

Lastly, we must bear in mind the regulator's paradox, namely the fact that banks have enough capital for benign market conditions, but can never have enough capital in bad times. In this respect while CRD IV / CRR added some macro-prudential elements to the framework, much remains to be done to address well-known systemic risks such as the procyclicality of leverage and interconnectedness.

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Question 3: What role have the additional capital requirements and buffers exceeding the harmonised requirements set out in the CRR played in the capitalisation process? Are such additional micro- and macroprudential capital requirements and buffers commensurate to the level of risk incurred and posed by banks? Please back up your view with specific evidence.

Additional macro-prudential capital requirements and buffers were a welcome addition in the CRD IV / CRR package. However as evidenced by a large number of studies, these buffers do not by themselves address comprehensively systemic risk factors, and additional macro-prudential measures are needed to reduce the risk of joint bank default.
In particular, as discussed in our latest position paper[1] we should investigate the possibility to tie-in capital requirements more directly with an institution's contribution to systemic risk. One possibility among others could be to use metrics such as CoVaR (Value-at-Risk of institutions conditional of distress of other financial institutions).

In addition, as discussed in our position paper "*To end all crises*"[2], we believe that a future leverage cap should also include a countercyclical element, which would be both consistent with the countercyclical buffer and reduce the risk of fire sales caused by a hard threshold. Instead of introducing different leverage caps for different business models as is currently envisioned, we would much favour a flexible ratio fixed at 5% / 20x leverage for normal times and at 3% / 33.3x leverage in downturns. This would give the countercyclical flexibility needed to adapt the banking landscape to economic cycles. In this respect we welcome the considerations of the ESRB regarding structural and cyclical macroprudential leverage ratios.[3]

Question 4: Have increased capital requirements influenced the overall capacity of banks to lend? 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? How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?

Increased capital requirements have indeed increased the overall capacity of banks to lend. As a recent BIS paper put it "*the main lesson from the financial crisis is that only well capitalised banks are able to provide lending on a sustainable basis*".[4]

[1] "A missed opportunity to revive "boring" finance" http://www.finance-watch.org/press/press-releases/995-fw-position-paper-on-ltf-securitisation-and-securities-financing
[2] http://www.finance-watch.org/our-work/publications/330-crd4-position-paper-to-end-all-crises pages 18-20
[3] June 2015 The ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector Addendum: Macroprudential Leverage Ratios
[4] BIS Papers No 75 Long-term finance: can emerging capital markets help? http://www.bis.org/publ/bppdf/bispap75.pdf

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Another BIS review had already found that "*banks in aggregate do not appear to have cut back sharply on asset or lending growth as a consequence of stronger capital standards. However, banks that had high capital ratios at the start of the process or strong profitability in the post-crisis years did tend to grow more than other banks. This points to the importance of solid bank balance sheets in supporting lending*."[5]

Demand-side factors seem to have been a major contributor to the decline in the volume of loans, except in specific southern European countries such as Italy, Greece, Spain and Portugal where specific issues linked to the national economic context played a key role.

It has also been documented that the heavy reliance of large European banks on wholesale funding creates excess elasticity in their balance sheets, potentially leading to sharp declines in lending activity during downturns.

Had increased capital requirements not been introduced, banks might be less well capitalised today, and in turn less able to lend in a sustainable manner.

The design of the soon-to-be-introduced liquidity ratios may however have an adverse impact on lending, as they favour liquid tradable securities over loans. Indeed both the Liquidity Coverage Ratio and the Net Stable Funding Ratio give banks the choice between having more stable funding or more liquid assets. Large banks typically prefer the latter option as liquid assets can be used for securities financing, the cheapest source of funding. As a result, investments into liquid tradable assets could crowd out loans to the (real) economy.
We have previously argued for a redesign of the liquidity ratios[6] in order to incentivise more directly stable funding over liquid assets.

Question 5: Are the effects of increased capital requirements, such as they are, generally temporary and transitional or have structural changes been seen? Has the requirement to hold higher levels of capital increased the cost of funding banks? Has the per-unit cost of bank capital decreased as banks have become less risky?

Higher capital may translate temporarily into a higher cost of funding. However over time as shareholders realise the related higher solvency, their expected return on equity should be adjusted down to reflect these changes.

We should also take into account two important changes likely to have a significant impact:
- First, the introduction of bail-in-able debt should lead to the expected returns from debt and equity converging and blur the distinction between both.
- Secondly, the proposed removal of the favourable tax treatment of debt over equity should also lead to a convergence in the cost of funding for both instruments.

[5] BIS Quarterly Review, September 2013
[6] See "A missed opportunity to revive "boring finance"" page 15-16 Finance Watch, 2014

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Lastly, the possible higher cost of equity over debt may come for a large part from the fact that the type of debt on which large EU banks rely is not stable long term debt but rather very short term collateralised debt such as repo.
If and when we finally address the stability issues linked to excessive reliance on wholesale funding and securities financing by introducing minimum haircuts and capping the re-use of collateral, and if and when we redesign the liquidity ratios to favour stable funding over liquid assets, banks' debt maturities are likely to increase, reducing this gap.

Question 6: Have increased capital requirements affected the market for some categories of assets more than others? If so, which ones and how? 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?

Increased capital requirements have had the unintended consequence of increasing the distortion created by the zero risk weights for sovereign debt, with the consequence that for many banks sovereign debt crowds out lending to the real economy.

Higher capital requirements have also affected small banks disproportionately, since the standardised approach they use to calculate their regulatory capital does not enable them to "optimise optimistically" their capital as the IRB approach does for large banks.

The liquidity ratios are likely to have promoted liquid tradable securities over loans, as banks typically prefer to increase their liquid assets rather than increase their stable funding, since the former enables them to have collateral for securities financing. As a consequence, liquid tradable securities may crowd out loans to companies.

Question 7: Do you think the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions? If so, please explain how.

We do not think that the phase-out of the transitional provisions under CRR will have an incremental impact on future lending decisions.
Except in selected southern Europe countries the lack of growth in bank loan books comes mostly from a lack of consumer demand for loans, not from a lack of regulatory capital that would constrain lending.[7]

[7] See ECB SAFE survey 2015 "*Euro area SMEs considered access to finance the least important problem that they faced.*"

""*Finding customers" remained the dominant concern for euro area SMEs in this survey period, with 26% of euro area SMEs mentioning this issue as their main problem*."

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Question 8: To what extent has this provision been effective in supporting lending to SMEs? 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?

All other things being equal this provision made a positive contribution. However, as described earlier, a combination of other factors seems to have played a bigger role, overriding the positive impact of this provision. Typically the lack of consumer demand that translated into lower demand for loans has been identified as a major contributing factor.

In addition as discussed earlier, the upkeep of the zero risk weighting for sovereign debt and the introduction of liquidity ratios that implicitly promote liquid tradable securities over loans made it comparatively less attractive for banks to lend to SMEs.

Question 9: What specific difficulties do banks face when lending to SMEs, compared to when lending to larger corporates? Are these related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties in other ways than by adjusting rules for SMEs, or do they need to be resolved by some other means? If so, what other means would be adequate?

Lending to SMEs in a sound and sustainable manner requires a local presence in order to understand the local economic context and competition and to be able to integrate crucial qualitative elements in the creditworthiness assessment.
Retail funded traditional banks with local branches are best placed to perform this activity. They are also typically more focused on this activity than large universal banks which may choose to allocate their capital to other more profitable activities.

These difficulties are not related to the CRR. The CRR could however promote SME lending through several measures:
1. Remove the inbuilt advantage of the IRB approach over the standardised one. This would stop promoting unfairly large banks over small banks and promote instead the business model most dedicated to SME lending.
2. Redesign the liquidity ratios to promote stable funding over liquid assets. This would stop incentivising banks to invest in liquid securities over illiquid loans.

Question 13: 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? How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market? Are there any provisions that could potentially be applied with greater differentiation? If so, what are these provisions? Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application? Are any concrete changes desirable in this context? If so, what are these changes and the associated costs and benefits?

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There should indeed be more differentiation between business models and risk profiles. The CRD IV / CRR was designed mostly to deal with risks in large universal banks and thus does not promote the level of diversity in banks' business models needed for financial stability and to serve the needs of the economy.

Addressing this issue without compromising financial stability and the level playing field could be best achieved by our earlier recommendations:
1. Remove the inbuilt advantage of the IRB approach over the standardised one, and truly address the discrepancies between banks' risk weights for identical assets. This would improve the regulatory level playing field between large and small banks.
2. Refrain from making the standardised approach more risk sensitive: this would create new flaws similar to those of the IRB approach, make it less robust, more complex and more vulnerable to manipulation.
3. Introduce a credible and binding leverage cap that would reduce large banks' ability to manipulate the internal models-based risk weighted assets, thus strengthening the level playing field between large and small banks.
4. Redesign the liquidity ratios to promote stable funding over liquid assets. This would make large banks' funding structures more robust and refocus them on lending. As importantly, this would contribute to reduce the unfair funding advantage of large banks over small ones, stemming from the fact that the negative externalities of securities financing have yet to be internalised in the funding costs of banks.

Question 14: Which areas of the CRR could be simplified without compromising the Regulation's objective of ensuring prudence, legal certainty and a level playing field? Are there areas that could be simplified, but only for specific types of bank or business models? 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? What would be the risks with such an approach?

The CRR could and should be simplified, as recognised by the Basel Committee on Banking Supervision[8]. The excessive complexity stemming from alleged increased risk sensitivity failed to translate into better predictive power of banks' distance to default[9], whereas the exponentially higher number of input parameters made the approach far more costly to implement and far more vulnerable to mistakes or arbitrage.

Simplifying the framework would thus strengthen - and not weaken - prudence, legal certainty and the level playing field. Specifically, removing the IRB approach and replacing it

[8] The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper July 2013 http://www.bis.org/publ/bcbs258.htm
[9] OECD, 2013. Blundell-Wignall, A., Atkinson, P. and Roulet, C., Bank business models and the Basel system: Complexity and interconnectedness http://www.oecd.org/daf/fin/financial-markets/Bank-Business-Models-Basel-2013.pdf

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by a combination of binding leverage cap and standardised approach would make the framework more robust and simpler, and it would strengthen the level playing field.

Question 15: What additional measures could be taken in the area of prudential regulation to further promote integration and enhance a level playing field? Can you indicate specific examples and evidence of discretions that affect the cost and availability of bank lending?

Outside of the scope of CRD IV / CRR, the European Commission should urgently implement the FSB's binding recommendations on securities financing transactions (SFT) by introducing minimum haircuts and capping the re-use of collateral, in line with the commitments made in the Regulation on SFT transparency (inter-institutional agreement of 29 June 2015).

Doing so would address key systemic risks: it would reduce the procyclicality of leverage and the excessive elasticity of large banks' balance sheets. It would also reduce the fragility of large banks' funding structures and internalise the negative externalities of SFT.

As the funding cost of SFT does not reflect their true cost, implementing the FSB's recommendations would enhance the level playing field between large EU banks whose main source of funding is SFT (61% of total liabilities on average[10]) and small banks which rely more on retail deposits.

Specific examples of discretions that affect the cost and availability of bank lending include the following:
- Prudential liquidity ratios currently implicitly favour liquid tradable securities over loans, thereby reducing the availability of bank lending, as securities can crowd out loans;
- The zero risk weight for Sovereign debt also pushes banks to lend to governments instead of lending to households and businesses;
- The favourable tax treatment of debt financing compared to equity pushes banks to minimise their regulatory capital, potentially affecting adversely their ability to lend in a sustainable manner.

[10] IMF, Lopez-Espinosa, G., Moreno, A., Rubia, A. and Valderrama, L., Short-term Wholesale Funding and Systemic Risk: A Global CoVaR Approach, WP/12/46, February 2013a

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