European Banking Authority Basel III Monitoring Exercise Results

Frederic Gielen
Partner
Avantage Reply

Scott Warner
Senior Consultant
Avantage Reply

The Basel III framework is intended to increase the resilience of the banking sector by strengthening the quality and quantity of regulatory capital and setting liquidity standards. The impact of the new requirements is being monitored and evaluated semi-annually on a global level by the Basel Committee on Banking Supervision (BCBS or the "Basel Committee"). At the European level this analysis is conducted by the European Banking Authority (EBA), the successor to the Committee of European Banking Supervisors (CEBS).

On 4th April 2012 the EBA published its first impact assessment report on the results of its Basel III monitoring exercise. 158 European banks from 20 countries submitted data as of 30th June 2011 for this exercise.

Background

The Basel III regulatory framework was finalised in December 2010.[1] To assess the impact of the new requirements set out in the 2009 consultative documents prior to that, both the Basel Committee and the CEBS conducted and published comprehensive quantitative impact studies during 2010.

The Basel Committee study found a capital shortfall for the 263 participating banks of €173 billion for the Common Equity Tier 1 (CET1) minimum requirement of 4.5% and €602 billion for the CET1 target level of 7.0%.

The CEBS study found a capital shortfall for the 246 participating European banks of €62 billion for the CET1 minimum requirement and €291 billion for the CET1 target level.

These studies assessed the impact of policy proposals that differed significantly from the final Basel III framework, and results are not directly comparable to the current study.

This EBA monitoring exercise is based on the final published framework and is a follow-up to the previous quantitative impact study.

Scope of the EBA Basel III Exercise

The EBA monitoring exercise provides an impact assessment of the following aspects of Basel III:

- Changes to banks' capital ratios and estimates of capital shortfalls, and estimates of capital surcharges for global systemically important banks;
- Changes to the definition of capital that result from the new CET1 standard;
- Changes in the calculation of risk-weighted assets resulting from changes in the definition of capital, securitisation, trading book and counterparty credit risk requirements;
- The capital conservation buffer;
- The leverage ratio; and
- The liquidity coverage ratio and net stable funding ratio standards.

The proposed European Union Capital Requirements Directive and Regulation (referred to as "CRD IV" and "CRR IV", respectively) implementing Basel III in the EU are not yet finalised, and the EBA exercise is carried out assuming full implementation of the Basel III framework without taking into account transitional arrangements. It is based on static balance sheet assumptions and does not take into account planned management actions. This allows for identifying effective changes in banks' capital base rather than those based solely on underlying modelling assumptions, and is not directly comparable to industry estimates.

Key Results

48 Group 1 and 110 Group 2 banks participated in the exercise.[2] Aggregate coverage of the banking sector

[1] BCBS, *Basel III: A global framework for more resilient banks and the banking system,* December 2010 and revised June 2011; BCBS, *Basel III: International framework for liquidity risk measurement, standards and monitoring,* December 2010.

[2] Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active. All other banks are categorised as Group 2.

was high, reaching 98.5% of Group 1 Basel II risk-weighted assets.

Impact on Regulatory Capital Ratios and Estimated Capital Shortfall

Assuming full implementation of the Basel III framework as of 30th June 2011 without taking into account transitional arrangements, the capital ratios of participating banks would have declined significantly. Contrary to the current framework, average capital ratios would be higher for Group 2 banks than for Group 1. 44% of Group 1 banks would be at or above the 7.0% target CET1 level. The additional capital conservation buffer and loss absorbency requirement for global systemically important banks must be met with common equity after the application of deductions. A significant effort by banks to address the shortfalls and fulfil the risk-based capital requirements is expected.

Estimated Capital Shortfall (€ billion)	Group 1	Group 2
Minimum CET1 Shortfall - 4.5%	18	11
Target CET1 Shortfall - 7.0%	242	35
Minimum Total Capital Shortfall - 8.0%	128	22
Target Total Capital Shortfall - 10.5%	485	59

Main Drivers of Changes in Banks' Capital Ratios

Reduction in CET1 capital is driven mainly by goodwill deduction. The largest contributor to the increase in risk-weighted assets (RWA) is the introduction of Counterparty Credit Risk (CCR) Credit Valuation Adjustment (CVA) capital charges. A larger proportion of the total CVA effect is attributable to the application of the standardised method than to the advanced method. For Group 1 banks, the overall impact on the CET1 ratio is due almost equally to changes in the definition of capital and to changes related to the calculation of risk-weighted assets. Group 2 banks' business models are less affected by the revised counterparty and market risk rules, and they have a lower increase in RWA.

Changes in Regulatory Capital Ratios	Group 1	Group 2
Definition of Capital	-22.7%	-25.9%
Goodwill Deduction	-17.3%	-14.8%
RWA Calculation	21.2%	6.9%
CCR CVA Capital Charge	8.0%	2.9%

Leverage Ratio

The simple non-risk based Leverage Ratio is calculated as the quotient of aggregate Tier 1 capital divided by total aggregate exposure. Group 1 banks have a significantly lower average leverage ratio (and higher average leverage) than Group 2 banks. Assuming full implementation of Basel III at 30th June 2011, 41% of Group 1 banks meet the calibration target of 3% for the leverage ratio. The hypothetical ratio is based on the current definition of Tier 1 capital.

Leverage Ratio	Group 1	Group 2
Basel III Tier 1 Leverage Ratio	2.7%	3.4%
Hypothetical Current Leverage Ratio	4.0%	4.7%

Liquidity Standards

The 30-day Liquidity Coverage Ratio requires banks to have sufficient unencumbered, high-quality liquid assets to withstand a stressed funding scenario. 34% of the banks in the sample already meet or exceed the 100% minimum ratio requirement. Wholesale funding activities attract much higher stress factors than retail, and Group 1 banks show a notably larger percentage of total outflows compared to balance sheet liabilities than Group 2 banks. The aggregate shortfall of liquid assets is €1.2 trillion, approximately 3.7% of the total assets of the sample.

The Net Stable Funding Ratio is a longer-term structural ratio to address liquidity mismatches and to provide incentives for banks to use stable sources to fund their activities. 37% of banks already meet or exceed the 100% minimum ratio requirement. The shortfall of stable funding is €1.9 trillion.

Liquidity Standards	Group 1	Group 2
Liquidity Coverage Ratio	71%	70%
Net Stable Funding Ratio	89%	90%

Conclusion

The EBA Basel III monitoring exercise results confirm that the impact of the new capital and liquidity standards is great. Significant effort is needed by banks to fulfil the requirements. Management actions are expected to mitigate the effects by increasing capital and decreasing risk-weighted assets. While the new EU CRD IV and CRR IV are not yet finalised, implementation is required to be underway and to continue with phase-ins through 2019.

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Contacts

London
Frederic Gielen / Scott Warner
Partner / Senior Consultant
Avantage Reply
5th Floor | Dukes House | 32-38 Dukes Place | London | EC3A 7LP | UK
Tel: +44 20 7709 4000
E-mail: f.gielen@reply.eu / s.warner@reply.eu