Rabobank

Position Paper
Basel 3.5 Capital requirements

Are the proposals feasible?

Introduction

For more than two years now, supervisors, banks and policymakers have been discussing draft proposals from the Basel Committee to change the international requirements for the risk models used by banks. In these proposals (known as ‘completion of Basel III’ or ‘Basel IV’, we will stay with ‘Basel 3.5’ in this paper) there is a radical new view of risk models and supervisors will impose additional limitations on the banks in their modelling of risk.[1] This Position Paper addresses the latest state of affairs and discusses the major remaining difficulties. We present the viewpoint of Rabobank and offer a conclusion. Rabobank wishes to make a further contribution to the debate that will take place in Brussels and The Hague after Basel, when the necessary amendments to legislation will be considered.

Where are we now?

The Basel Committee for Banking Supervision (BCBS, hereinafter: ‘the Basel Committee’) has drawn up a package of new prudential rules for banks, consisting of a revision to the standard approach to credit risk, the introduction of a capital floor based on standardised approaches, the use of internal models, limitation of options for modelling operating risks, and new rules for the establishment of risk-weighted items and unused credit lines at the banks. The separate elements of the package are now (largely) complete at a technical level, and the debate in Basel is turning to the final calibration. The proposals are connected and their effects are cumulative. The total capital effect should be moderate (agreement in the G20) and the different elements should strengthen each other and not contradict each other. The Basel Committee therefore already stated in advance that it wished to present the proposals to the ‘Group of Governors and Heads of Supervision’ (GHOS) as an integrated package. This proved to be difficult and the presentation has been postponed several times. If the Basel Committee and GHOS reach agreement, then this does not yet mean that the recommendations will be implemented, as a parliamentary process will then follow. This will happen in all the jurisdictions that normally implement Basel guidelines. Broad-based support is essential for this.

What is the problem?

The proposals are controversial because they do not take proper account of collateralisation and differences in markets and legal systems between countries. The result may be less lending, or more expensive lending than otherwise would have been the case. The first problem concerns the possible introduction of an

[1] See previous Position Papers at www.rabobank.com/en/about-rabobank/in-society/principles/index.html.

international minimum capital floor that prescribes that the result of calculations of internal bank models must amount to a certain minimum fixed percentage of the result on the basis of a standard model. For banks with an international 'average' portfolio of loans on an 'average' bank balance sheet and with an 'averagely robust' system of bankruptcy law in the country in which they operate, this is not a problem. It is also not a problem for loans with a high risk profile, since high risk weights already apply. Paradoxically, it is mainly a problem for loans with relatively 'secure' collateral and for banks with a low risk profile. The standard capital floor will have disproportionate consequences for European mortgage banks and agricultural banks with strong collateral security and low loss ratios. The banks most unduly affected will actually be those with a high proportion of low-risk banking activities and which also use internal modelling. Regarding mortgages, there is also no account taken of the existence of a (statutory or otherwise) maximum loan principal for households in a country or the presence of a good social security system so that there is more certainty that households will be able to continue to afford a mortgage. In this case the financing risk of mortgages is lower than the international average risk norm set by the capital floor.[2] Despite the fact that increasing the level of capital in a banking system and an even more prudent estimation of risk will be welcomed by many, it is extraordinary that the package will seriously affect loans that are well collateralised. We consider this to be an indication that the package has not been properly calibrated.

Apart from mortgages and agricultural loans, Basel 3.5 will also increase the minimum capital reserves for trade and project finance. Given the social and economic importance of these activities, there needs to be further consideration of whether this is indeed proportional for all countries. Trade and commerce are important for the economy.[3] Furthermore, and probably unintentionally, the package will have damaging effects on operations of banks in developing countries and emerging markets (FMO and Rabobank, 2017). The proposals do not make sufficient distinction between different situations. For project and trade finance, in practice it makes a great deal of difference that a bank has many years of expertise in a market segment and is a large professional party. This is why banks have invested for years in increasing their expertise, knowledge of sectors and knowledge of risk modelling. This needs to be better reflected in the proposals than currently is the case.

Moreover, the requirements could lead to incentives for making an incorrect evaluation of risk and return. As was the case after Basel I, it will become attractive to dispose of low credit risks that are affected by the minimum floor to external investors and keep high risk loans on the book. If the regulator's calibration is not correct, the markets will arbitrage this. This emphasises the importance of accurately establishing these criteria.

Widespread call to acknowledge differences

Banks and supervisors from many European countries, Canada, Australia and Japan have urgently called for improvements to the proposals. Despite compromise proposals by the Basel Committee and from Ingves, its chair, several attempts to reach an agreement in the GHOS that is acceptable to all supervisors have failed.

Box: Europe versus the US

Three fundamental differences which in any case have to be considered are:

1) The economies of Europe and the US are financed in different ways: in Europe the ratio of bank finance to capital market finance is roughly 70%-30%, compared to 30%-70% in the US.
2) In Europe, mortgages are included in bank balance sheets, which is not the case in the US.
3) In the US, only the 15 largest banks have to meet the international requirements for advanced models, meaning that the impact on the sector is less severe. In Europe the requirements apply to all banks.

[2] This is especially the case in the Netherlands, where loss ratios on mortgages are low, even during the economic crisis (2008-2013), when house prices fell by an average of 20% and the number of transactions declined by around 45%. In this period, losses did not exceed 0.2% of the total mortgage debt (DNB Bulletin, Nov 2016).

[3] The International Chamber of Commerce and the International Institute of Finance have also referred to this in 2016 and 2017 in various reports (see list of sources).

What would Rabobank like to see happen?

We propose that the Basel Committee should mark time and conclude an agreement only on the less controversial elements of Basel 3.5. Basel could for instance choose to include the improvements on the standard approach for risk models that are used by both smaller and larger banks. This would then include an additional category for the risk weighting of the lowest loss risks with strong collateral and a lengthy series of loss data. The proposals for the advanced modelling approach should however be reassessed because they will have a negative effect. It is important to recognise that the introduction of minimum generic floors will mean that only loans with a very low risk profile will be assigned a higher capital requirement. Additionally, Basel could – where necessary – implement limitations on the modelling of operating risks.

Many parties agree that Basel should abandon the idea of making an equal capital floor mandatory worldwide. Such a capital floor does not take adequate account of the composition and risk profile of the balance sheet and would completely distort the operation of the banks' internal risk models.

Supervisors and policymakers could also take more note of the work of the European Banking Authority (EBA) and the European Central Bank (ECB) with respect to improving the models. We believe that the 'Targeted Review of Internal Models' (TRIM) of the ECB and new technical standards of the EBA could provide a good basis for this, subject to a proper discussion of differences between business models and the choice of principles in risk models continuing to be possible. More can also be done with the efforts of the banks themselves and of individual supervisors. As far as we are aware, all the banks and the international supervisors are making progress in this area.[4]

We expect that Basel will not achieve the intended simplification of risk models with its current proposals and will not be able to prevent over-optimistic risk assessments by certain individual banks. We do not believe that the aim of more comparability between banks and transparency regarding risks within banks will be achieved. Instead, new problems will be created. We argue for a more targeted approach to improving risk models.

We support two other measures to strengthen the stability, transparency and comparability of risks at banks. Firstly, continue the approach to non-performing loans and introduce a differentiated risk requirement for government paper. Try to achieve agreement on this in Europe within a short time period. Secondly, set up a European deposit guarantee fund in due course once the Banking Union has proved itself and the non-performing loans have been cleaned up. This will mean that shocks in the banking system can be more effectively absorbed, even if large banks get into difficulty.

Conclusion

Our conclusion is that the current proposals still contain too many weaknesses, and we therefore believe that the supervisors in the Basel Committee should not approve this draft package. The Basel Committee would be better advised to go for a more limited agreement. This can be implemented, and alternatives can be sought for the remaining items subsequently. It is important that a level playing field is safeguarded as far as possible and that negative effects on the economy are avoided. We see various possibilities for improving the rules for internal models, and primarily of course the models themselves, within this total package, as explained in this paper and in previous papers. We have confidence that the improvements that are most needed will be implemented. We will be glad to play our part in looking for the most effective, practical and feasible formulation of international regulations.

[4] This is not only happening via minimum capital requirements: model risks are also being addressed in accounting (including IFRS 9) and stress testing (for instance, CCAR).

For further information, please contact:

First contact:

Bouke de Vries, Advisor to the Board on Public Affairs, Rabobank, Tel +31 (30) 2161195, Bouke.de.Vries@rabobank.nl

Second contacts:

Berry van Nieuwkerk, Risk Manager Integrated Risk Capital, Rabobank. Tel +31 (30) 2161466, Berry.van.Nieuwkerk@rabobank.nl

Claire Kouwenhoven-Gentil, Head Risk Management Portfolio Management, Rabobank.
Tel +31 (30) 7122572,
Claire.Kouwenhoven-Gentil@rabobank.com,

List of sources

Basel Committee, 2014, *Capital floors: the design of a framework based on standardized approaches*.
Basel Committee, 2015, *Revisions to the Standardised Approach for credit risk*.
Basel Committee, 2016, *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches.*
FMO and Rabobank, 2017, *Joint Position Paper: The Unintended Consequences of Basel IV on Developing Countries* (see website Rabobank.com).
Institute of International Finance, 2016, *Proposed Basel Changes: Impacts for Emerging Market Economies.*
International Chamber of Commerce, 2016, *International Trade Register Report.*
Rabobank, 2016, *Position Paper Capital Requirements and Agri: potential impact of Basel 3.5 on agriculture.*
Rabobank, 2016, *Rabobank response to the BCBS consultation imposing constraints on the use of internal models* (see website Rabobank.com).