Position Paper
Capital requirements and Agri

The potential impact of Basel 3.5 on agriculture

Introduction

Basel is working on what are referred to as the Basel 3.5 proposals for capital requirements. These proposals address the 'denominator' of the capital ratios of banks: the risk-weighted assets. Basel has already done much work on the 'numerator': the size and quality of capital has increased strongly since the crisis in 2009. The aim of the new proposals is to reduce the variation in capital outcomes of the internal models of the banks and to make banks even more robust. The proposals are expected to be presented at the end of this year. After this, there will be a process in Brussels that could last for a year or two. Ultimately, the proposals, whether in amended form or not, will be included in the European Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR).

Rabobank, the Dutch Banking Association (NVB) and parties such as VNO-NCW and Business Europe recognise the value of evaluating the capital requirements for internal models, but have also expressed concerns. In their current form, the proposals will lead to a sharp increase in the capital that European banks will have to hold for lending and this threatens to drive costs up for banks and their customers. There is also a danger of risk selection, and contraction of the loan portfolio. In our view, there is as yet little awareness of the potential impact on the financing activities of European banks outside the group of policymakers and risk specialists. Our aim with this paper is therefore to devote extra attention to this issue.

The impact on banks will be especially great in EU Member States and in sectors in which the banks provide much of their funding on the basis of collateral. In the Netherlands and the other Northern EU Member States, mortgages and lending to agriculture will be particularly affected. In the whole EU, including the Netherlands, the impact on project, infrastructure and commodity finance is expected to be significant. There will also be effect on exports. This is because collateral structures and risk controls are applied with respect to these loans, and the proposals do not take sufficient account of this.

Focus of this paper

In this position paper we focus on the consequences of the Basel 3.5 capital proposals for the agricultural sector, after having discussed the scale of the impact on all asset categories of banks in a previous paper (see Rabobank's response to the new Basel proposals for internal risk models). We argue that:

1. The output floor should be abandoned.[1]
2. Specific 'input floors' should be used for the agri sector, based on the banks' available data.

[1] The output floor is a fixed percentage of the risk weights in the revised standardised approach to credit risk. The output floor sets a minimum level of capital to be held. It is not yet clear at the time of writing whether the output floor will apply per asset class, per risk type (credit risk, market risk, operational risk) or at total bank level. The input floor is the minimum value for the risk parameter in the IRB models.

Among other things, this will require an expansion of the Basel Quantitative Impact Study.

If Basel does not sufficiently adjust the treatment of strong collateral, we believe there should be compensation for loans to these sectors that are very important to the real economy. In any case, the result should be that an appropriate capital requirement should apply for all loans.

Our main arguments for a better distinction according to risk and collateral are:

1. The risks in the agri sector are demonstrably lower than for non-agri finance. The large agri banks have a large amount of data over a long period on hundreds of thousands of businesses that illustrate this. The data that we have provided to DNB and ECB show that on average the *loss given default* loss ratios over the whole portfolio are 50% lower than for non-agri loans.
2. Within the agri sector, the risks for agriculture and horticulture and animal husbandry also vary. The application of a single floor will lead to inappropriate capital reserves and misallocation of capital.
3. We see the same problem with respect to mortgages, commodity finance and project finance. Here too, the approach of high fixed capital floors means there is a danger that risks in these portfolios will not be properly reflected, especially for low risk exposures.

We argue that the output floor should be completely abandoned and we also are critical with respect to the concept of input floors. Instead of this, it would be better in Rabobank's view to tighten the requirements for internal models, as the EBA and the ECB are already doing simultaneously in Europe (see the discussion of alternatives in this paper below).

What are the most controversial issues?

Undervaluation of collateral

The central problem in the Basel 3.5 proposals in our view is that the value of collateral is not properly recognised. Collateral forms an important basis for the loans the banks provide. The greater the collateral and the higher the quality of that collateral, the more finance a bank is willing and able to provide.[2] Most loans in the agricultural sector are financed against collateral, and this significantly reduces the banking risk.[3] The current proposals are however to a large extent based on a standardised approximations and fixed percentages for risk estimates. Collateral is not a prominent item for consideration. This is why we expect the agricultural sector to be one of the sectors hit hardest by the Basel proposals. We consider it highly striking that this aspect has not been properly considered.

The output floor will overwrite risk models

Besides our criticism of the treatment of collateral, the planned introduction of an output floor is one of our biggest problems with this proposal. This floor sets a minimum capital outcome for loans. The capital must be at least a factor – for example 60% - of the outcome as if a standard model had been used. The standard model is a very simplified model that leads to very approximate and conservative capital requirements and takes less account of aspects such as collateral. The capital floor therefore actually entirely 'overrides' the results of the banks' internal risk models.

If this element in the proposals is retained, we see two consequences:

1. The risk sensitivity of risk models will diminish. There will be no financial incentive to independently estimate risks as accurately as possible. It will also 'reward' taking on more risk within certain risk categories that have equal capital requirements or removing risks with relatively high capital requirements from the balance sheet.
2. Capital levels in Europe will increase more than elsewhere since most of the large banks in Europe use advanced internal risk models. Fewer banks in the

[2] Other factors also play a part in loan decisions, such as the assessment of the business plan, the cash flow, other financial variables, the prospects for the company and the sector in which it operates.

[3] The banking term for loss in the event of bankruptcy is 'loss given default' (the LGD). The probability of bankruptcy (the PD) is also an important priority in risk management, however as far as we can assess this is properly taken into account in the new proposals.

US and Asia for example use these models. The effects there will therefore be more limited.

Impact on lending is significant
We expect the proposals for IRB banks in Europe to lead to an increase in the capital required and that prices may have to rise in order to bear these costs. This will occur mainly in the lending segments that are treated unfavourably. The proposals may also lead to less availability of credit for certain segments, or to less favourable loan conditions. We consider this to be an especially unfair and frustrating development that will also be very difficult to explain to the agri sector. We accordingly are looking for ways to improve the proposals, mainly in areas where the underlying risks are demonstrably lower than as currently included in the proposals. In our view, the internal risk models should continue to be used as a permanent starting point.

Collateral for agri finance
Most agricultural companies have strong collateral in the form of land and buildings, or business assets. The value development of these assets is usually also relatively stable. In case of default, therefore, the loss for the bank will be significantly limited. The bank can therefore provide more finance that would otherwise be possible and/or charge a more favourable rate than would be the case if only income were taken into account (unsecured lending). If insufficient account is taken of collateral, businesses will pay too much. Paradoxically, the problem concerns the best risks from a banking point of view. The higher risks will actually not be affected by the floor (not by the input floor and not by the output floor) since the customers are already paying a higher risk premium. These customers accept this premium because it is based on actual losses and forecasts for the sector, and on the customer's individual situation. It is however likely that customers will be far less ready to accept paying more for bank buffers as a precautionary principle while the risks for these businesses are actually relatively more limited.

Important differences between the United States and Europe

The desire for an output floor originates from the Americans, as US banks work with standard models for the determination of regulatory capital rather than with IRB. Another pertinent point is that the vast majority of mortgages at American banks are not on balance sheet and the risks are assumed by the government via Fannie May and Freddie Mac. But the output floor has a particularly great effect on mortgages. This is not therefore a balanced situation. We also do not believe that an institution such as Freddie Mac should come to Europe. We think it is better for the market to estimate and bear these risks rather than having them assumed by the government. However, the European banks should not suffer an unjustified disadvantage as a result of this fundamental difference, as currently would appear to be the case.

On the other hand, the Americans - and the others that support this in Basel - are correct in our view in saying that some internal models of banks are not sufficiently transparent and also may not always lead to appropriate capital reserves being formed. There are indications that the results of bank risk models are highly variable and it would be a good idea to look at why this is the case. In a number of cases the models are too complicated as well. To address these points however, other measures are possible that entail much less collateral damage for the economy and the banks in Europe. We will turn to this point in the following section of this paper.
It is important to state here in any case that American support for the output floor should be understood in the context that mortgages there are off balance sheet.

Further, we believe that the proposed new requirements for the agri sector will affect the agri sector in the US: finance from foreign agri banks there may be reduced if the plans do not take better account of collateral. We wonder if this has been sufficiently considered. Rabobank Agri Finance - our international agri business - has already referred to this risk in its consultation response.

The role of bank finance in Europe
The European economy is largely financed by the banks, and to a lesser extent by the capital markets and institutional parties. The Capital Market Union programme of the European Commission may expand the financing structure in future, but this will certainly take many years to materialise. Given the current role of bank finance, the European banks have expressed their concerns regarding the potential impact of the proposals on lending and the economy in Europe. There are entire sectors in the Member States that depend more or less fully on bank finance. If a large and rapid change is imposed at this point, the effects will be felt. In our view, there has not been sufficient analysis of this impact. The significance of finance that is strongly collateralised has also not been sufficiently recognised. We believe that failure to include this institutional difference in the financing of the real economy in impact analyses and decision-making would be negligent.

What are the alternatives?

First of all, it cannot be assumed that Basel and the GHOS will agree to a proposal that will have very divergent effects in various parts of the world. It would seem likely that technical adjustments will follow. This will also be necessary in order to achieve the goals of improving risk models and the robustness of the system. Thereafter, there may be further calibrations in the translation of the Basel proposals into EU regulation (and in the US and Asia as well) in order to be able to take account of differences between the financing structures of economies and certain other specific differences there may be between countries and markets. Countries will of course strive to stick to the proposals as closely as possible in order to achieve a level playing field. However, a level playing field and correct operation in practice requires a level starting position, a point which has not received proper consideration.

We see the following alternatives to the currently proposed introduction of capital floors:

1. Unexplainable differences between bank models could be reduced by more internal model benchmarking.
2. Harmonisation of definitions and data pooling for example to enable better comparability of results could further contribute to more consistency in application.
3. Across the line there can be (and already is) more monitoring and more dialogue/knowledge exchange between banks and supervisors regarding how models are designed, which data and definitions are used, and how models accurately and consistently represent real business practices among banks. Also, we see it as logical that data from at least an entire economic cycle should be used, so that the downturn is also included. The ECB is already carrying out stringent tests of models and as far as possible is doing so in the same way for all the large EU banks.

These alternatives may still lead to higher capital requirements for individual banks, but in any case without the disadvantages that good risks will be punished by the requirements, cost increases are incurred across the board, and the playing field will be disrupted.

Conclusion

The proposed Basel guideline for capital requirements threatens to make secured lending more expensive because it does not take sufficient account of the value of the collateral. In the case of agri finance, the resultant problems and the parties that will bear the cost are clearly visible. Business owners and banks will be forced to bear unnecessary costs, which potentially will be passed onto end-users. Our criticism also applies to the treatment of other commercial loans and mortgages in the proposals. In this paper, we have focused mainly on agri finance. In previous papers (see Rabobank.com for the consultation response) we have put forward our views regarding other points and alternatives. We call for more attention to what we see as an unintended problem for loans that are strongly collateralised and a prudent application of the guideline in Europe.

Also, we believe the situation calls for a much more fundamental discussion of the capital proposals than there has been so far due to heavy time pressure in Basel, and we would welcome the opportunity to participate in this.

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