bankenverband BDI

Joint position paper

of the Association of German Banks (BdB) and the Federation of German Industries (BDI)

Basel IV is putting pressure on tried and tested corporate finance

July 2016

Bundesverband deutscher Banken e. V.
Burgstraße 28
10178 Berlin
Telefon: +49 30 1663-0
Telefax: +49 30 1663-1399
www.bankenverband.de
USt.-IdNr. DE201591882

Bundesverband der Deutschen Industrie e.V.
Breite Straße 29
10178 Berlin
Telefon: +49 30 2028-1422
Telefax: +49 30 2028-2422
www.bdi.eu
USt.-IdNr. DE123048726

Summary

Tried and tested corporate finance should not be put at risk

- *Efficient banks with stable customer relations are a prerequisite for efficient corporate finance. Germany's private banks wish to remain holistic funding partners and continue to offer a comprehensive range of financial services. And firms in Germany continue to need comprehensive support from banks located here and, if necessary, assistance when doing business worldwide. Banks perform an intermediary function, which ensures stability in corporate finance. The capital markets union desired by the European Commission – and the market-based funding which makes good sense for medium-sized and large businesses – also needs an efficient, robust banking sector alongside it.*

- *The financial regulation introduced in recent years has done much to enhance the stability of the financial markets and market participants. The more stringent capital and liquidity requirements, in particular, are sensible safety nets in a complex environment. Banks have implemented the new rules.*

- *This regulation has not been without consequences for banks' lending capacities. Today, however, the impact on corporate finance is barely perceptible to clients in Germany because it is being obscured by other factors. These include the phase of extremely low interest rates, the favourable economy, the (nonetheless) low demand for credit and the stiff competition among suppliers. The Basel III package, which has still to be implemented in full, has not yet been in place over a complete business cycle.*

- *We warn against overtightening the regulatory screws at this juncture by introducing further requirements. Basel IV could lead to a significant increase in so-called risk-weighted assets (RWAs) and the associated need for regulatory capital. Excessive standardisation of risk models would result in corporate risks, which are comparatively low in Germany, no longer being appropriately reflected. The current regulatory projects also risk squeezing out the banks' traditional function of maturity transformation, thus limiting their ability to assume long-term risks. Measures of this kind would have low marginal utility but high marginal cost, the effects of which would also be keenly felt by businesses in the future.*

Stable and inexpensive corporate finance

Corporate finance in Germany has long been stable and inexpensive. Banks are the most important providers of debt capital and play a key role in the funding of companies of all sizes. In the difficult years following the financial crisis banks proved themselves to be stable partners and continued to stand ready to meet the demand for finance during the subsequent upswing. At present, businesses can generally expect banks to be willing to provide finance for economically viable investments and business models: loans are available on comparatively very favourable conditions. There are nevertheless signs that traditional **long-term funding** is beginning to experience adverse effects. Though loans with a term of over five years continue to account for around two thirds of total outstanding lending to businesses and the self-employed in Germany, terms of over ten or 15 years have been replaced by seven to eight-year loans.

There are various reasons why, despite the far-reaching **financial regulation** introduced in recent years, the overall picture remains positive. The numerous regulatory measures – the centrepiece of which is the extensive Basel III framework – have by no means failed to leave their mark on banks' **capacity to supply funding**. The objective of most measures was, and is, to increase the stability of the financial system and its market participants. Banks have successfully implemented, or are in the process of preparing for, the new requirements – such as the requirement to build up additional regulatory capital. Businesses in Germany have adapted to the changes as well and increased their own average equity ratio from around 23% (in 2014) to almost 30% (in 2014). This helped to mitigate the effects of the stricter lending standards which had already come into effect as a result of Basel II. In addition, businesses in Germany have gradually improved their financial communication over the years, thus fulfilling a major prerequisite for inexpensive and dependable lending, namely open dialogue between banks and their corporate clients.

Other factors have the effect of **obscuring the impact** of the new financial legislation on funding businesses:

- The sustained phase of extremely low interest rates (in Europe and the US) and the various liquidity measures of the European Central Bank are reflected in low interest rates on borrowing (in the form of loans or bonds). The overall effect is to make the trend, triggered by Basel III's liquidity requirements, towards more expensive funding costs for banks and restrictions on maturity transformation less noticeable for customers.

- In addition, Germany's healthy business sector is benefiting from favourable economic developments and corresponding revenue. For banks, therefore, relatively low loan loss provisions are associated with lending.

- On top of that, businesses use internally generated funds to finance a lot of their investment and the demand for loans has been comparatively low for many years. While the demand from small and medium-sized enterprises (SMEs) has remained stable, big businesses which are able to access the capital markets are increasingly making use of the bond market as well as bank loans.

- Finally, lending in Germany is characterised by extremely keen competition among banks. A number of foreign banks have joined an already crowded domestic market. There is also growing competition from non-banks, especially insurance companies, and – increasingly – debt funds. As a result, the higher cost (to banks) of lending is not being passed on to customers. While corporate clients are benefiting from low prices, the banks' significantly rising costs are matched by falling margins.

In summary, the full impact of recent regulation is not yet apparent. It is true that the mitigating factors will not all disappear in the future: the competition for business from German SMEs, in particular, is likely to carry on. The key point, however, is that the Basel III package, which has not yet been fully implemented, is still to experience a complete business cycle. Only when it has been in place over an entire cycle will it be possible to ascertain whether banks' capacity to supply funding has been curtailed to an undesirable extent and whether businesses in Germany can cope with the new environment.

We would therefore warn against overtightening the regulatory screws at this juncture by introducing further requirements.

Basel III, Basel IV and beyond

The open issues of **Basel III**, namely the leverage ratio and the net stable funding ratio (NSFR), are to be finalised before the end of 2016.

- **Leverage ratio**: The objective of the leverage ratio is to place a risk-insensitive limit on banks' business activities. In January 2016, the Basel Committee decided that the leverage ratio should be introduced as a binding limit under Pillar I in 2018. The Commission plans to issue a legislative proposal for implementing this decision in Europe at the end of 2016. It is not clear as things stand whether the ratio will remain a monitoring instrument or become binding, how high the ratio will be or whether it will be set at different levels for different business models. Quite apart from the fact that a non-risk-sensitive leverage ratio basically has no place in modern management processes, the problem for corporate finance is that the leverage ratio will tend to disadvantage high-volume but low-risk and, as a result, low-margin business. Such business includes state-backed export finance, which is indispensable for an exporting nation like Germany.

- **Net stable funding ratio**: The objective of this requirement is to further reduce the risk of banks experiencing liquidity squeezes. The Basel Committee has proposed introducing a binding ratio from 2018. The Commission wants to issue a corresponding legislative proposal in the course of 2016. A traditional core economic function of banks is maturity transformation, enabling short-term deposits to be converted into long-terms loans. Loans with long maturities are essential to the funding of German businesses, enabling them to have planning security and make long-term investments. Excessively strict requirements introduced with the NSFR would unduly undermine banks' ability to undertake maturity transformation and ultimately make long-term loans more expensive. Derivatives could also become more expensive as a result of increased refinancing requirements. Yet derivatives are important instruments for hedging against a number of economic risks (e.g. fluctuations in interest rates, currencies or commodity prices) and as such a key element of businesses' risk management. As a result, they also help companies to retain their credit quality and ability to tap the capital market. Furthermore, the planned privileged treatment of trade and export finance should be significantly improved since these two types of funding are indispensable for economic growth in an exporting nation like Germany.

In addition to these two open issues, which were already part of Basel III and are now shortly to be finalised, the Basel Committee is also working on other measures. These measures, also known as **Basel IV**, could lead to a further significant increase in the amount of regulatory capital banks are required to hold. The objective of the Basel IV measures is basically to reduce the variation across banks in calculating risk-weighted assets (RWAs).[1] However, internal risk models enable the comparatively low risks in the German corporate sector to be measured appropriately and without overstating the risk. This would no longer be possible under Basel IV. The upshot would be higher RWAs and thus higher capital requirements.

- **Standardised approach and internal ratings-based (IRB) approach to credit risk**
  - The consultative documents issued by the Basel Committee envisage, among other things, that risk weights for SMEs will be reduced (from 100% to 85%). Whether this actually translates into capital relief will depend on whether the SME supporting factor is retained permanently (i.e. beyond the extension recently called for by the European Parliament) when the new rules are implemented in the EU. In addition, capital requirements for specialised lending are to increase significantly; this will affect project and infrastructure finance, which is highly important for businesses.

[1] A bank's risk-sensitive capital requirements depend on the risk associated with each asset (e.g. a corporate loan) and thus on the bank's total risk-weighted assets (RWAs). Less regulatory capital needs to be set aside for a loan with a low risk of default than for a loan with a higher risk of default. The risk of default is calculated or estimated with the help of models.

- The planned new credit conversion factors (CCFs) for off-balance-sheet exposures are another cause for concern. CCFs for undrawn credit lines granted to businesses are to increase by between 50% and 275%. This is likely to result in a major tightening of credit facilities, making it much more difficult to fund peak borrowing requirements. Urgent reconsideration of this proposal is needed, since firms with reduced, tight credit lines are less stable than those which have financial room for manoeuvre commensurate with their risk-bearing capacity and type of business.
- For banks which use internal models (the IRB approach) to calculate credit risk and losses in the event of default, the introduction of floors based on the standardised approach to credit risk is likely to lead to a substantial increase in RWAs. This could translate into much higher capital requirements for banks in Germany since it would no longer be possible to take account of the comparatively low risk attached to businesses in this country.
- A further problem is that the Basel Committee wishes to drop the use of the IRB approach for loans to large companies. Unless the company had an external credit rating, a 100% risk weight would have to be applied under the standardised approach, leading to considerably higher capital requirements. The new rule would also hit numerous small and medium-sized companies belonging to a group because the proposed ceiling of 50 billion euros in total assets is to be applied at consolidated level. On top of that, the Basel Committee envisages allowing only the foundation IRB approach to be used for medium-sized firms (with total assets of less than 50 billion euros and a turnover exceeding 200 million euros). This would mean that the low Loss Given Defaults (LGDs) in Germany as a result of a conservative collateralisation policy could no longer be taken into account.

- **Interest rate risk in the banking book (IRRBB)**
  In view of the current phase of low interest rates and the expectation that rates will start to rise in the future, the aim of the revisions in this area is to regulate and standardise more firmly the way banks assess their exposure to interest rate risk. Here again, the typical customer behaviour and traditional lack of sensitivity of deposits to interest rate movements in Germany mean that interest rate risk is low and can only be adequately assessed with the help of flexible models. Excessively strict requirements for risk models could have a detrimental effect on the tried and tested long-term debt culture in Germany, which is also reflected in corporate finance.

- **Credit valuation adjustment (CVA) risk framework**
  In future, banks will not only have to set capital aside to cover the counterparty credit risk from derivatives contracts, but will also have to consider possible changes in their counterparty's credit rating. There are currently certain exemptions in the EU if the counterparty is a certain type of company. These exemptions may in future no longer apply. The anticipated impact on companies' derivative transactions would be exacerbated further by the proposed restrictions on measuring risk with the help of internal models (IRB approach). The implications for corporate finance are that companies may find it more expensive to use

derivative instruments to hedge against market risks – a practice which is becoming increasingly important.

At the same time as these measures are being introduced, the new Basel **securitisation framework** is to be implemented in the EU. Changes were already made following the financial crisis to major aspects of how securitisation is regulated in order to make products more transparent, tighten incentive and liability mechanisms, and reduce the risk associated with securitisations overall. The new framework now envisages raising capital requirements for securitisations by more than 100%. The European Commission has proposed introducing a category of "simple, transparent and standardised" (STS) securitisations, though the complexity of the proposals and the plan to increase capital requirements by almost 50% (compared to today) are totally at odds with the Commission's aim of revitalising the securitisation market. Given the past default rate on European securitisations, which remained very low even during the financial crisis, there is no justification for such a drastic increase in capital requirements. Here, too, excessive requirements would make it economically unviable for banks to transfer risks. A key instrument, which enables banks to diversify the risks associated with a pool of corporate loans and thus free up capital for further lending, would be put at risk.

As a result of regulation already in place, especially higher capital and liquidity requirements, banks have significantly reduced their trading and **market making** activities, i.e. the ongoing purchase and sale of securities such as shares and bonds. Market making enables banks to provide liquidity and thus ensure less volatility for securities. Other rules relating to banks' liquidity risk expressly require the liquidity of bonds to be demonstrated. Restrictions on market making will achieve exactly the opposite. There are already signs of a fall in liquidity even though the impact of the banks' withdrawal is possibly still being mitigated by the generally high supply of liquidity in the markets. As things stand, there are no alternative players which could take over the banks' market-making role. For businesses, the increase in volatility means they will need to price in a higher risk premium when issuing new securities, i.e. they will need to pay a higher price for the capital they raise. This will have an adverse effect on capital market funding. It is not certain, in this situation, how banks will be impacted by further regulatory measures which are still under discussion or not yet implemented in full: the Fundamental Review of the Trading Book (FRTB, part of Basel IV), MiFID II and MiFIR, the planned German and European ring-fencing legislation, and last but not least the financial transactions tax.

Regulatory screws should not be overtightened

Need to adjust to intended changes

Recent financial regulation has pursued the objective of enhancing financial stability, among other things by requiring banks to reduce their risks. Banks and their corporate clients will need to adjust to a number of changes intended by regulators to achieve this end:

- Banks will be able assume fewer risks in general.
- The divergence of lending terms and conditions will increase, with conditions depending on the credit quality of the client or project.
- The loan review process will become more stringent and the requirements to be met by clients in terms of security, equity ratios and financial communication will increase.
- Banks will not be able to grant long-term loans on the same scale and on the same conditions as before. Maturities have already been reduced from over ten or even 15 years to around seven to eight years.

Banks should not be squeezed out of the corporate finance market

Efficient banks with stable customer relations are a prerequisite for efficient corporate finance. Bank loans will continue – even with a capital markets union – to be the most important, and often the only, source of funding for small and medium-sized businesses. Funding through bank loans, especially long-term loans, has proved itself stable and effective over decades. Banks also support corporate funding with a broad range of further financial services. These include, in addition to the provision of operating, investment, development and export loans, above all national and international payment services, hedging instruments for currency, price and interest rate fluctuations, advice and support for capital-market funding and for mergers and acquisitions. In their own interests, banks in their role as intermediary perform the key task of evaluating individual risks. Germany’s private banks wish to remain holistic funding partners and continue to offer a comprehensive range of financial services. And businesses in Germany continue to need comprehensive support from banks located here and, if necessary, assistance when doing business worldwide.

Regulation – especially the Basel IV measures currently in the planning stage – should not result in banks no longer being able to offer tried and tested financial services:

- Every bank has a limited amount of regulatory capital. This inevitably limits their capacity to assume risk, especially by lending.

- What is more, if the cost of providing a financial service can no longer be earned by a bank, the bank will not be able to go on offering the service.

- Current regulatory projects threaten to squeeze traditional maturity transformation activities out of banks' balance sheets. This could compromise their ability in the future to take on long-term risk.

- The capital markets union desired by the European Commission – and the use of market-based funding which makes good sense for medium-sized and large businesses – needs a strong, efficient banking sector alongside it. By squeezing banks out of market making, this aspect of their role in the financing of businesses also risks being eliminated.

Given the upcoming regulatory measures, especially Basel IV, it is vitally important that banks' capital requirements do not rise further still. The greater political focus on financing growth in Europe underlying the capital markets union project – along with the need for more stable financial markets – should also be reflected in the regulation and treatment of banks.