EUROPEAN BANKING AUTHORITY

CAPITAL IN EUROPEAN BANKS

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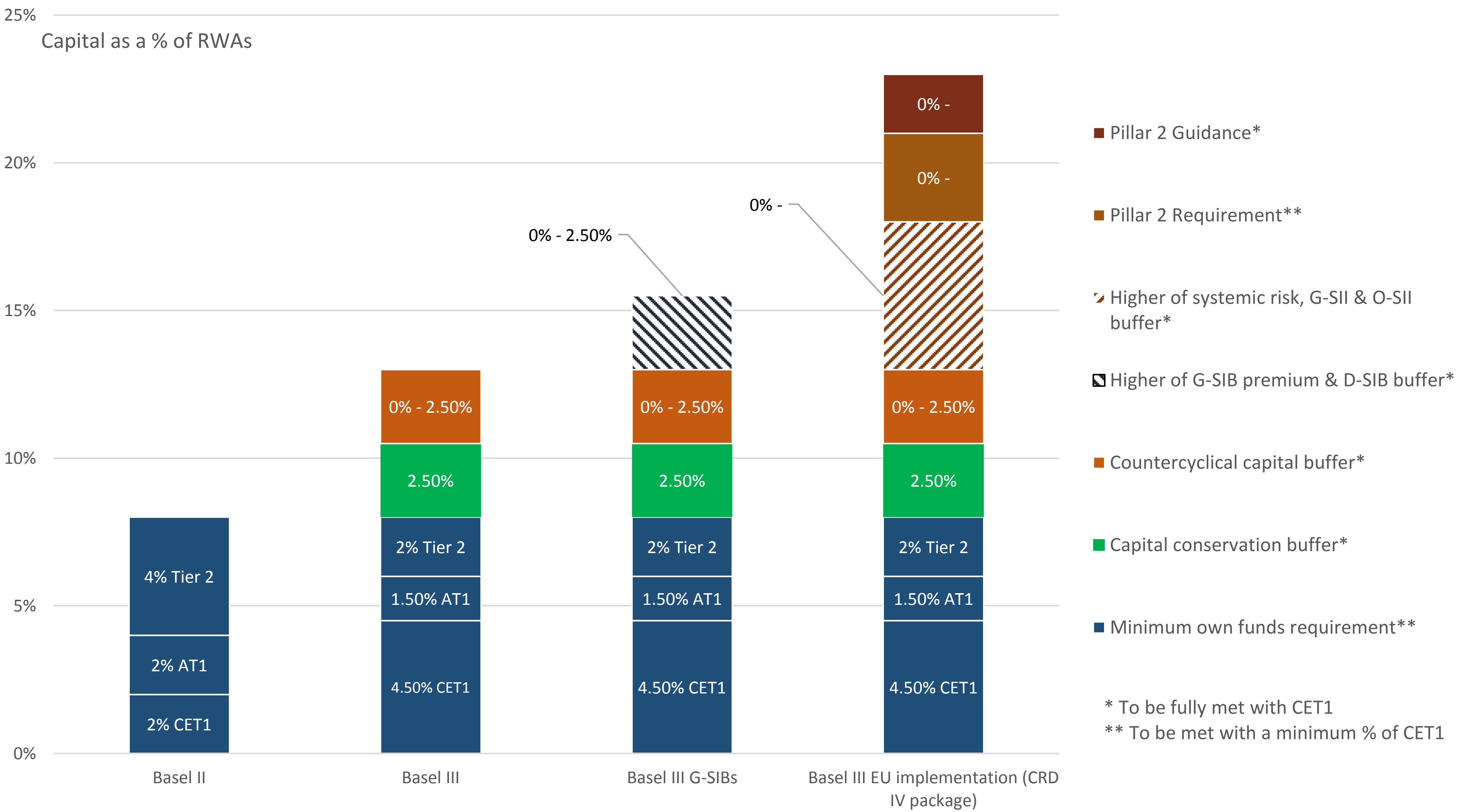
Capital standards over time

- 2004: **Basel II**: focus on RWAs
- 2010: **Basel III:** focus on capital and additional metrics:
    - **Increase** minimum requirements imposed on banks
    - **Improve** the quality of capital to be held at all times
    - Introduce a **macroprudential** perspective

Basel III vs EU regulation (CRR/CRDIV + GLs)

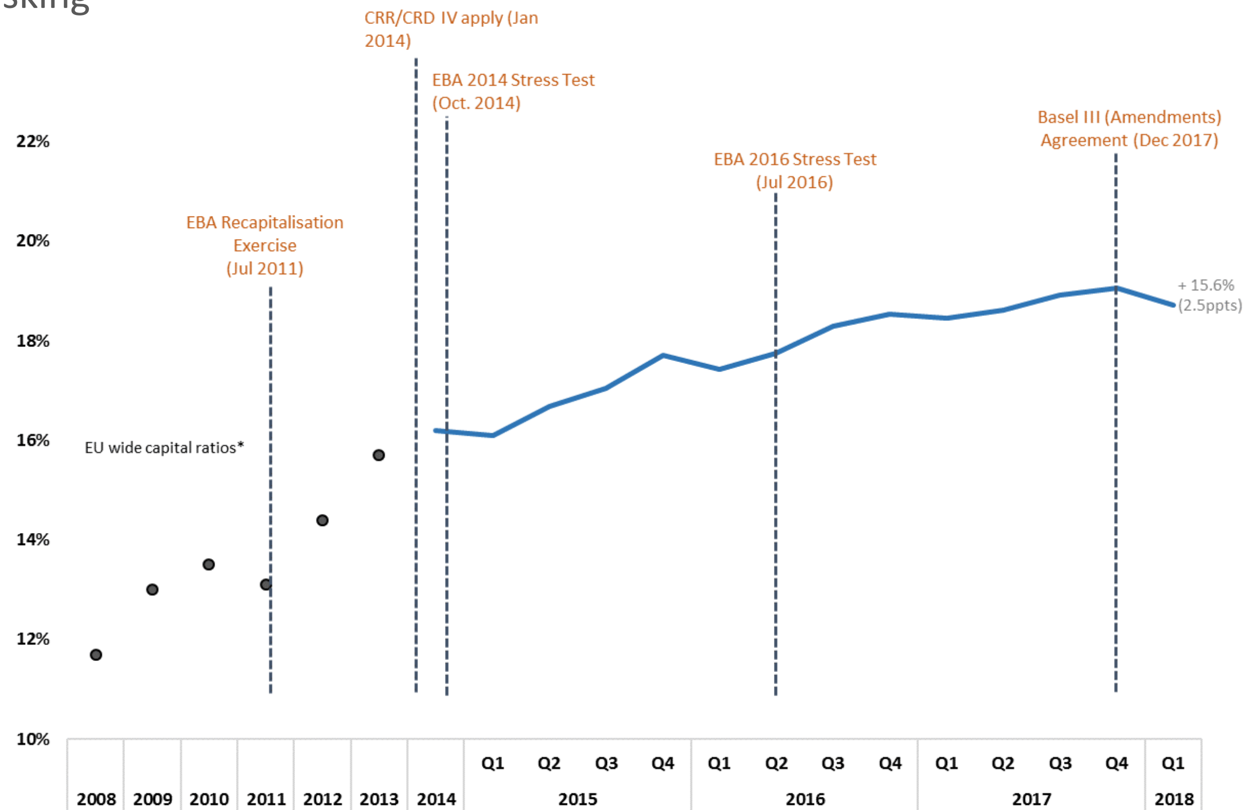


Evolution of bank capital in the EU since the crisis

As the result of:

- Adjustment to the **new capital requirements**
- **Recapitalisation** during the crisis (stress test and capital exercise)
- **Deleveraging** and de-risking

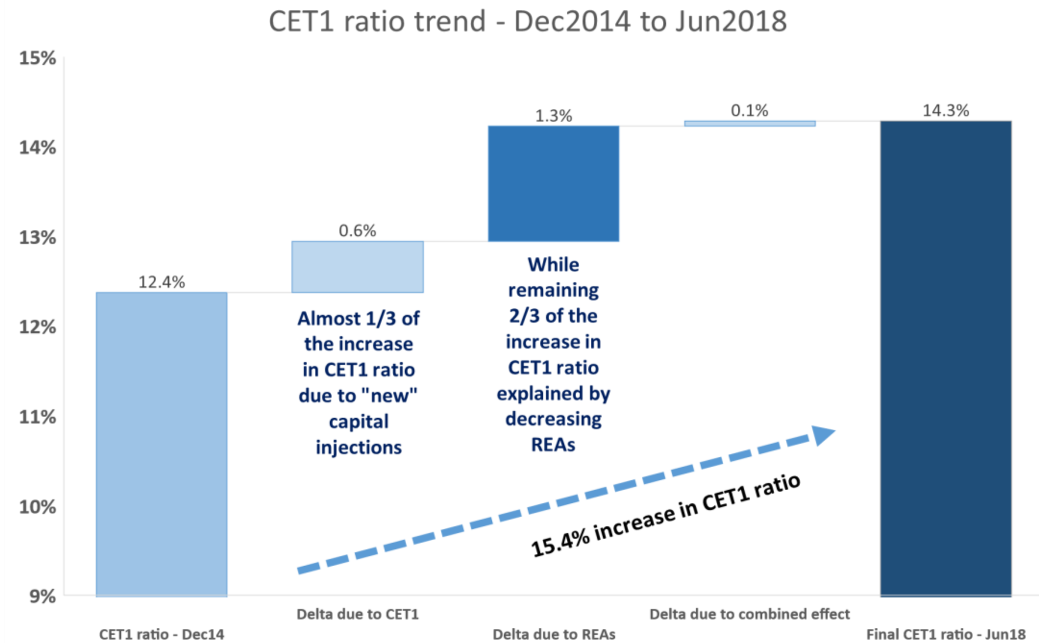
TC ratio dynamics 2008-2018



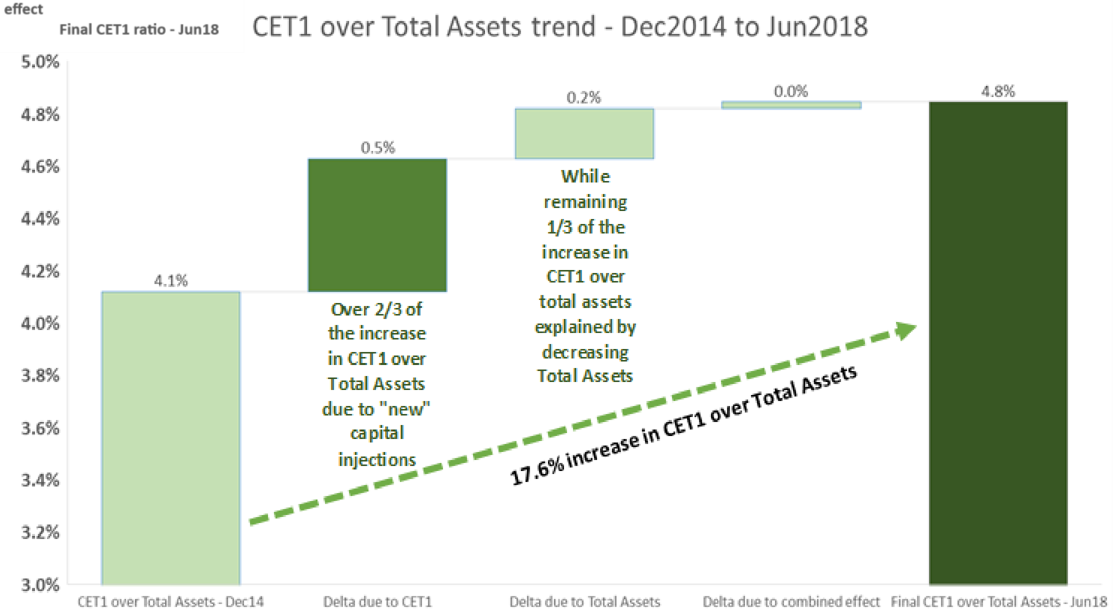
*First COREP reporting data in Q1 2014.

Sources: ECB EU Banking Sector Stability Report August 2009; EBA Risk Dashboard;

More capital or less (RW) assets? (1/2)



...EU banks have been deleveraging...

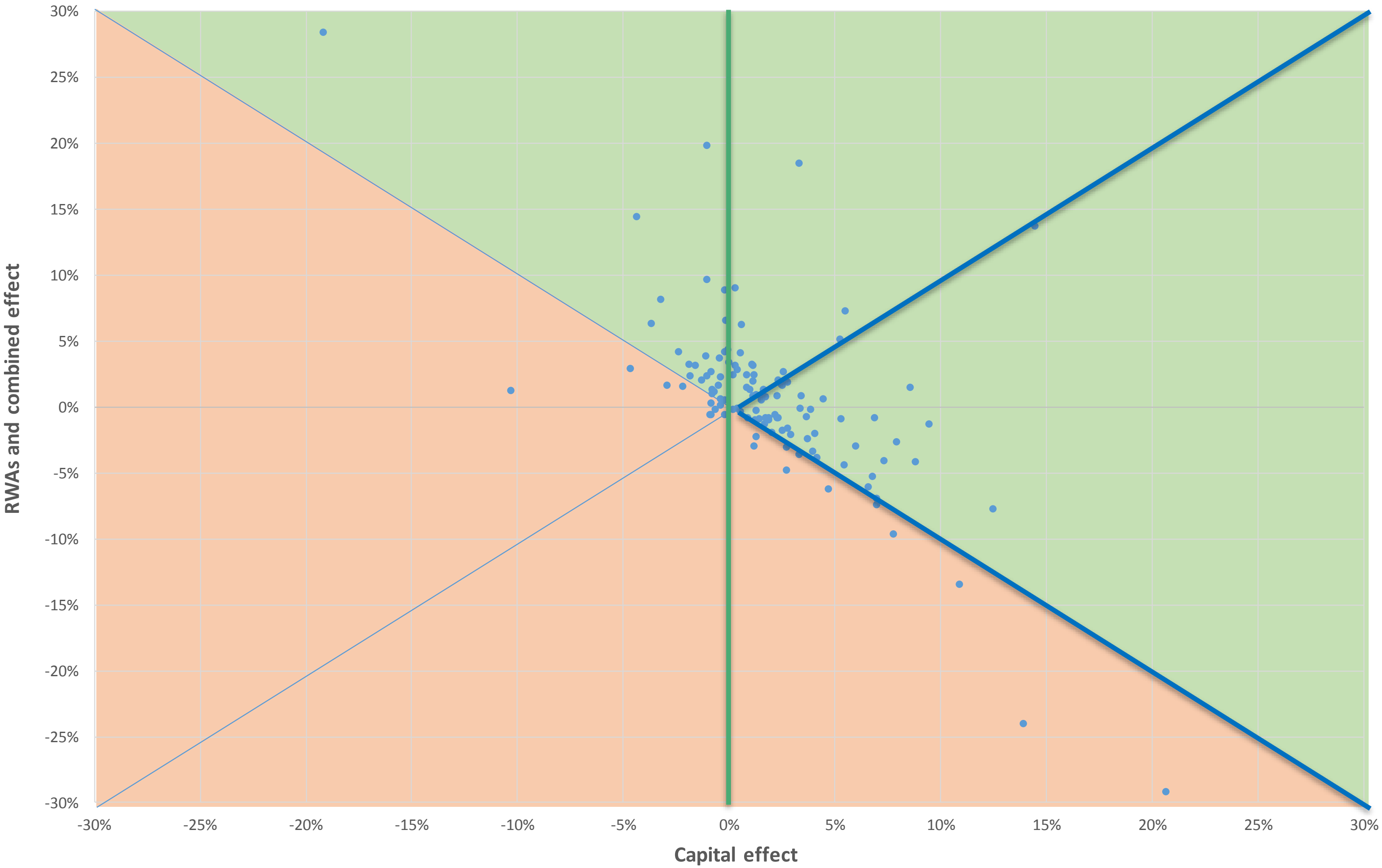


...and "new" capital kept on being injected

Source: EBA supervisory data (weighted averages from common sample of EU banks reporting COREP and FINREP; minor differences to EBA Risk Dashboard which has larger sample but changing composition)

More capital or less (RW) assets? (2/2)

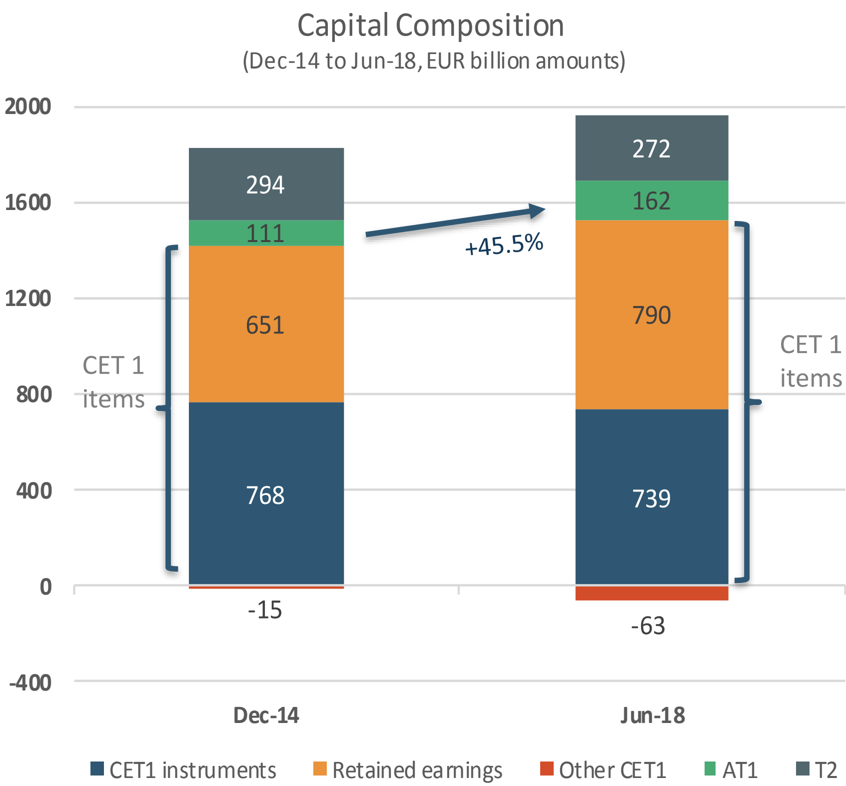
Volume of capital increased for most banks with an increase in CET1 ratio

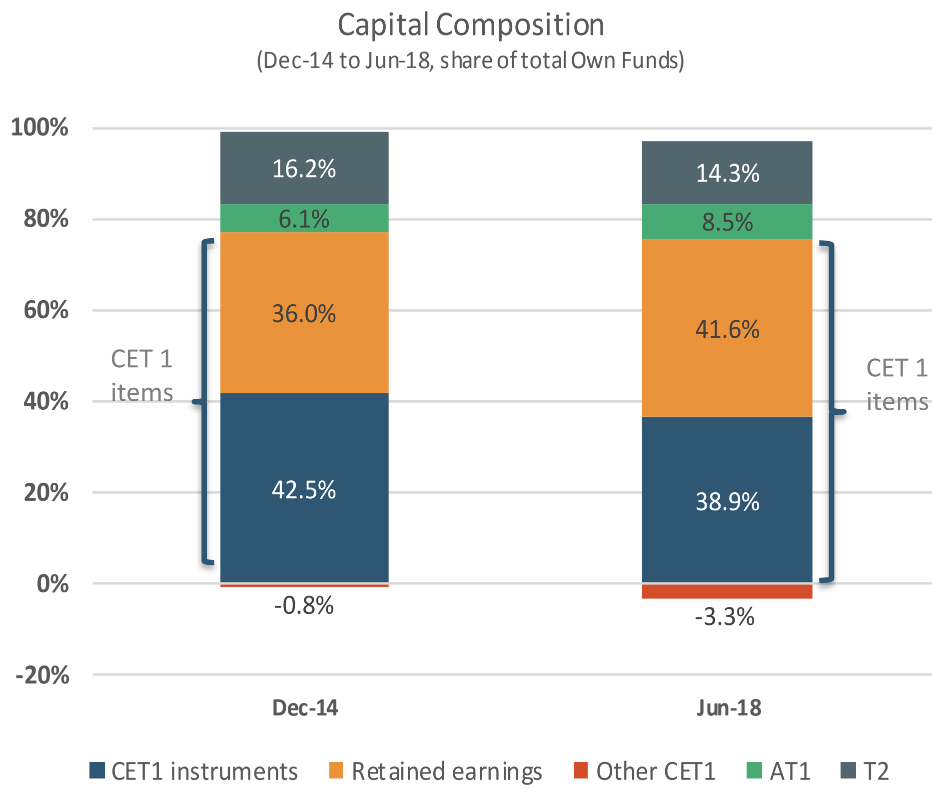


Source: EBA supervisory data, CET1 ratio developments from December 2014 to June 2018, for a common sample of 115 EU banks reporting COREP

Capital composition

Emphasis on CET1 capital at the beginning, then AT1

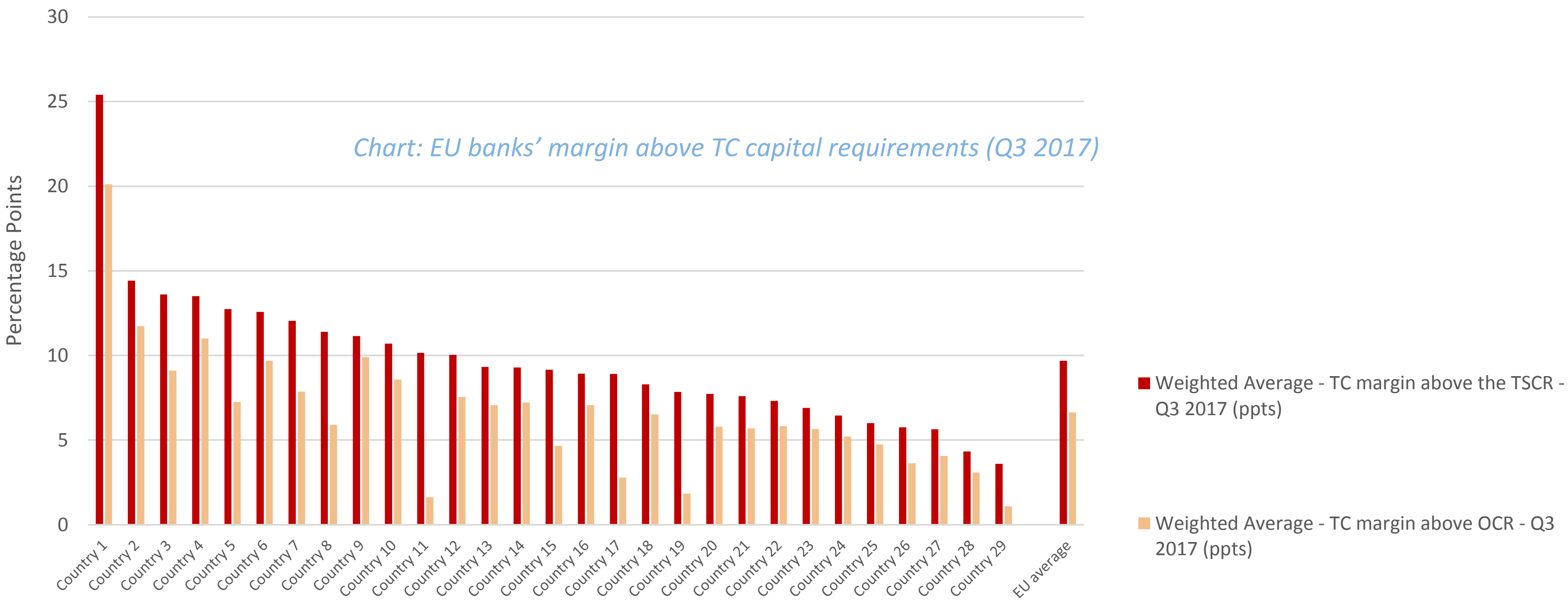




Source: EBA supervisory data (COREP, common sample of 115 EU banks, minor differences to EBA Risk Dashboard which has larger changing composition sample)

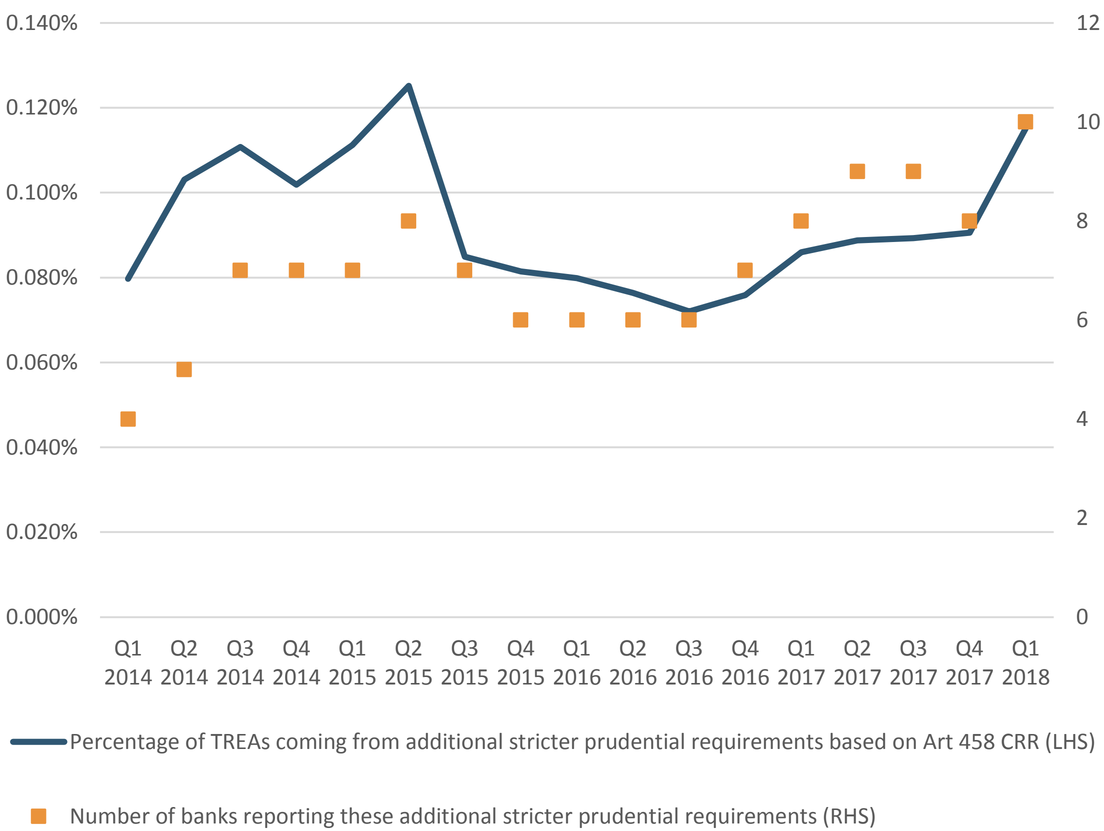
Margins above capital requirements

- EU banks generally hold **capital comfortably above their requirements** (Sept-2017): about 10 ppts above total SREP capital requirements (TSCR), 7 above overall capital requirements (OCR), with dispersion across countries.
  - **Expectation** of **upcoming requirements**;
  - The need for a "**security buffer**" on top of the regulatory minimum;
  - Banks' **internal appetite** of capital levels/targets, related to idiosyncratic factors.



Macropru: not only buffers

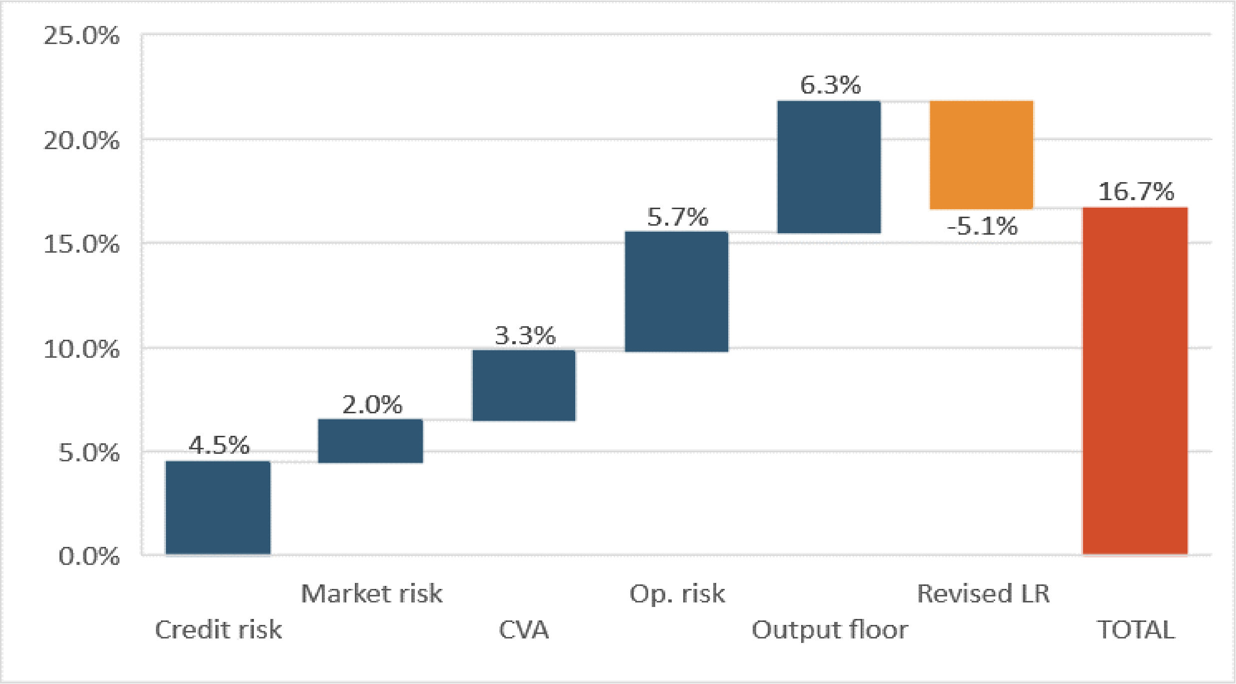
- Discretionary **macroprudential tools** can also be imposed to modify the **risk-weights** or risk parameters for some asset classes, for example, **Article 458** of the CRR allows for an increase in RW for targeting asset bubbles in the residential and commercial property sector.



- The use of these tools has been **more frequent** in the most recent years, and especially during the last quarters (2017-2018).
- They also affect Pillar 1.
- For some of the macroprudential tools used (Article 124 and 164 CRR) **no supervisory reporting data** is available, so that no analysis can be performed.

Basel III almost final: impact for EU banks of Dec 2017 package

Impact of full implementation of the final Basel III (2027), in % change of Tier 1 MRC, All banks



- Main drivers are **output floor** and **operational risk**
- 37 banks are **constrained by LR** under the final Basel III (14.9% of the total RWA) compared to 54 banks under the CRR/CRDIV (43.0% of the total RWA)
- **Shortfall** of **EUR 24.5 bn in Total capital** (due to risk-based CAR and LR)
  - Of which: EUR 15.0 bn in Tier 1
  - Of which: EUR 6.0 bn in CET1

Outstanding issues (1/3)

✓ How much capital is **'enough'?**

- Some concerns that minimum requirements are **not high enough** to ensure banks hold enough capital and proposals of an **optimal capital requirement** of 15-20% (Miles et al., 2013).
- Nevertheless, once **capital buffers** are factored in, banks need to meet CET1 ratios of up to 14.5%, excluding P2R and P2G.
- Also, additional requirements strengthen gone concern capital (TLAC, MREL)

✓ **Credibility** of the capital requirement framework.

- The financial crisis has revealed a number of **shortcomings in risk-based capital ratios,** including the build-up of **excessive leverage** and **unwarranted RWA variability.**
- As a response, Basel III introduced **leverage ratio**, **constraints** on the **use of internal models**, and an **output floor.**
- EBA advocated the **repair and benchmark of models** (bottom-up approach) rather than **restrictions of their use,** but **final calibration** of output floor strikes a **good balance.**

Outstanding issues (2/3)

- **Complexity** of the capital requirement framework.
  - Regulatory framework has become more **robust** but also more **complex:**
    - Interaction of RWA, leverage ratio and output floor.
    - Industry raised concerns that non-risk based measures could have **conflicting incentives** (e.g. increase risk-taking and remove incentives for prudent risk management) or result in **potential double-counting of risks.**
    - Hierarchy of capital instruments with bail-in: **non-preferred senior debt**, which takes losses after subordinated debt but before preferred senior debt.
- Differences across countries have **hindered comparability** of bank capital requirements and MREL.
  - National implementations of **macro prudential instruments**

Outstanding issues (3/3)

- Time for **greater transparency?**

  - While banks must publicly disclose Pillar 1 capital ratios, the decision on **Pillar 2 disclosure is left to banks:**

    - Greater transparency can reinforce **market discipline** on weaker institutions…
    - …and investors should know what can affect their remuneration.
    - On the other hand, it can trigger **self-fulfilling processes** due to undesirable reactions by investors trying to benefit from “first-mover’s advantage” (e.g. if capital close to maximum distributable amount trigger).

Thank you for your attention

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