Sujet: Bale III et l'intérêt européen
De : "Nicolas Veron" <nicolas.veron10@gmail.com>
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Pour : "Nicolas Veron" <nicolas.veron10@gmail.com>

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Bonjour,

Le billet ci-dessous (en anglais), publié cette semaine par Bruegel et par le Peterson Institute et à paraitre bientôt sur Vox, fait le point de la mise en oeuvre de l'accord international de Bale III sur les fonds propres et la liquidité des banques. Contrairement à une perception très répandue en Europe, l'UE est en retard sur beaucoup de pays dans ce processus, et surtout risque d'adopter Bale III avec des écarts importants par rapport à l'accord mondial, notamment sur le point essentiel que constitue la définition du capital réglementaire. L'intérêt européen serait de corriger ces écarts avant l'adoption définitive du règlement communautaire sur les exigences de fonds propres bancaires, actuellement en discussion. Je serais très heureux de connaitre vos réactions.

Bien sincèrement a vous,
Nicolas Véron

Basel III: Europe's Interest Is to Comply

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On February 14, European Commissioner Michel Barnier and Federal Reserve Governor Daniel Tarullo both indicated their agreement to quickly give the Basel III accord binding force over, respectively, European and American banks. This is welcome. But even more important than the speed of adoption is that implementation should stay true to what the accord stipulates. At this point, and contrary to many perceptions in Europe, this goal is more likely to be reached by the US than the EU.

Basel III is the work of the Basel Committee on Banking Supervision, which includes 27 countries as its members (plus EU institutions and the International Monetary Fund as observers) and is hosted by the Basel-based Bank for International Settlements with a small permanent secretariat there. It is the crowning achievement of the G-20's financial regulatory agenda in the wake of the Lehman Brothers collapse in 2008. Other prominent initiatives have had only partial or mixed results, including the centralized clearing of over-the-counter derivatives, accounting standards convergence, the regulation of rating agencies, or restrictions on compensation practices or regulatory havens. By contrast, Basel III has moved ahead quickly and can be labeled a clear success for global financial regulation. It is already making a difference, and a positive one, in the way the global banking system operates. Credit for this goes to the Basel Committee's members and to its successive chairmen and secretaries-general since 2007.

Without going into all the details of a rather long text, Basel III makes the definition of regulatory capital much more rigorous; increases minimum capital requirements dramatically, from 2 percent to 7 percent for the key ratio of common equity to risk-weighted assets; tightens the methodology to weigh the risk of assets; introduces a minimum leverage ratio (capital to non-risk-weighted total assets) to mitigate the risk of manipulation of risk weights; introduces additional requirements depending on the financial cycle and the systemic importance of some banks; and introduces regulatory standards and ratios for banks' liquidity profile.

The accord has been criticized from all sides of the financial regulatory debate. Much of the banking community, including the Institute of International Finance, has argued that the increase in capital requirements would greatly impede growth and that the liquidity ratios would harm market functioning. J.P. Morgan Chase's head, Jamie Dimon, has lambasted the additional capital requirements for systemically important financial institutions, including his own, as "anti-American." But third-party studies suggest that bankers have been exaggerating the negative impact, and that the standards' adverse effects will be more than compensated by the benefits of additional financial stability for the system.

Conversely, a number of academics and advocates argue that Basel III is insufficient, or even toothless. The critics call for the need for even higher capital requirements (see also here). They also criticize the widespread gaming of risk-weighting calculations; the excessively long phasing-in period for the standards to take full effect; and the recent announcement that liquidity standards would be less stringent than initially envisaged. But the authors of these critiques fail to present an obvious better alternative or address how to avoid banks circumventing the rules. Pushing minimum capital levels even higher would lead to widespread migration of financial intermediation towards the less-regulated shadow banking system. Risk-weighting is flawed, but the alternative of focusing on a ratio of capital to non-risk-weighted assets is even easier to game. Furthermore, Basel III's leverage ratio creates a backstop against risk-weight manipulation that did not exist in Basel II. The phasing in now looks rather steep to many banks, particularly in Europe, and in any case was arguably the most acceptable price to pay in the compromise to get the accord through in spite of the opposition of some Basel Committee members. The watering down of liquidity ratios appears justified by the uncertainties about the impact of this new and untested regulatory instrument, and the lessons from the euro zone crisis regarding the possible credit risk and illiquidity of sovereign debt markets. In fairness, Basel III goes remarkably far for a consensus-driven Committee that had been much less bold in the past, especially with the previous comprehensive accord (Basel II), which now appears to have been embarrassingly complacent.

Beyond the accord itself, the Basel Committee, in an unprecedented (though arguably long overdue) move, has designed a three-level process to nudge its members to adopt and implement its standards rapidly and consistently. Level One checks that each member jurisdiction has adopted rules that legally mandate the application of Basel III by those for which it was intended, namely large internationally active banks. Level Two checks in detail the consistency of the legislation or regulation with all points covered in the text of Basel III. Level Three assesses how the accord is implemented in practice. The Basel Committee has published regular short reports to the G-20 since 2011, scoring countries' progress on Basel III and the earlier accords' adoption (Level One). The Committee also started in October 2012 to publish detailed reports on the consistency of adopted or proposed legislation/regulation with Basel III, with the first three reports devoted to Japan, the US and the EU (Level Two); and in January 2013 the Committee published its first study on actual implementation, devoted to the consistency of risk-weighting across a sample of banks (Level Three).

The picture that emerges is not uniform, but is encouraging from a global perspective. Eleven of the Committee's 27 members (Australia, Canada, China, Hong Kong, India, Japan, Mexico, Saudi Arabia, Singapore, South Africa and Switzerland) have adopted Basel III and started implementing it in time on January 1, 2013 (India has a delay until April 1). In the EU, which includes 9 other Committee members (Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden, and the UK), the implementing legislation, known as the Capital Requirements Regulation (CRR) and Fourth Capital Requirements Directive (CRD4), was proposed by the European Commission in July 2011. It is in a final phase of discussion between the European Commission, Parliament and Council. (This phase is known as trilogue in the Brussels jargon.) In the US, the three federal agencies jointly in charge – the Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) – have published a regulatory proposal in June 2012 and are currently working on a final version. Work is also in progress in the remaining Basel Committee members, namely Argentina, Brazil, Indonesia, South Korea, Russia, and Turkey.

Among the three jurisdictions reviewed in more detail under the Basel Committee's Level-Two process, Japan gets high marks for essentially complying with the accord. The US (based on the June 2012 proposal) is compliant on all areas tested but one: its rejection of any reference to credit rating agencies' assessments in bank prudential regulation, enshrined in Section 939A of the Dodd-Frank Act of 2010, creates differences with parts of Basel III which keep some references to credit ratings (even though the Basel Committee has also tried to reduce the extent of such references). The EU is found "materially non-compliant" in two areas: the definition of capital and an exemption that the review found too broad from one of the risk-weighting methods. The definition of capital is the more important of the two, as it goes to the core of capital regulation: it is no good to have high minimum requirements if the definition includes "funny equity" that is not genuinely loss-absorbing in a crisis.

These differences are attributable to differences in financial cycles and local politics. The EU is in a state of banking system fragility that has not been resolved by the recent improvement in market conditions. Forbearance is thus a temptation, even though experience suggests that forbearance is a losing crisismanagement strategy. By contrast, Japan, Mexico and much of Asia have learned their lessons the hard way during the crises of the 1990s, and their banks have strong enough balance sheets for the early transition to Basel III to be an easy one. Banks in Canada and Australia have been thriving recently. Switzerland and the US, like the EU, have faced severe banking crises in 2007-08, but unlike the EU, have largely resolved them in 2009-10, which makes their implementation of Basel III requirements less challenging than in several EU member states.

The delay and spotty compliance in the EU stands in stark contrast to Europe's championing and early adoption of Basel II, in the early 2000s. It is not uncommon for EU financial policy leaders to offer support for the Basel III process and to criticize it at the same time. In particular, the European Commissioner in charge of financial services has reacted angrily to the Basel Committee's Level-Two report on the EU, arguing that some of its findings "do not appear to be supported by rigorous evidence and a well-defined methodology" while simultaneously affirming his "support [for] the Basel Committee's intention to assess consistent implementation."

The Commissioner implies in his reaction that the EU's CRR/CRD4 legislative proposal was assessed unfairly and negatively in comparison with the reviews of Japan and particularly of the US. However, the Basel Committee's Level-Two assessment process has involved Europeans prominently: they represent no less than half of the respective assessment teams for both Japan (6-member team led by the Banque de France's Sylvie Mathérat and also including members from the German and Swedish central banks) and the US (6-member team including members from the French and Italian central banks and from the European Commission). As for the EU, the assessment team was led by Charles Littrell from the Australian Prudential Regulation Authority. It also included five other members from prudential authorities in Japan, New Zealand, Singapore, Switzerland, and the US. (The teams are formed on the principle of no self-assessment, which is why no EU member state is represented in the EU assessment team.)

The Basel Committee has put a lot of effort into ensuring the quality and consistency of its assessment methodology, and there is no convincing evidence of anti-European bias from a detailed reading of the Level-Two reports. The Committee's policy so far has been not to react publicly to the European Commissioner's critique. But it is evident from the content of the Level-Two report on the EU that the same arguments put forward in this critique have been carefully considered by the assessment team before completion of the report.

The reaction from many stakeholders in Europe to the US delay in Basel III adoption has been similarly shrill. The joint press release of the Fed, the FDIC and the OCC does nothing more than announce that the deadline of January 1, 2013 will be missed in the finalization of the rulemaking process, given the large number of written comments received on the June 2012 proposals that justify in-depth analysis. This has been widely denounced in continental Europe as a de facto abandonment of the effort, which would justify significant delaying of the EU's own decision-making process on grounds of competitive fairness: the European Banking Federation sent a letter interpreting the US press release as implying that "our US competitors will not have matching obligations imposed on them in parallel [with the EU's CRR/CRD4], or in a foreseeable future." The head of the Italian Banking Associated said that "Basel III must be postponed, full stop."

In fact, the EU and the US are likely to adopt Basel III around the same time, probably in both cases in the second quarter of 2013. As mentioned above, the procedures are different. In the EU, CRR and CRD4 are produced by a legislative co-decision process that involves the European Parliament and the Council, involving a degree of politicization. (CRD4, being a directive, requires further transposition in all member states' national legislation, while CRR will be directly applicable in all member states once adopted by the European Parliament and Council.) In the US, the process is more technocratic. It is in the hands of the three federal agencies (Fed, FDIC and OCC) but is also subject to the scrutiny of Congress, which may still impose further delay.

On both sides, there is no indication that the points of "material non-compliance" found in the Basel Committee Level-Two preliminary assessments will be corrected in the final version. In the US, Section 939A of the Dodd-Frank Act prohibits reference to credit ratings in the prudential regulation of banks and is unlikely to be abrogated by Congress any time soon. The EU is ill-placed to criticize the US on this, as it has itself put much blame on credit rating agencies in the crisis context and submitted them to increasingly stringent regulation. In the EU, there is no indication that the revision of the non-compliant parts of CRR are among the points that the co-legislators in the European Parliament and Council intend to revise in the current final phase of legislative "trilogue."

There would be sound justifications, however, for a second look in the EU that would enable the adoption of a Capital Requirements Regulation that would be fully compliant with the Basel III accord.

- First, the direct economic impact of the necessary changes would be limited, especially if the changes only apply to the large internationally active banks for which the Basel Committee's standards are intended. In his response to the Basel Committee's Level-Two report on the EU, the European Commissioner argues that the report's reservations on the definition of capital of non-joint stock companies (presumably referring to so-called "silent participations" in some public banks in Germany) "concerns a single internationally active bank," and that the other material issue about the treatment of insurance subsidiaries "can arise only in very few banks." These points are designed to argue that the non-compliance with Basel III is not material. But the argument can be reversed in the sense that correcting the non-compliance would not have a systemically detrimental effect on the EU economy.

- Second, full compliance with Basel III would enhance trust in European banks. The EU's deviations from the international accord feeds the widespread presumption in the investor community that at least some supervisory authorities in the EU tend to apply a high degree of forbearance to banks within their remit and are reluctant to force them to apply high and consistent capital standards. This market sentiment is detrimental to all EU banks, including those (presumably many) that are sufficiently capitalized, and thus puts a drag on the European economy as a whole. The cost-benefit balance is without a doubt favorable to bringing CRR to full compliance with Basel III.

- Third, the EU's incomplete adoption of Basel III undermines the global authority of the Basel Committee, encourages other jurisdictions to introduce exceptions of their own, and diminishes the EU's own moral stature in the global financial regulatory debate. In the past two decades, the EU has been a champion of global financial regulatory convergence, in particular with its endorsement of International Financial Reporting Standards in the early 2000s and support of Basel II and Basel 2.5 throughout the 2000s. The calculation was that global financial convergence and integration would support an agenda of harmonization and integration within the EU itself. This calculation remains relevant, even after the shift from a G-7 to a G-20 global framework in which the EU member states' relative influence is less than it used to be. The European Union's co-legislators should revisit their stance and make the Capital Requirements Regulation fully compliant with Basel III before they put their final stamp on it.

Nicolas Veron *is a Senior Fellow at Bruegel (Brussels) and a Visiting Fellow at the Peterson Institute for International Economics (Washington DC).*