Do European banks need much more capital?

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Today the European Commission launched its proposed Directive and Regulation – CRDVI/CRR3 which seeks to implement the final Basel III standards in Europe. Despite assertions by the authorities to the contrary, these proposals will require European banks to raise significant additional amounts of equity capital to maintain their current ratios. They come at a time when banks hold record capital levels and have demonstrated considerable resilience throughout the Covid-19 economic collapse. Not only this, but they have exhibited their ability to withstand catastrophic stress test scenarios and have started to release bad debt provisions.

The proposals themselves limit the extent to which banks can make use of their internal models to calculate their capital requirements. One way they do this is by not allowing modelled capital needs to fall below 72.5% of those calculated using a simpler standardized approach. They also introduce fresh rules on market and operational risks, imposing more precise capital requirements on areas of banks' activities that were hitherto less specifically targeted.

The December 2017 Basel III agreement is supposed to be the final element of the post 2008 financial crisis repair programme. As part of this, the Basel standard setters committed to no further post crisis regulatory capital increases and also claimed that the proposals would not lead to any significant overall increase in banks' minimum capital requirements.

Unfortunately, impact studies requested by the European Commission from the European Banking Authority and the Commission's updated study published today - which suggests single digit capital increases - are based only on minimum required capital standards. So not only do the studies assume that all proposals are fully accepted by the co-legislators, but they also completely fail to show the real capital increase. This is likely to be in double digit percentages especially for the largest European banks which will to continue to operate at capital levels well in excess of minimum standards. In monetary terms therefore it is probable that the true capital shortfall compared to market required levels is a multiple of what the Commission is suggesting. This in turn could have negative consequences for lending and broader economic activity as balance sheet growth is constrained to conserve capital.

Since the last financial crisis, European banks have raised hundreds of billions of equity capital taking their average Core Equity Tier 1 ratio – the best measure of capital strength - to a record 15.9% at March this year. Recently, banks have proved their resilience throughout the Covid-19 induced economic crisis. They have also been subjected by the EBA to its harshest ever stress test based on assumed massive falls in GDP, huge increases in unemployment and catastrophic falls in asset and market prices, emerging with a strong average CET1 ratio of over 10%.

So what is the purpose of additional capital requirements? While significant financing is still required to aid the recovery from Covid-19; rather than taking on additional debt, businesses need more equity or equivalent instruments which should be raised on the capital, rather than the banking markets. In this respect, progress has already been seen with capital raising of €52bn by euro area corporates so far this year. This compares to net bank lending to euro area corporates of €56bn. However, smaller and medium sized entities - unable to easily access capital markets - are likely to continue to rely on banks for their financing needs. To the extent that the new EU proposals constrain banks' ability to satisfy this requirement, (particularly through the application of the Output Floor, introducing a less risk sensitive approach to lending), then this may harm economic recovery.

Some will also point to the need for additional capital to meet the risk of increased credit losses from banks' customers as government support is withdrawn. While a pickup in losses is anticipated, this is likely to be manageable. And having built up significant reserves against prospective losses, banks have recently been releasing some of these suggesting confidence over provisioning levels.

There are of course new risks on the horizon which could hit banks' capital. The threats from climate change are often mentioned in this context. Yet climate related risks are very largely the amplification of already well-established risk categories such as credit, interest rate, counterparty, and foreign exchange. And while such amplified risks should certainly be incorporated in banks' overall risk assessments and capital requirements, it is unclear that they need their own separate pot of additional capital.

The Basel capital standards have played a major role in improving the resilience of banks, removing their implicit funding subsidy, and reducing systemic risk. The Basel Committee was right when it said that no significant additional system wide capital requirements should result from its final standards. European banks are already very well capitalized, and while some modest adjustments to requirements might be appropriate, European co- legislators should keep this firmly in mind as they evaluate the Commission's latest proposals.