Basel III implementation: preserving EU banks' capacity to finance the economy

Note written for Eurofi by Véronique Ormezzano

Key messages

- EU banks are now recognized as well capitalised, with a CET1 capital amount that has more than doubled since the Global Financial Crisis, a CET1 ratio that has reached at 31st Dec 2023 an all-time high of 16%[1], up from 6% in 2011, and a shock absorbency capacity confirmed in stress tests.
- However, their competitiveness remains lower than their non-EU peers. Their ROE, boosted by a rise in Net Interest Margin (+17 bps in 2023 vs 2022), has reached around 10%[2] in 2023, covering (at last) their cost of equity[3], and helping valuations to somewhat recover. However, it is likely to decline in 2024 as higher funding costs squeeze margins and the cost of risk likely rises.
- The "finalisation of Basel III", which will be implemented in the EU from 1 January 2025, as planned, will significantly impact EU banks' Risk-Weighted Assets (RWA), with a 10.7% increase, and 15.1% for G-SIIs[4]. While the Output Floor is the single most important driver, and benefits from a phase-in until 2030, the combined other drivers represent half of the increase for G-SIIs, and will therefore materialize as early as Q1 2025.
- Given the remaining high degree of uncertainty in timing and substance of implementation in the US and, to a lesser extent, in the UK, this would further deteriorate the competitiveness of EU banks, and further reduce the EU's sovereignty in the financing its investment needs.
- However, there remains significant room for maneuver to either worsen or improve the situation, in the course of implementation of CRR3 in the next few months.
  - On one hand, the impact on EU banks may be significantly worsened if level 2 and 3 texts are weighing on the conservative side compared to the level 1 text, a real risk given the large number of mandates given to the EBA.
  - On the other hand, the RWA inflation should be financed by the capital buffers accumulated by banks, subject to a reduction of CET1 ratio targets being allowed by supervisors. Indeed, the EBA reports that "the first driver to hold a management buffer target is to anticipate regulatory changes"[5]. It would therefore be natural that when this change materializes, the buffer is released.

It is critical that a clear policy be articulated and communicated to the market in the next few months as regards this recalibration of buffers. This would be a way for the EU to implement its commitment faithfully, while avoiding fragilizing its banking sector, which finances the bulk of the EU economy. Otherwise, if EU banks face the obligation to maintain their target ratio at or close to the current level, they will have to accumulate up to €200 bn of additional CET1 capital, with serious impact on financial stability, and freezing up to 1.2 trn of potential additional lending, at the expense of the European economy.

1. EBA RISK ASSESSMENT REPORT – July 2024 - https://www.eba.europa.eu/sites/default/files/2024-07/9604ba14-0ec4-4236-94e9-b07cb79db918/Risk%20assessment%20report%20%20July%202024.pdf
2. Id.
3. S&P Global estimates EU banks cost of equity to range from 8 to 12% depending on countries. Source: S&P Global - European Banks' Earnings Top Equity Costs, For Now – March 2024 https://www.spglobal.com/ratings/en/research/articles/240319-your-three-minutes-in-banking-european-banks-earnings-top-equity-costs-for-now-13041748
4. EBA BASEL III MONITORING EXERCISE – RESULTS BASED ON DATA AS OF 31 December 2022 (ANNEX – ANALYSIS OF EU SPECIFIC ADJUSTMENTS) September 2023 – Table 2 EBA QIS data (December 2022), sample 157 banks
5. EBA STACKING ORDERS AND CAPITAL BUFFRS – July 2024 https://www.eba.europa.eu/sites/default/files/2024-07/3f548b65-873a-4f0d-ab5a-094cd18dee33/Report%20on%20stacking%20orders%20and%20capital%20buffers.pdf

1. EU banks are well capitalised

Regulators and supervisors are now regularly communicating on the resilience and high capitalisation of EU banks, which has been demonstrated through various angles.

1.1 EU banks' average CET1 ratio has reached as of Dec 2023 a record high of 16%, a much higher level than international peers

As shown in the BCBS Monitoring report, the CET1 ratio of European banks has continuously increased in the last decade, reaching 15% in June 2023, and 16% as per EBC figures as of December 2023 (*see Figure 1*).

This increase is in contrast with the stabilisation of CET1 ratios in other jurisdictions around 12.5% since 2017.

The BCBS comments that "Across all regions and groups, the drivers of the change in capital ratios were mixed. Capital ratios in the Americas remained flat due to similar-size changes in Tier 1 capital and RWA. The rise in capital ratios in Europe was attributable to capital increasing at a greater pace than RWA, and the decline in capital ratios for the rest of the world was due to an increase in RWA."

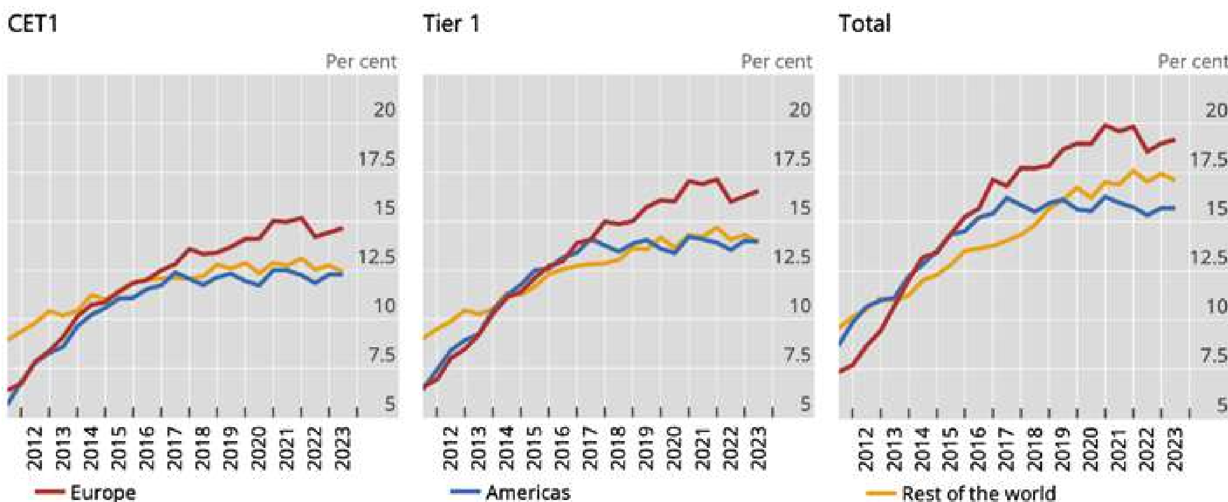
1.2 In the EU, this continuous increase since 2014 was achieved through a combination of earnings retention and subdued RWA growth

Indeed, European banks have achieved this record CET1 ratio by accumulating capital through earnings retention, and low RWA growth.

As per the EBA Dashboard[7], since 2014, the CET1 capital amount of EU banks increased by close to 40%, while the RWAs have only increased by 10%. Such a low RWA cumulated increase over a decade, not adjusted by inflation, and while TRIM and the IRB repair program have rather increased RW density of loan portfolios, shows that banks have been highly constrained in volume growth, which impacted their profitability and reduced their capacity to finance the EU's economic growth, at the benefit of non-EU banks and non-banks. In particular, unlike their peers, European banks have reduced the availability of higher-risk loans – and, therefore, their contribution to financing the productive economy – rather than raise or generate additional capital, due to subdued profitability and valuation. (*see Figure 2*)

This very high level of CET1 accumulation is in response to ever increasing buffer requirements by supervisors and macro-prudential authorities, and on top of them, ever higher "management buffers",

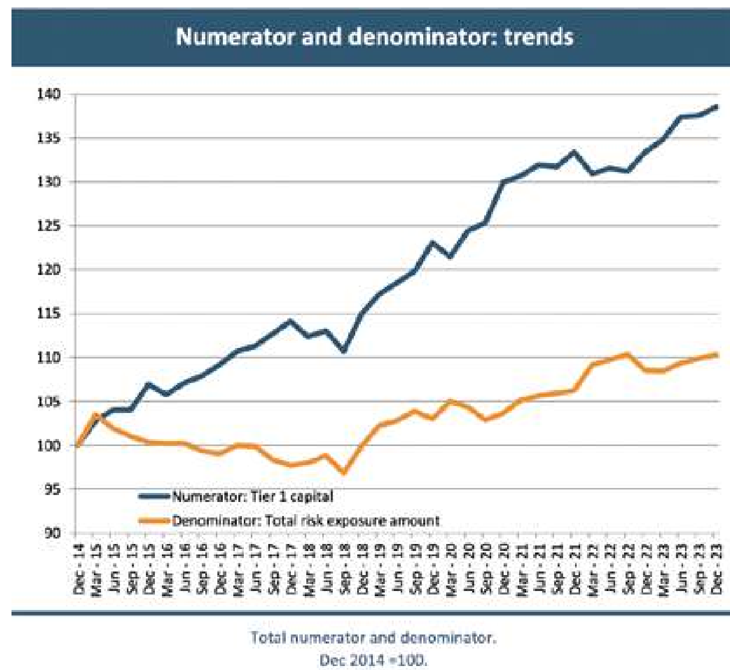
FIGURE 1.
Evolution of Capital ratios by region
Initial Basel III CET1, Tier 1 and total capital ratios, by region
Group 1 banks, balanced data set



Source: BCBS Monitoring Report, March 2024, Data as of June 2023 – https://www.bis.org/bcbs/publ/d570.pdf [6]

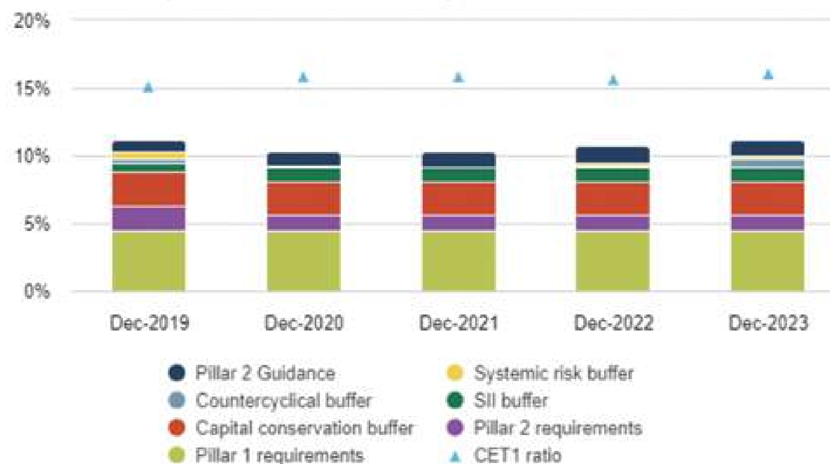
6. The BCBS sample includes 178 banks, including 112 Group 1 banks and 65 Group 2 banks. Group 1 banks are those that have Tier 1 capital of more than €3 billion and are internationally active. Only 12 US banks have contributed to the QIS exercise, given the limited scope of application of BCBS standards in the US. 40 banks are included in the European sample, o/w 30 in the EU.
7. EBA Risk Dashboard – Q1 2024 - https://www.eba.europa.eu/sites/default/files/2024-06/b4a17394-1285-4b4e-923e-642a2f725d7e/EBA%20Dashboard%20-%20Q1%202024.pdf

FIGURE 2.
Evolution of CET1 capital and Risk Weighted Assets[8]



Source: EBA

FIGURE 3.
Evolution of Capital requirement and guidance vs reported CET1 ratios



Source: EBA supervisory reporting data

notably anticipating the future impact of CRR3. The EBA graph below (*see Figure 3*) shows the ongoing increase in capital buffers requirements since 2020 (a "low" point where contracyclical buffers had been reduced due to Covid-19), and the ample capital headroom on top of them.[9]

Those two trends are analysed below.

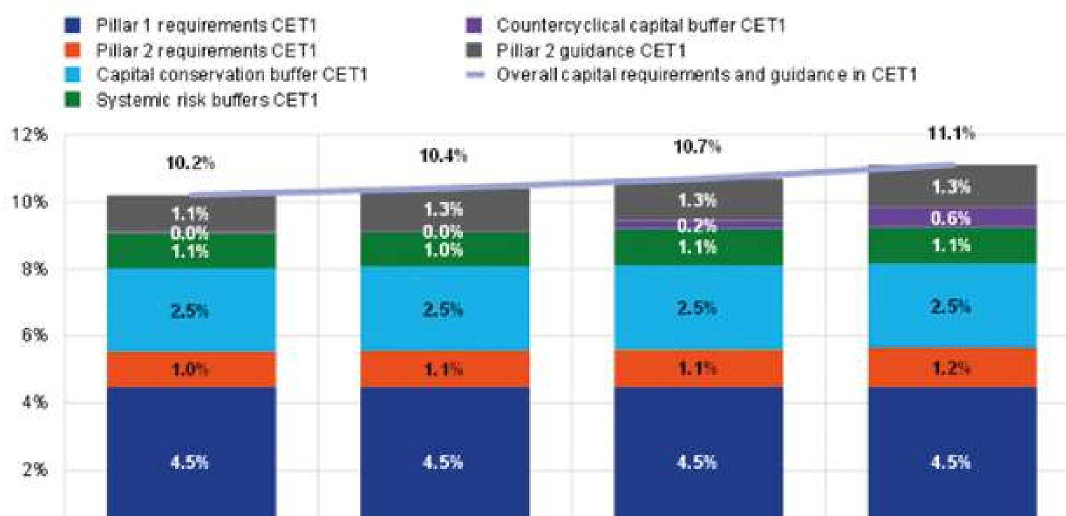
1.2.1 Evolution of buffer requirements

The ECB Aggregated results of SREP 2023[10] shows the evolution of the overall CET1 capital requirements and guidance. It increased by 0.9 pp since 2021 to reach an average of 11.1% to be reached by EU banks in 2024 (*see Figure 4*).

From 2023 to 2024 alone, the average overall capital requirements and guidance increased by a further 0,4 pp (mostly due to increases in CCyB and in P2R), absorbing most of the CET1 capital accumulated by EU banks which amounted to 0.5 pp during the same period (from a CET1 ratio of 15.4% to 15.9%). The EBA notes "EU/EEA banks' CET1 headroom above overall capital requirements (OCR) and Pillar 2 Guidance (P2G)

8. EBA Risk Dashboard - https://www.eba.europa.eu/sites/default/files/2024-04/b26d6541-df25-498c-adbe-9702c031c8e9/EBA%20Dashboard%20-%20Q4%20 2023.pdf
9. EBA - RISK ASSESSMENT REPORT – July 2024 - https://www.eba.europa.eu/sites/default/files/2024-07/9604ba14-0ec4-4236-94e9-b07cb79db918/Risk%20 assessment%20report%20%20July%202024.pdf
10. ECB Aggregated SREP results 2023 - https://www.bankingsupervision.europa.eu/banking/srep/2023/html/ssm.srep202312_aggregatedresults2023.en.html

FIGURE 4.
Evolution of the Overall Capital Requirement and Guidance



Source: ECB A Aggregated SREP Results 2023

has remained at comfortable levels. This is due to a nearly parallel rise in CET1 ratios and respective requirements." in its Risk Assessment Report.

Said otherwise, this means that 80% of the earnings retention of EU banks in 2023 had to be allocated to cover the increase in capital requirements on the existing portfolio, and that only 20% of this additional capital was available for the financing of new business. No surprise if EU banks' shares remain unattractive for investors... And if such a trend were to continue, needless to say that banks would not be in a position to contribute to the financing of the EU renewed ambitions.

Such a level of buffer requirements is also to be compared to the BCBS framework, which includes:

- a minimum CET1 capital ratio requirement of 4.5%
- a Capital Conservation Buffer of 2.5 percent
- if applicable, a capital surcharge for G-SIBs, which is at least 1%
- a Countracyclical Buffer

leading to a minimum of 7% minimum CET1 ratio which, based on the EU G-SIBs and CCyB buffers above, would translate into a minimum of 8.7% (7% + G-SIB + CCyB).

The BCBS also includes a Pillar 2 concept, but does not provide prescriptive guidance as to whether it should be applied or how it should be calibrated, leaving it to competent authorities' supervisory judgment.

1.2.2 Why have the banks accumulated so much capital on top of the already elevated buffer requirements?

In its Risk Assessment Report, the EBA comments: "EU/EEA banks' CET1 headroom above OCR – which consist of Pillar 1, Pillar 2 and the combined buffer requirements – and P2G, have remained at comfortable levels. They rose slightly YoY, reaching nearly 500 bps as of Q4 2023 (around 490 bps in Q4 2022)."

The EBA has analysed in detail this subject in a study called "Stacking Orders And Capital Buffers"[11].

First of all, the EU prudential and resolution framework is conducive to the establishment of additional buffers on top of the capital requirements, unlike other jurisdictions.

Citing the EBA, "in addition to minimum requirements, buffer requirements and Pillar 2 requirements and guidance, institutions are also required to determine their own internal requirements. Following their internal processes and given their own strategies and risk appetite, EU institutions may hold additional financial resources in the form of own funds and/or eligible liabilities above the applicable minimum requirements (including possibly P2G). In accordance with EBA guidelines on recovery triggers, **banks are expected to set triggers above levels requiring supervisory intervention.** Therefore, recovery triggers should be set sufficiently above capital and leverage requirements / TLAC / MREL plus CBR. Moreover, from a prudential standpoint, institutions are also required to define their risk

11. EBA - STACKING ORDERS AND CAPITAL BUFFERS – July 2024 - https://www.eba.europa.eu/sites/default/files/2024-07/3f548b65-873a-4f0d-ab5a-094cd18dee33/Report%20on%20stacking%20orders%20and%20capital%20buffers.pdf

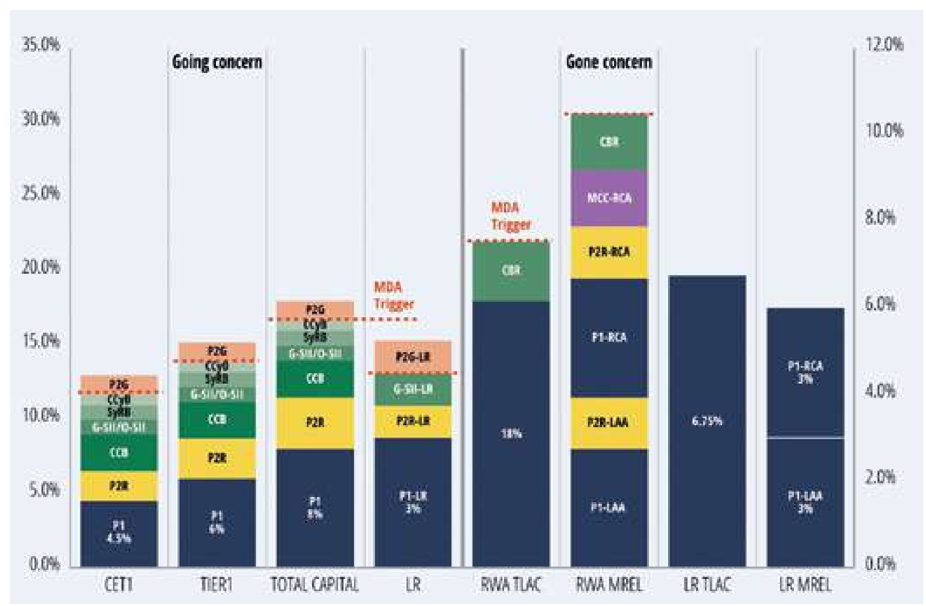
appetite statements and to develop their risk appetite framework around a set of limits and early warning triggers **which imply a higher level of financial resources. Competent authorities may also set more specific expectations for additional management buffers.** For example, **the SSM's ICAAP guide states that 'the institution is expected to assess and define management buffers above the regulatory and supervisory minima and internal capital needs that allow it to sustainably follow its strategy."**

Second, the capital target must allow the bank to comply not only with the CET1 requirement, but all capital stacks. The EBA identifies up to 10 different capital requirements that need to be met: "EU G-SIIs are subject to four going concern capital requirements (between solvency and leverage) and up to six gone concern ones (from a risk-based and leverage perspective), which can be illustrated graphically as in *Figure 5*. For simplicity neither the subordinated MREL requirement, expressed as % TREA and % TEM, nor the 8% TLOF rule have been included." The additional complexity introduced in CRR3 with the output floor is not taken into account either.

"As can be seen from the figure, multiple Maximum Distributable Amounts (MDA) thresholds apply. First in the risk-based own funds stack (CET1, T1 and TC), second in the leverage ratio stack (for G-SIIs only) and third in the risk-based TLAC (G-SIIs only) and MREL stacks. The process to restrict MDA is triggered upon breach of CBR (G-SII LR buffer requirement for the LR stack)."

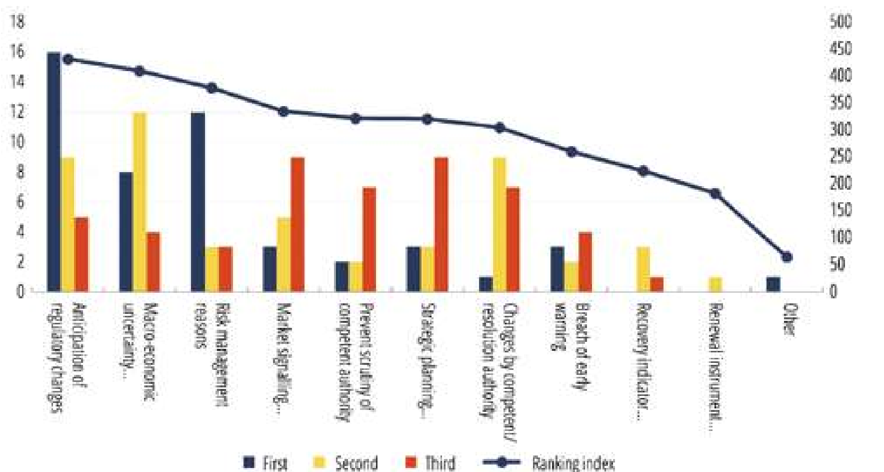
Maintaining a sufficient Distance to MDA for all metrics has therefore become a major aspect of capital management, and "Distance to MDA" is a key indicator of resilience for equity and debt investors. In practice, this means that the target level of capital must be set as a function of the most binding constraint(s), which can be, depending

FIGURE 5.
EU capital requirement framework



Source: EBA - Stacking Orders and Capital Buffers

FIGURE 6.
Ranking of drivers to set a management buffer



Source: EBA - Stacking Orders and Capital Buffers

on the risk profile of each bank, the Risk based capital ratio, the leverage ratio, the TLAC/MREL ratios…

The room for reducing the management buffer is therefore not necessarily only a function of the evolution of RWAs, although there are some interactions between the stacks, for example, the TLAC stack also includes the capital buffer requirement, so would be positively impacted by a reduction in CET1 buffers.

Finally, the EBA reported the outcome of a survey of banks about their practices on management buffers. This survey shows that the primary driver for banks in setting up CET1 targets is the need to "anticipate changes in regulation" (*see Figure 6)*.

This finding confirms that banks have accumulated capital above the buffer requirements and guidance in order to anticipate the impact of CRR3, and that they are well prepared to absorb this shock while continuing lending to the economy, without the need to further increase their capital.

1.3 Banks' shock absorbing capacity is confirmed in stress tests

In the last stress test, conducted in 2023, EU banks were submitted to an extreme shock, combining a 6% decline in GDP over the 3-years period, large drops in Retail and Commercial Real Estate prices, and higher interest and credit spreads, reflecting an underlying assumption of higher and more persistent inflation.

Such scenario translates into simulated losses of €496 bn, a level much higher than observed losses during the Global Financial Crisis.

Despite this severity, EU banks' stressed CET1 ratio remained at 10.4%. According to the EBA[12], "The results of the stress test indicate that on average banks finish the exercise in the adverse scenario with a Common Equity Tier 1 (CET1) ratio above 10% and shows that banks can continue to support the economy also in times of severe stress". The ECB communication[13] is more sober and states that "The stress test results show that the euro area banking sector is overall resilient to a severe economic downturn, as represented in the adverse scenario."

European authorities refrain however to set an explicit minimum level post stress, contrary to their US counterparts.

The FED communication[14] is very clear that banks need to comply only with the 4.5% minimum Pillar 1 CET1 requirement post stress, making all buffers explicitly "usable" to cover stressed losses, as per their "raison d'être" (*see Figure 7*).

Instead, the more ambiguous European communication leads banks to accumulate "buffers on top of the buffers". This reopens the debate on the usability of buffers which was initiated after Covid-19 and remained inconclusive.

Given a record high level of CET1 ratio, and a proven capacity to absorb massive losses, a logical conclusion should be that EU banks do not need to further increase their level of capital, a

FIGURE 7.
FED communication on 2023 Stress tests

Aggregate capital ratios, actual, projected 2023:Q1–2025:Q1, and regulatory minimums Percent			
Regulatory ratio	Actual 2022:Q4	Stressed minimum capital ratios, severely adverse	Minimum regulatory capital ratios
Common equity tier 1 capital ratio	12.4	9.9	4.5
Tier 1 capital ratio	14.1	11.6	6.0
Total capital ratio	16.1	13.9	8.0
Tier 1 leverage ratio	7.5	6.1	4.0
Supplementary leverage ratio	6.3	5.1	3.0

Source: Dodd-Frank Act Stress Test 2023: Supervisory Stress Test Results - June 2023
Note: The capital ratios are calculated using the capital action assumptions provided within the supervisory stress testing rules. See 12 C.F.R. §238.132(d); 12 C.F.R. §252.44(c). These projections represent hypothetical estimates that involve an economic outcome that is more adverse than expected. The minimum capital ratios are for the period 2023:Q1 to 2025:Q1. Supplementary laverage ratio projections only include estimates for banks subject to Category I. II. or III standards.

12. EBA - 2023 EU-WIDE STRESS TEST RESULTS - 28 July 2023 https://www.eba.europa.eu/sites/default/files/document_library/Risk%20Analysis%20and%20Data/EU-wide%20Stress%20Testing/2023/Results/1061374/2023-EU-wide-stress-test-Results.pdf
13. ECB - 2023 stress test of euro area banks Final results - July 2023 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.Report_2023_Stress_Test~96bb5a3af8.en.pdf
14. FED - Dodd-Frank Act Stress Test 2023: Supervisory Stress Test Results - June 2023 https://www.federalreserve.gov/publications/2023-june-dodd-frank-act-stress-test-executive-summary.htm

message which also resonates with on one hand, the G20[15] and ECOFIN statements that the implementation of the final Basel III should not lead to a significant capital increase, and on the other hand, with the EBA monitoring report[16] which concludes that, despite the significant increase in RWAs, EU banks show a minimal capital shortfall.

2. However, the competitiveness of the EU banking sector remains low

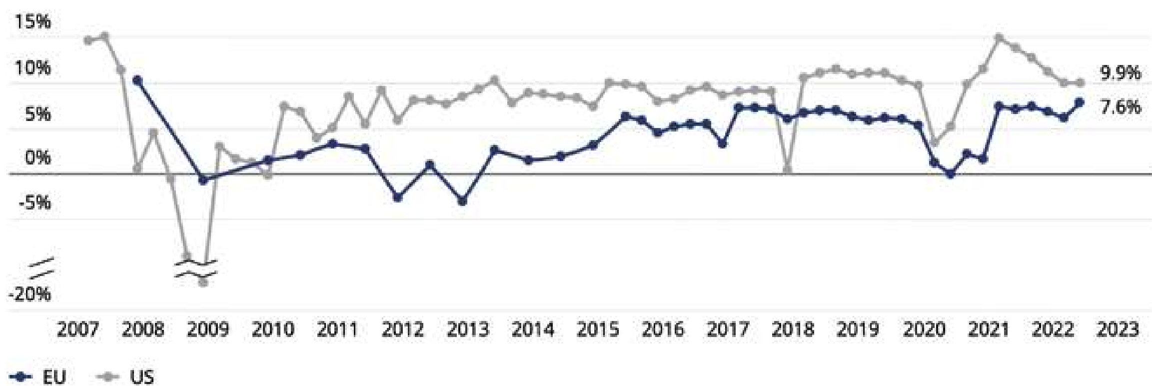
EU banks' competitiveness remains lower than their non-EU peers. Since the Global Financial Crisis, their RoE as been consistently lower than their US peers, while their cost of equity has been consistently higher, weighing on their valuations.

In 2023, EU banks' ROE, boosted by a rise in Net Interest Margin (+17 bps in 2023 vs 2022), has reached around 10% in 2023, covering (at last) their cost of equity, and helping valuations to somewhat recover. However, after a peak in Q2/Q3 2023, RoEs have started to decline in Q4 2023, at 9.31% as higher funding costs squeeze margins and the cost of risk likely rises.

In this context, while EU banks' profitability has reached multi-year highs in 2023, bank equity valuations has not substantially exceeded pre-pandemic levels.

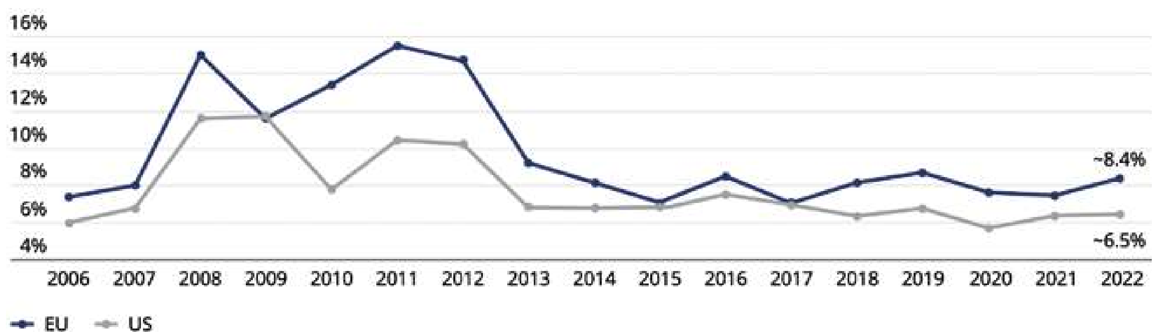
Weak bank stock valuations and a high COE increase the cost of lending to the real economy and make it harder for banks to raise capital. Uncertainty about the outlook for bank profits and asset quality, coupled with concerns about the sustainability of dividend payouts following announcements of

FIGURE 8.
Comparison of RoE between EU and US banks)[17]



Source: Oliver Wyman, based on data from Eurostat, AFME and SIFMA – January 2023

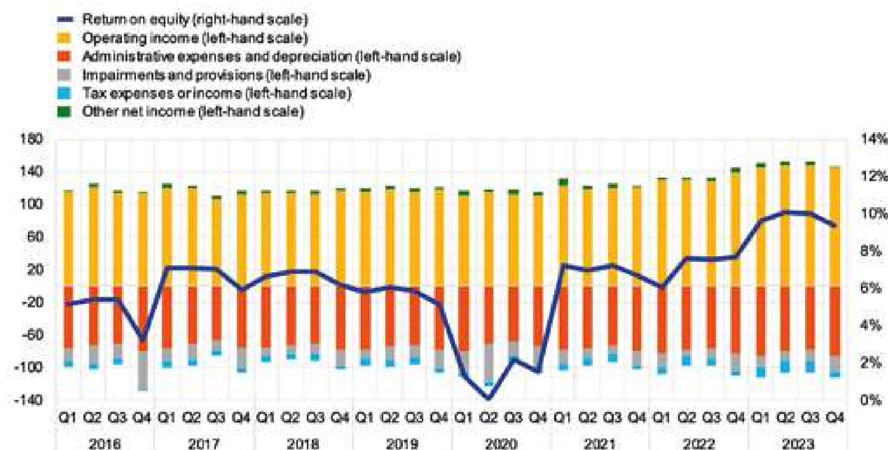
FIGURE 9.
Comparison of Cost of Equity between EU banks and US banks



Source: Oliver Wyman, based on data from Eurostat, AFME and SIFMA – January 2023

15. Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting on 17-18 March 2017, available at http://www.g20.utoronto.ca/2017/170318-finance-en.pdf.
16. EBA - BASEL III MONITORING EXERCISE – RESULTS BASED ON DATA AS OF 31 December 2022 (ANNEX – ANALYSIS OF EU SPECIFIC ADJUSTMENTS) - September 2023 https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2023/Basel%20III%20monitoring%20report/1062188/Annex%20to%20Basel%20III%20monitoring%20report%20as%20of%20December%202022%20-%20EU-specific%20Analysis.pdf
17. Oliver Wyman, based on data from Eurostat, AFME and SIFMA – January 2023 https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2023/jan/The-EU-banking-regulatory-framework-and-its-impact-on-banks-and-economy-.pdf

FIGURE 10.
RoE of SSM supervised banks – recent trends[18]
(in billions of euros; as a percentage)

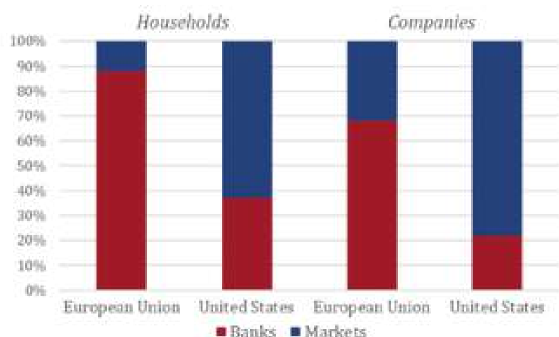


Source: Press release from the Banque de France

higher bank taxes, is contributing to the stagnant valuations and persistently high equity risk premia observed in the euro area banking sector. In the long run, this may adversely affect financial stability as banks which are valued by investors at a discount will likely find it more challenging to raise new equity when needed. As capital required to support lending is remunerated by lending rates, weak valuations translate directly into stricter terms and conditions for finance to the real economy.[19]

The European economy is mostly financed by banks. In the EU, banks account for 90% of household debt and 70% of business debt. By comparison, these figures are just 40% and 20% respectively in the United States (*see Figure 11*). Banks therefore meet the vast majority of financing needs in Europe, whereas the markets play a prominent role in the United States. Yet, it is to be noted that this market dominance in the US does not exclude banks from the equation altogether: they act as market makers and originate assets, which are then traded on the markets (securitisation).

FIGURE 11.
Banks and Capital Markets as a share of household and corporate funding, EU and United States, 2022[20]



Source: Oliver Wyman, based on data from Eurostat, AFME and SIFMA – January 2023

As such, and even if European authorities intend to give a new impetus to the Capital Market Union, banks need to play an important role in the financing of the European renewed investment ambitions, which will require additional capital to be generated organically or raised in the market. To note, a substantial scale-up of the securitisation market would be part of the solution, as it would allow banks to maintain or grow their lending origination while transferring part of the risk to market participants, reducing their additional capital need.

3. At the same time, the "finalisation of Basel III" will significantly impact EU banks' Risk-Weighted Assets (RWA)

Despite some (mostly temporary) adjustments, considering "European specificities", the impact of CRR3 will remain significant: indeed, the implementation of CRR3 is estimated by EBA to translate into a risk-weighted asset (RWA) increase by 15.1% for EU G-SIIs, and by 10.7% for all banks, an increase that will inevitably weigh on the EU banking sector capacity to finance the EU households and businesses.

While the Output Floor is the single most important driver, and benefits from a phase-in until 2030, the combined other drivers represent half of the increase for G-SIIs, and will therefore materialize as early as Q1 2025.

The impact of Basel III on EU banks is even more critical at a point where total uncertainty remains on the timing and content of the US implementation

18. https://www.banque-france.fr/fr/communiques-de-presse/la-bce-publie-des-statistiques-de-supervision-bancaire-sur-les-etablissements-importants-pour-le-1#:~:text=Le%20rendement%20annualis%C3%A9%20agr%C3%A9g%C3%A9%20des,%25%20au%20quatri%C3%A8me%20trimestre%202022).
19. ECB - Euro area bank fundamentals, valuations and cost of equity – November 2023 https://www.ecb.europa.eu/press/financial-stability-publications/fsr/focus/2023/html/ecb.fsrbox202311_05~519e436375.en.html
20. Oliver Wyman, based on data from Eurostat, AFME and SIFMA – January 2023 https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2023/jan/The-EU-banking-regulatory-framework-and-its-impact-on-banks-and-economy-.pdf

FIGURE 12.
Increase in Minimum Capital Requirement in the Basel III and EU specific implementation[21]

Bank group	Scenario	Credit risk				Market risk	CVA	Op Risk	Output floor	Other Pillar 1	Total risk-based	Revis ed LR	Total
		SA	IRB	Securitisation	CCPs								
All banks	Basel III (ILM = 1)	2.6	1.6	0.0	0.0	1.2	2.4	2.2	6.8	-0.4	16.3	-3.8	12.6
	Delta	*-1.4*	*-2.2*	*0.0*	*0.0*	*0.0*	*-2.0*	*0.0*	*-0.1*	*0.0*	*-5.62*	*2.1*	*-3.6*
	EU-Specific (ILM = 1)	1.2	-0.6	0.0	0.0	1.2	0.4	2.2	6.7	-0.4	10.7	-1.7	9.0
Group 1	Basel III (ILM = 1)	1.9	1.6	0.0	0.0	1.3	2.6	2.6	7.4	-0.5	17.0	-3.7	13.3
	Delta	*-0.8*	*-2.4*	*0.0*	*0.0*	*0.0*	*-2.2*	*0.0*	*0.0*	*0.0*	*-5.5*	*2.2*	*-3.3*
	EU-Specific (ILM = 1)	1.1	-0.8	0.0	0.0	1.3	0.4	2.6	7.4	-0.5	11.5	-1.5	10.0
Of which: G-SIIs	Basel III (ILM = 1)	2.0	4.0	0.0	0.1	2.1	3.1	3.1	7.5	-0.3	21.7	-1.7	20.0
	Delta	*-0.8*	*-3.4*	*0.0*	*0.0*	*0.0*	*-2.4*	*0.0*	*0.2*	*0.0*	*-6.6*	*2.6*	*-4.0*
	EU-Specific (ILM = 1)	1.2	0.6	0.0	0.1	2.1	0.7	3.1	7.7	-0.3	15.1	0.9	16.0
Group 2	Basel III (ILM = 1)	6.0	1.9	0.0	0.0	0.4	1.0	0.5	3.2	-0.1	12.9	-4.0	8.9
	Delta	*-4.1*	*-1.6*	*0.0*	*0.0*	*0.0*	*-0.7*	*0.0*	*-0.3*	*0.0*	*-6.6*	*1.4*	*-5.3*
	EU-Specific (ILM = 1)	1.9	0.3	0.0	0.0	0.4	0.3	0.5	2.9	-0.1	6.3	-2.6	3.6

Source: EBA - Basel III Monitoring Exercise

of the "Basel endgame". The initial Notice of Proposed Regulation, issued for consultation in July 2023, and which is expected to see "broad and material changes", according to FED Chair Jay Powell in March 24, may broaden the scope of banks subject to Basel rules from 9 to 25 banks, and may result in an overall increase in RWAs of 16%. However, the politicized push back against this proposal is likely to result in a significant watering down of the final rule, and uncertain delay in its implementation.

This situation is extremely problematic, not only as regards the competitive advantage of US banks compared to those that must comply with the Basel rules, but also as regards the necessary trust among jurisdictions, and risk favouring further international regulatory and supervisory fragmentation.

At a time where the new European authorities will face considerable challenges and investment needs, numerous reports and statements issued recently (Noyer, Letta, Donohue, ECB Governing Council, Macron/Scholz…) have recognized the importance of the financial system as a pillar of European competitiveness and strategic autonomy, and called for ensuring that European financial regulation should not hamper the capacity of the financial system to play its full role in financing the EU's massive investment needs. Instead, the capital of the banking sector could be put at work, rather than frozen in ever increasing, and poorly justified regulatory and supervisory requirements.

4. In front of this situation, what can the EU do to preserve its financial sovereignty and its capacity to finance its ambitions?

Actually, the European Union still has significant degrees of flexibility to implement this package while being faithful to its international commitments, but minimizing the negative impact on the EU economy.

Those margins of flexibility are of two natures:

1. Avoid any unnecessary gold-plating in the design by the EBA of level 2 and level 3 measures mandated by the legislative texts. The EBA has been tasked with a considerable number of mandates to specify quantitative

21. EBA - BASEL III MONITORING EXERCISE – RESULTS BASED ON DATA AS OF 31 December 2022 (ANNEX – ANALYSIS OF EU SPECIFIC ADJUSTMENTS) - September 2023 https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2023/Basel%20III%20monitoring%20report/1062188/Annex%20to%20Basel%20III%20monitoring%20report%20as%20of%20December%202022%20-%20EU-specific%20Analysis.pdf

aspects of the RWA calculations. Given its governance and exclusive financial stability mandate, EBA's drafts produced so far already point to systematic extreme conservativeness compared to the Level 1 text, and some time compared to BCBS standards. Examples include the ITS project on pillar 3, which initial draft would have required banks to publish their capital ratios without considering the phase-in of the output floor nor the transitional provisions, which extend to 2032, but also the very restrictive definition of Uncommitted Cancellable Commitments, or the full revamping of the Prudent Valuation framework, where the mandate covered only the definition of exceptional circumstances. It is essential that the Commission and the co-legislators exert their rights to object to avoid a worsening of the already painful impact.

2. Ensure that the expected significant RWA inflation is at least partially absorbed by a commensurate reduction in capital ratio targets, that have been inflated in recent years, by the increase in capital buffers set by supervisors and macro-prudential authorities, and by a pressure by the SSM on banks to anticipate the implementation of CRR3. Given the revised RWA calculation will be implemented with CRR3, such buffers are less justified. And as we have seen above, the management buffer already includes the anticipation of regulatory changes, which means that it would be natural to use it when the changes materialize. This provides a clear avenue to reduce the impact of CRR3, without any further Basel deviation, given that the layering of EU buffers goes much further than the strict Basel framework.

There is only one important point to clarify, and to communicate explicitly to market participants: increasing RWA while not increasing the capital amount implies that the capital ratio (capital/RWA) goes down. If the RWA increase by 10/15% and the capital amount is unchanged, the CET1 ratio decreases by about 210/240 bps for all banks and G-SIIs respectively. Such a drop in the ratio should be considered explicitly as acceptable on average (of course, this recalibration of the capital target will be a case-by-case exercise with the supervisory teams). Actually, we are not talking about an increase in risk, but a change in risk measurement. CRR3 changes the graduation of the thermometer, not the height of the mercury column. Therefore, a 15% CET1 ratio today should be the equivalent of a 13% tomorrow. EU banks would have just been allowed to allocate the part of their capital buffer that they have set aside to prepare for CRR3. By the way, this would bring the average CET1 ratio of EU banks closer to the US banks' one, which has remained stable around 12.5% in the last 8 years. This would be a way for the EU to implement its commitment faithfully, while avoiding fragilizing its banking sector, which finances the bulk of the EU economy.

If such a clear and simple communication is not organized by authorities, then the market will push banks to rebuild their ratios, and then, the capital shortfall will be massive, as per an earlier EBF study which estimated a need for €200 bn capital if CET1 ratios were to be maintained. In such a scenario, banks' earnings generation for the next few years would be largely dedicated to rebuilding their CET1 ratios, at the expense of lending growth. Banks' ROE and distribution to shareholders would be severely damaged, impacting equity valuations and leading to potential self-inflicted financial stability issues. The degree to which the Capital Markets Union could grow, from their current low base, remains uncertain. This is why, in parallel, unlocking securitisation is an absolute must, to allow banks to continue originating loans in a highly regulated and supervised process, while reducing the capital charge through risk transfer to market participants.

•

As we approach the implementation date of CRR3, considerable uncertainties remain on fundamental implementation choices. Will the capital impact be minimal, as per the EBA studies, which implicitly assumes a drop in ratios, or will the capital shortfall be €200 bn, if ratios have to be maintained? A dialogue between authorities and the banking industry is urgent to clarify implementation policies and provide necessary market guidance.