



Assessing the Macroeconomic Impact of 'Basel 3' Proposals

Olivier GARNIER

Group Chief Economist

4 June 2010



'Basel 3' proposals: « Strengthening the resilience of the banking sector » (December 2009)

■ 'Basel 3' addresses six key issues:

1. Raising the quality, consistency and transparency of the capital base
2. Enhancing risk coverage (counterparty credit risk)
3. Supplementing the risk base requirement with a leverage ratio
4. Reducing procyclicality and promoting countercyclical buffers
5. Addressing systemic risk and interconnectedness
6. Introducing a global liquidity standard
 - Liquidity coverage ratio
 - Net stable funding ratio

■ We focus on the impact of two of the new proposed standards:

- ▶ Revised Tier 1 capital ratio
- ▶ Net stable funding ratio

■ Our assumption: full and immediate implementation of these new standards



Capital deficit: estimates for European banks

■ Bottom-up estimates from research analysts:

- ▶ Average core Tier 1 ratio: cut to 5.1% from 8.5% (-40%)
 - Excluding the new proposed capital charge for mark-to-market losses due to credit valuation adjustments (CVA)

■ Extrapolating to the aggregated balance sheet of EU banks:

- ▶ Core Tier 1 capital deficit: around €450bn
 - if the target ratio is maintained unchanged
- ▶ Close to the total amount of capital raised by banks since the beginning of the financial crisis
 - but a substantial part of it took the form of hybrid capital instruments



The new liquidity standard could further tighten bank lending supply

■ Available Stable Funding (Weight %)

- 
- ▶ Capital 100%
 - ▶ Liabilities > 1yr 100%
 - ▶ Stable deposits 85%
(retail & small business customers)
 - ▶ Less stable deposits 70%
(retail & small business customers)
 - ▶ Wholesale funding 50%
(Nonfinancial corp. customers)
 - ▶ All other liabilities 0%

■ Required Stable Funding (Weight %)

- 
- ▶ Cash 0%
 - ▶ Securities & Interbank < 1yr 0%
 - ▶ Government debt 5%
 - ▶ AA nonfin. corp. bonds > 1 yr 20%
 - ▶ A- nonfin. Corp. bonds > 1 yr 50%
 - ▶ Listed equities 50%
 - ▶ Nonfin. corp lending < 1yr 50%
 - ▶ Retail lending < 1yr 85%
 - ▶ All other assets 100%

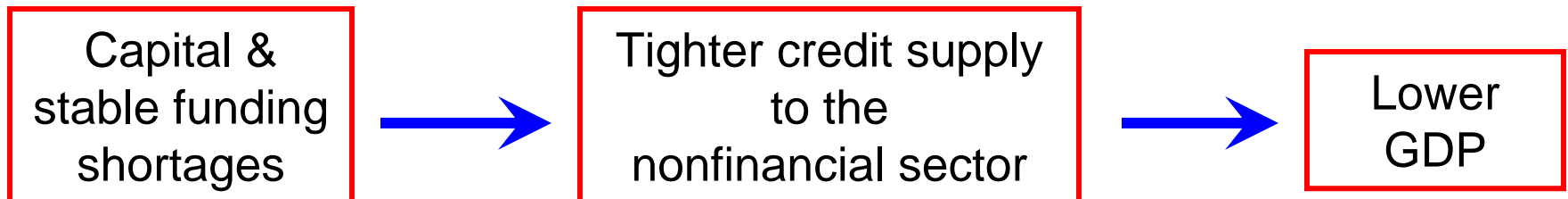
Net Stable Funding Ratio = ASF/ RSF > 100%

Eurozone banks: stable funding shortfall of €2-3 trn



Assessing the macroeconomic impact of banks' capital deficit: which approach?

- **Models incorporating a « bank lending channel » (distinct from the interest rate channel)**
 - ▶ Banks: imperfect substitutability among their liabilities
 - Bank capital availability does impact bank lending
 - ▶ Nonfinancial sector: imperfect substitutability between bank loans and debt securities
 - Bank lending availability does impact aggregate demand
- **The IMF and the EC used a similar two-step approach to quantify the impact on GDP of subprime-related losses**





Cumulative impact on the Eurozone GDP

- **Elasticity estimates are based on a recent ECB research report**
 - ▶ Capiello-Kadaraja-Sorensen-Protopapa : « *Do Bank Loans and Credit Standards have an Effect on Output? A Panel Approach for the Euro Area* », ECB Working Paper Series, N°1150 (2010)
- **Cumulative negative impact on the Eurozone real GDP (relative to the baseline scenario): about -6% over the long term**

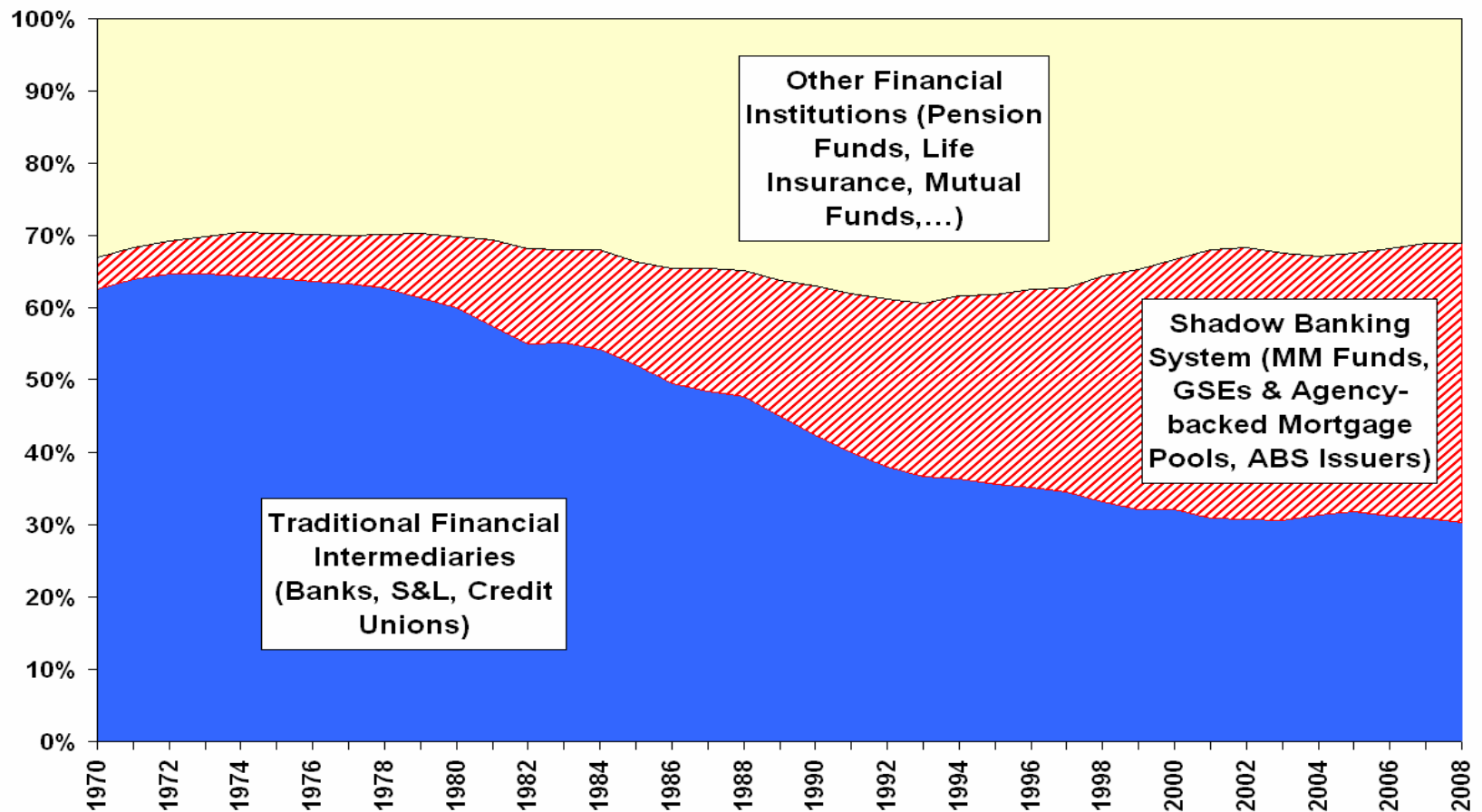


United States: milder economic impact of 'Basel 3'

- **Only the « core banks » would have to comply with 'Basel 3'**
 - ▶ Well capitalized and less impacted by the new capital requirements...
 - ▶ ...but their assets amount to barely half of the total assets of the US banking sector
- **The US « Shadow Banking System », which is still very large and is poorly (or not) capitalized, would remain exempted from capital requirements**
- **Bank credit-to-GDP ratio (mid-2009)**
 - ▶ US: below 50%
 - ▶ Eurozone: close to 130%
- **Bank lending share in the financing of the nonfinancial corporate sector (in Q3.2009):**
 - ▶ US: just above 25% of debt finance, and less than 10% of total external finance (equity + debt)
 - ▶ Eurozone: more than 80% of debt finance, et close to 25% of total external finance (equity + debt)

United States: the predominant role of « *non-banks* » in credit markets

US: Credit Market Assets held by Financial Sectors (as % of total)





Conclusion

■ Phasing-in the implementation of ‘Basel 3’

- ▶ Global economic recovery still very fragile
- ▶ Repercussions of sovereign debt market tensions

■ Trade-off between economic growth and financial stability

- ▶ Impact of tighter regulation on the probability and cost of financial crises?

■ Preserving “biodiversity” in the financial system

- ▶ Insurance companies
 - Long-term and “sticky” balance-sheets → stock market risk
- ▶ Banks
 - Arm’s-length credit monitoring → credit risk