Impact of Basel III and other regulation on European banks

CFA Fixed Income Seminar
27 February 2014

Erik van der Zee
Agenda

• Regulatory impacts on banking, Basel III

• Banking Union, Single Supervisory Mechanism and Single Resolution Mechanism

• Six theses for discussion
Regulatory developments are increasingly impacting the foundation of banking

<table>
<thead>
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<th>Regulation</th>
<th>Subject</th>
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<td>Basel III/ CRD IV</td>
<td>Bank capital adequacy and liquidity</td>
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<td>Volcker/Vicker/Liikanen</td>
<td>Organisational structures of universal banks: prohibition of proprietary trading</td>
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<td>Inducements</td>
<td>Transparency in costs incurred by customer</td>
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<td>Treating customers</td>
<td>Consistently delivering fair outcomes to consumers</td>
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<td>MiFID/ EMIR</td>
<td>Products, trading, clearing and reporting/ disclosure activities</td>
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<td>Payments: SEPA/PSD</td>
<td>Standardisation payment markets</td>
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<td>Reward policies / culture &amp; governance</td>
<td>Reward top talent / boardroom dynamics and risk conscious culture</td>
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### Basel III

**The regulators’ intent is a future of lower risk through more capital & liquidity**

| **Capital requirements** | • Minimum requirements  
- Common Equity, after deductions (4.5%)  
- Tier 1 (6%)  
- Total capital (8%)  
• Stricter definition of capital with greater deductions  
• Higher Risk Weighted Assets requirements |
| **Capital buffers** | • Capital conservation buffer (2.5%)  
• Countercyclical buffer (0%-2.5%) |
| **Global Systemically important banks (G-SIB)** | • Additional capital surcharge (1%-2.5%) |
| **Leverage ratio** | • Leverage ratio of Min 3%  
• Netherlands strives for Min 4%? |
| **Liquidity rules** | • Liquidity Coverage Ratio  
• Net Stable Funding Ratio |
## Banking Union and Single Supervisory Mechanism

<table>
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<th>Issue</th>
<th>Status</th>
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| **SSM**  
Single Supervisory Mechanism | • ECB to supervise significant banks (B/S > €30 bn)  
• Comprehensive Assessment in advance |
| **SRM**  
Single Resolution Mechanism | • Aim: SRM operational in conjunction with the start of the SSM, or soon after |
| **DGS**  
Deposit Guarantee Scheme | • Harmonisation of national DGS Framework  
• Establishment of Single Deposit Guarantee Scheme, to finalise the Banking Union |
|  | • SSM Regulation:  
• Resolution adopted October 2013  
• SSM to become operational at start of November 2014 |
|  | • Banking Recovery and Resolution Directive:  
• EU finance ministers June 2013  
• Trilogue with Parliament end 2013  
• BRRD implemented by 2018  
• SRM Regulation:  
• EC proposal agreed Dec 2013 |
|  | • DGS Directive (national schemes):  
• Trilogue with Parliament agreed Dec 2013  
• SDGS on hold - not expected soon |
**Expected timeline Comprehensive Assessment**

**RAS**
- Data collection for Risk Assessment
- Risk Assessment

**AQR**
- Risk-based Portfolio Selection
- Data Integrity Review
- Asset Quality Review
- Evaluation of results, Quality Assurance

**Stress-testing**
- Stress testing

**Timeline**
- **23 Oct 2013**: ECB published general approach
- **Oct 2013**: First wave RAS data templates
- **End Nov/early Dec 2013**: AQR data templates sent to banks
- **31 Dec 2013**: Ref date for AQR
- **Jan/Feb 2014**: Second wave RAS data templates
- **Feb/March 2014**: Expected start of AQR
- **June/July 2014**: Expected end of AQR
- **October 2014**: SSM comes into operation

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Implications of the results of the Comprehensive Assessment

- **Capital raising** – if capital shortages are identified according to the ECB’s thresholds
  - Different types of instruments, Equity, Subordinates, Coco’s
  - Profit retention (implications for business models)
  - Asset disposals/portfolio wind-downs
    - Time and market constraints are possible – banks need to think ahead
- **Intensity of future supervision** – may impact the ECB’s classification of banks that will determine the intensity of supervision under the SSM
- **Mergers / consolidations** – based on the results politicians may exert pressure for mergers or consolidations in the banking market
- **Recovery & Resolution Plans** – plans may become very relevant

Single Resolution Mechanism (SRM): bail-in hierarchy
(towards Core Tier 1 of min 8% of total assets)
Six theses for discussion

In the near future banks:

1. Are required to hold more capital for their business
2. have difficulty raising equity
3. have insufficient capital to continue present way of lending
4. need to fund and transact more in credit markets
5. be more active cross border in funding and merging
6. become more risky for investors
1. Regulation requires banks to hold more capital for their business

Source: DeLeverage take two (PwC report), BIS, EBA Quantitative impact studies Sept 2013; Deutsche Bank
2. **Banks have difficulty to raise capital: RoE < CoE**

**Breakdown of CoE**

\[ Rf + B \times (Rm - Rf) \]

**Risk Correction Factor for the Specific Security**

(Ajusted Beta based on peer group)

- 2009: 1.6
- 2010: 1.6
- 2011: 1.6
- 2012: 1.7
- 2013: 1.9

**Equity Market Risk Premium – PwC Estimate**

- 2009: 5.0%
- 2010: 5.0%
- 2011: 6.5%
- 2012: 6.0%
- 2013: 5.8%

**Risk Free Interest Rate at an All Time Low**

- 2009: 4.0%
- 2010: 3.5%
- 2011: 2.6%
- 2012: 2.0%
- 2013: 2.6%

**Calculated CoE = 12-14%**

### Return on Equity

<table>
<thead>
<tr>
<th>Bank</th>
<th>RoE</th>
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<tbody>
<tr>
<td>ING</td>
<td>9 %*</td>
</tr>
<tr>
<td>ABN Amro</td>
<td>8.5 %</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>7 %**</td>
</tr>
<tr>
<td>Banco Santander</td>
<td>5.4 %</td>
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**Source:** Banks’ quarterly results publications

* ING bank (excl. insurance)

** Core bank (excl. Non core activities)
3. Banks have insufficient capital to continue present way of working

Source: PwC analysis
4. **Banks need to transact more in credit market**

Asset sales in 2013 estimated at €60 billion+

Source: Publicly available information, PwC information and analysis

Note: Based on the location of the head office of the bank selling the assets

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5. Banks will become more active cross border in funding and merging

PwC-DSF seminar (Dec 2013) on Comprehensive Review:

“National supervisors restrict cross border transfer of savings money for banks operating in several countries. ECB will have a more European perspective.”

European Central Bank Vice President Vitor Constancio:

“The weak profitability and excess capacity of the European banking sector suggests that efficiency gains could be achieved,”... “I would not be surprised if the SSM would open a period of restructuring in the European banking sector”
6. Banks become more risky for investors

1. Higher solvency
2. Rightly valued assets
3. Tighter supervision

1. Bail-in vs bail-out
2. Securitization / sale best assets
3. Cherry picking of good assets by non-banks
4. Political support remote
Thank you.
Erik van der Zee
Partner, FS Advisory Leader
Phone: +31 (0)88 7925142
Mobile: +31 (0)6 22798744
erik.van.der.zee@nl.pwc.com

Background
Erik has more than 20 years of experience in addressing strategic, operational and regulatory issues. He works with banks and insurance companies on structural, business model improvements. Erik holds a masters degree in economics from Erasmus University in Rotterdam and a MBA from Stanford University in USA.

Relevant experience
Erik van der Zee leads PwC’s consulting to financial services industry in The Netherlands. Relevant experiences include: implemented corporate banking expansion strategy; implemented common finance system worldwide; built successful internet bank; established direct banks in several countries; developed mortgage strategy and process optimalisation, structured (subsequent) savings bank mergers and integrations; and improved private banking business model.
Appendix
1. Banks will require more capital for their business

**DB analysis suggests significant additional provisions required**

Additional provisions (€m)

- Additional provisions (€m)

Leading to significant capital shortfalls.....

Capital shortfall estimates (DB)

- Pot. capital shortfall (€m)

Source: Deutsche Bank, PwC Analysis
4. Banks need to fund and transact more in credit market

Amount and % of mortgages funded through RMBS

Asset sales in 2013 estimated at €60 billion

Source: European Mortgage Federation (2013), European Covered Bond Council (2013)
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Note: Based on the location of the head office of the bank selling the assets
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