Addicted to risk

The banking lobby in the European Union is waging a successful battle against regulation that will undercut international Basel rules. They’re succeeding in putting competition and the right to risky bets before concerns for financial stability.

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Summary

This year the European Union is expected to adopt new rules on banking. In 2008 when the financial crisis broke, legislators promised bold reforms and public expectation was high. In view of the dire consequences of the collapse of big banks across Europe, now was the time to make up for the omissions of the past and fix the rules to avoid speculative excesses.

Today, more than three years later, those new rules are in the pipeline, but few expect them to be much of an advance. At the international level, the banking lobby watered down proposals for international rules, – called Basel III – and these showed so little improvement that it was hard to imagine the European Union could go lower.

Even so, thanks in part to lobbying by the banks, the proposal tabled by the Commission and discussed by the European Parliament and in the Council at the time of writing, is indeed weaker, driving standards lower than the global level.

With a draft heavily influenced by the banks, any fight for improvements will be an up-hill battle. And in this case it’s hard to imagine the outcome will even live up to weak international standards. It is high time to ask whether banks should be responsible for setting the standards for banks, and whether indeed they should be allowed to set the terms for the debate on banking regulation.
Introduction

Big banks have been subject to public scorn and contempt since the financial crisis broke in 2008, revealing how banks had made irresponsible bets with vast quantities of money. In the end, taxpayers had to foot the bill to cover the enormous losses made by the banks in order to keep them afloat and to avert a meltdown in parts of the economy. At the time, governments, EU Commissioners and politicians stood in line to attack the banks, promising resolute action to change the rules and avoid a repetition in the future.

Among the rule books blamed for the crisis were the international standards on banking regulation, known as the Basel rules. Negotiations on a new and third set of Basel standards quickly started. But those who believed a global financial meltdown was enough to prove the necessity and provide the political impetus for effective reforms were to be disappointed. With the new regulations about to be introduced in the US, Japan and the European Union, critical analysts of banking regulation can mostly look back on a series of political battles from which the banks emerged victorious. The changes to the Basel rules have ended in disappointment, not least due to effective scaremongering by the banking lobby.

The good news is, however, that the battle is not entirely over. In principle, implementation at the EU level provides an opportunity to strengthen these rules considerably, going beyond what was agreed at the international level. But the bad news is that here too, banks are managing to set the agenda. It looks like the EU rules will in fact water down the new Basel rules even more – again, in no small part thanks to successful lobbying by the banks.

How did this sorry scenario come about?

What was wrong with Basel II?

Banking legislation is multi-faceted, with rules formed and adopted at several levels. But the rules based on the Basel guidelines have an important place. Under the umbrella of the Bank of International Settlements, the so called Basel Committee on Banking Supervision (BCBS), made up of the central bank governors of the 27 major financial powers, is responsible for negotiating a set of rules designed to ensure banks don’t go bankrupt and that risky investments do not lead to the collapse or the insolvency of individual banks, or to wider systemic turmoil. This is done by agreeing to ensure the solidity of the finances of banks, mainly via requirements on the amount of capital banks should hold in order to withstand a crisis or a bank-run.

Following the financial crisis, there was intense and fundamental criticism of the Basel rules. Some felt the whole approach of Basel was wrong and stressed the need for example to prevent banks from becoming so systemically important so that they would not need to be bailed out by taxpayers, but could be allowed to sink. Others pointed out that the requirements for available capital and liquidity were too low, and that the banks could easily circumvent the Basel rules.

The so-called Basel II agreement had left open two major loopholes allowing banks to take risks that were not covered by capital reserves. Securitising debts allowed the banks to use complicated financial instruments to hide the true size of the debt. Alternatively, they could use their own analytical models to assess the riskiness of their own investments, declare them to be safe, and consequently write down their obligations to hold ready capital.
These shortcomings were highlighted when the US investment bank, Lehman Brothers, collapsed under the weight of bad loans. In Europe banks like Northern Rock (UK), Icesave (Iceland), Hypo Real Estate (Germany) and many others followed suit.

**Big banks set agenda from beginning**

This loss of prestige by the banks did not seem to undermine their political clout in the European Union. Only a few weeks after the collapse of Lehman Brothers, the Commission and the Council appointed a high-level advisory group to give initial overarching guidance on the reforms needed in the financial markets. The group was named after its chairman, Jacques de Larosière, who at the time worked for French bank BNP Paribas. The *De Larosière Group* was dominated by bankers; five of the seven group members had strong links to major financial institutions. The group’s report, released in February 2009, would prove to be highly influential. Yet the group refrained from any fundamental criticism of Basel II. While the paper did call for ‘a gradual increase of capital requirements’ and ‘stricter rules for off-balance sheet items’, the basic elements were not called into question.

The report by the *De Larosière Group* was endorsed by the Commission and later by the Council. The group had set the agenda - far from the kind of radical overhaul of banking regulation some had hoped for.

**Scaremongering in Basel**

In the next year and a half, the Commission and a number of member state governments were involved in negotiations in the Basel Committee on Basel III, which ended in a clash between negotiators and the banking lobby. By then, the mood had already changed considerably. The financial crisis had triggered an economic crisis, and politicians were more focused on immediate growth rather than on financial stability. This was exploited to the maximum by the lobby association representing the biggest global banks, the Institute of International Finance (IIF), always a powerful player at the Basel negotiations.

The IIF’s successful tactic was simple: scaremongering. Against the backdrop of the economic crisis, they claimed that stronger regulation would harm employment and growth severely. At the September 2009 IIF annual congress, 1,700 bankers discussed what the IIF president Joseph Ackermann, chief executive of Deutsche Bank called the “very real risk that regulatory reforms come into force that could undermine global recovery and job creation.”

In October 2009, de Larosière who had recommended a “gradual increase of capital requirements” earlier that year, now spoke for the IIF, warning: “Capital ratios, if they are not well conceived, could substantially harm our economies. I see a great danger here.”

This line was pushed vigorously by the big banks and the IIF until the following summer. In the first half of 2010 a series of studies was launched on behalf of the big banks, such as Morgan Stanley. One study concluded that proposals would lead to a “dramatic industry shrinkage.”

According to the head of French bank BNP Paribas, Jean-Laurent Bonnafé: “if Europe accepts this, it means either two guaranteed years of deep recession or four years of zero growth.”
In an interview with banking analyst and financial expert Ranjit Lall in February 2010, a member of the Basel Committee admitted the campaign was taking its toll: “While it’s clear that some kind of reform will happen, it’s also clear that what’s adopted will be a heavily watered down version of what appears now. It’s inevitable”11.

In the late summer of 2010 a deal was sealed that indeed represented a watering down of previous ambitions. “Three years on, the markets are masters again,” Philip Stevens of the Financial Times noted12, and stressed that not only is the deal unimpressive – it was not to be fully implemented until 2018. A message that rewarded the banks with a jump in share value when finally announced in September13.

In September and October 2010, the Bank of International Settlements, the international ‘central bank of central banks’, issued a series of reports and analyses that refuted the claims made by the banks during their campaign to water down the proposed regulation14. But by then it was too late.

**Don’t just look at Wall Street, look at Brussels**

While the banks on Wall Street had clearly made an effort to scale down ambitions with Basel III, it would be too simplistic to put the blame only on them. In fact, according to one academic analyst, opposition against Basel III was even stronger among banks from Germany, Japan, France and Italy. In some European countries, both banks and regulators complained that strong rules would put them at a competitive disadvantage. 15

Consequently, how Basel III is implemented in EU legislation is crucial. For while the Basel agreements represent authoritative sources of legislation, they are merely guidelines, and provide discretion for implementation at national level, or, as in the case in the EU at regional level. And it’s been clear from the outset that the banking lobby had tried to exploit any opportunity to water down regulation even further than what had been achieved at the international level.

That battle is on-going, but a walk-through of the state-of-play shows clearly that the banks made headway from an early stage in the debate. In the following it’s important to note that most of the research done covers the phase between the release of the Basel III agreement in July/August 2010 to the moment when the Commission tabled its proposal for implementation in the EU in July 2011, in the form of two separate documents called the Capital Requirements Directive IV and the Capital Requirements Regulation16.

**The procedure and the lobbyists**

The first major battle on any financial regulation is always about the Commission’s proposal, and in this case, the proposal on implementation of Basel III had been developed in a debate between Single Market Commissioner Michel Barnier and his services, a working group of representatives from member states (the Capital Requirements Directive Working Group, CRDWG), and the financial lobby.

The dialogue between the Commission and the financial lobby took place in various ways, including through advisory groups (or ‘expert groups’) – in this case a group called the Group of Experts on Banking Issues (GBEI), which was set up in June 2010 (and dissolved in October 2011). This group was heavily dominated by “experts” from banks affiliated to the IIF lobbying group, which had worked so hard to water down the international regulations. Of the 42 members...
of the advisory group, 34 came from banks and investment firms; of the 25 that come from banks, 23 were members of the IIF. In other words, the banks that watered down the international Basel III rules advised the Commission on how the EU should implement these rules.

In parallel to the discussions in the GEBI group, the Commission consulted “various EU banking industry associations and individual institutions”. The extent of their input is unclear as despite repeated requests for access to documents and a formal complaint, the Commission has refused to release all the documents involved. But on the basis of those documents that were released, it can be concluded that many of the key demands made by the banking lobby were met by the Commission in its final proposals, released in July 2011.

**Lobbyists fingerprints all over it**

As we shall see, the fingerprints of the banking lobby can be identified in many parts of the text. Though the examples below do not constitute an all-encompassing or comprehensive description of the proposals, they do touch on key elements of the Basel agreements and the proposed implementation in EU legislation.

1. **Underplaying the need for resilience: deleting minimum standards on capital requirements**

   Capital requirements are at the core of the Basel agreements. Capital requirements mean the amount of money a bank must have available in relation to what it has lent or invested. The higher the requirement, the smaller the risk of bankruptcy when markets fall or investments turn sour. In the aftermath of the financial slump in 2008, many big banks turned out to be vulnerable, and the Basel rules were blamed. They were widely criticised for the low percentage of capital that they held, and at the start of the negotiations there was some political pressure for significantly higher requirements. But in the end, only a modest increase was adopted, requiring banks to hold just 8 per cent.

   The modest nature of these proposals can be illustrated by contrasting it with studies that identify a need for a 20 per cent requirement. Others, including the free market proponent and former head of the US Federal Reserve Alan Greenspan, suggest 13-14 per cent is required.

   So, though requirements were indeed increased in comparison with Basel II, they still fall far short of most recommendations for a stable banking system. It would then be unimaginable that the EU would set a lower rate. But Deutsche Bank’s Ackermann found an approach that would ring a bell with the Commission. In a letter on Basel III to Commissioner Barnier in November 2010, he wrote on the importance to stick to a harmonization approach, rather than setting minimum standards on banking: “National initiatives, based on political pressures from within individual member states are detrimental to the Single Market ‘and must be resisted.” In other words, should a member state consider national rules, including capital requirements, that were higher than the minimum agreed at the Basel negotiations, this should be stopped.

   This view was firmly backed by the GEBI group when they were asked to consider the EU approach to the Basel rules: “Most members expressed strong support for a truly single set of consistent rules across the internal market, as uncoordinated national initiatives and/or
disproportionate application of rules result in regulatory fragmentation,” civil servant Mario Nava concluded from a meeting in June 2011.  

This clearly resonated with the Commission. In July 2011, it proposed a level of harmonization that would create obstacles for any member state that wanted to go further than the Basel requirements, if adopted. “The Commission suggests removing national options and discretions from the CRD, and achieving full harmonisation by allowing Member States to apply stricter requirements only where these are a) justified by national circumstances (e.g. real estate), b) needed on financial stability grounds or c.) because of a bank's specific risk profile”.

So, while the Basel agreements were about “minimum requirements” in the EU context this was turned into a fixed percentage and a maximum, to avoid actions “detrimental” to the single market. As a consequence, any member state that wanting to raise requirements, eg. in order to save its banking system, would find itself compelled to argue its case with the Commission, and might be barred from doing so.

2. Creative risk accountancy: little will to close loopholes

The relevance of capital requirements of course depends entirely on the loopholes available to banks to lower the requirements. It’s all very well to put requirements in place, but if banks are allowed to work around them, they are of little value. And there have been ample opportunities for this since the adoption of Basel II in 2004. Banks were allowed to use their own internal assessments of their investments, called the ‘advanced internal ratings-based approach (A-IRB). The results were “large capital reductions relative to Basel I levels for banks employing the A-IRB approach”.

The agreement had failed to make the banks shore up more ready money to make them stronger when facing pressure from losses.

It was clear at an early stage that neither the Basel Committee, nor the European Commission were prepared to tighten the loopholes in Basel II in any serious way. The European Commission’s proposal for a Capital Requirements Directive IV in fact inserts the A-IRB option explicitly in legislation. This comes after some pressure from the banking community, including from Deutsche Bank which has lamented the absence of a common approach, which it says is “one of the clearest examples of not justifiable inconsistency between member states”.

The result appears to be an agreed approach which provides all the space necessary to do creative calculations of risks, and consequently to bring down the capital necessary to fulfill the obligations.

That the issue of loopholes is as important as the requirements themselves, is obvious from reports about banks preparations for “higher standards”: well before Basel III is implemented in the EU, European banks are making sure its impact will be minimal. In fact, some, such as French bank Credit Agricole, have already managed to circumvent the new requirements via the use of complicated financial instruments, using a method proposed by consultants McKinsey which has produced what is described as a manual for circumventing capital requirements.

3. Antagonising the need for liquidity

Perhaps the Basel proposal that has drawn the heaviest fire from the banking lobby are the guidelines on bank liquidity. Liquidity is about having the necessary money at hand to withstand a
bank-run or any other pressure on the finances of a bank. The most important standard in this respect is called “the Bear Stearns rule” (Liquidity Coverage Ration, LCR), which suggests that banks should have money (high quality liquid assets) available for a month of steady net outflow of cash. According to the Basel agreement, the signatories are to adopt the ratios asap and then, after an observation period, these should be adjusted in 2015 to avoid “unintended consequences”, such as drops in lending to ‘the real economy’.

But not with the willing cooperation of the EU, as it stands.

The proposed Basel standards on liquidity worried the biggest players in the European banking lobby. In Spring 2010 a new exclusive lobby group of high-level officers appeared, made up of chairmen and chief executives from the 11 major European universal banks: Deutsche Bank, BNP Paribas, Credit Agricole, Nordea, Credit Suisse, HSBC, UniCredit, BBVA, Royal Bank of Scotland, ING and Banco Santander. They called themselves The European Banking Group.

Through a series of letters and meetings, the European Banking Group engaged with the Commission in an attempt to avert the introduction of the Basel standards on liquidity in the EU, first by influencing the Commission’s proposal on the matter. The group’s Michel Pébereau (BNP Paribas) warned in a letter to the Commission in April 2011 against “the potential negative impacts the Basel liquidity standards will have on the financing of the European economy if introduced in their current form”28. The big banks opposed the ratios of Basel III and suggested an observation period with a much less ambitious experiment based on parameters that should not be clearly defined in legislation. On the very same day, Christian Clausen of the European Banking Federation (EBF) sent a letter with basically the same message29. In June, this message was once again brought to the Commission via the bankers in the GEBI advisory group30.

This effort paid out for the banks. When the draft of the Commission’s proposal was leaked, the financial press reported a sigh of relief and joy among bankers. “The current CRD IV text, which does not contain a hard metric for the LCR, mirrors industry concern that more work needs to be done,” Simon Hills of the British Bankers Association said. Another senior banker noted to his satisfaction that “the Commission will not accept just what the Basel Committee has decreed”31.

4. Leverage ratio: Lehman Brothers considered sound

A new discipline in the Basel Agreements is a ‘leverage ratio’ – a ratio that determines whether a bank has lent too much money compared to its assets. This part of the package was toned down in the course of the negotiations, and has ended up as being of little significance, if not outright a waste of paper. Indeed many analysts have pointed out that if Lehman Brothers had been scrutinised shortly before its collapse, it would have been considered a sound enterprise! At that time, the leverage ratio of Lehman Brothers was 31 to 1. Under Basel III the limit is slightly higher, at 33 to 132.

So European banks had little to fear from Basel III on this, unless the Commission or the Council proposed a stricter ratio. But there was no sign of any such danger. On the contrary, Commissioner Barnier was impressed by a call from the European Banking Federation to have a closer look at the “unintended consequences” of the leverage ratio for financing international trade, and has promised the EBF to be “very attentive to the specificities of the European Banking market and the possible impact of any new rules”33.
5. Too-big-to fail: defining non-existent giants

A few elements of the Basel III agreements are still under construction, one of which deserves a special mention. In the on-going negotiations, the most contentious issue seem to be the treatment of “systemically important financial institutions” (SIFI) – the banks that are ‘too big to fail’ and whose solvency and resilience is particularly important to the economy. Some argue that the banks should simply be broken up, but the Basel Committee suggests a modest ‘surcharge’ on capital requirements for the biggest banks – a pool of money slightly bigger than for other banks.

In explaining the necessity for this, the president of the Basel Committee, Stefan Ingve, said recently: “The impact caused by the failure of large, complex, interconnected, global financial institutions can send shocks through the financial system which, in turn, can harm the real economy. This scenario played out in the recent crisis during which authorities had limited options other than the provision of public support as a means for avoiding the transmission of such shocks”\(^{34}\).

The proposal to define a ‘surcharge’ was endorsed by the G20 in November 2011, but this is clearly just the beginning of another lobby battle. In the European Union, the biggest banks have reacted with horror, rejecting the need for specific measures. “Too much attention paid to” the big banks “may result in insufficient attention being paid to other risks,” according to Christian Clausen from the Nordic bank, Nordea, who went on to explain that this risked not enough attention being paid to smaller banks not considered ‘systemically important’\(^ {35}\). Deutsche Bank’s Ackermann has voiced a concern that specific initiatives on the big banks will “create competitive distortions”. The new group of big banks, The European Banking Group, for its part, claimed that the “consensus view of the industry is and will continue to be that the concept itself is misguided, will not enhance financial stability, and will have negative economic consequences”\(^ {36}\).

It does look as if a surcharge could be on its way. But as the banks have proved on many occasions, few proposals are so resilient that they can’t be undermined by a countermove. In the case of special rules for big banks, one of the suggestions aired by the European Banking Group is: “To assess the ‘SIFI-ness’ of European banks, the EU single market should be regarded as a single domestic jurisdiction”\(^ {37}\). In other words, banks that have a massive importance in ‘just’ one or two countries should be deemed unimportant in the bigger picture and escape regulation.

Conclusion

The battle over implementation of the Basel Agreement in the European Union is not yet over, leaving a hypothetical chance for a new turn of events. But from what we’ve seen to date, it’s clear that the European Commission is diligently taking care of the big banks’ interests. So far the Commission has proposed regulations that seem to undercut the Basel agreements on several accounts. Bearing in mind that Basel III was a major disappointment in the first place, this leaves us with a poor result from the strong demands made after the flaws in banking regulation and liberalised financial markets became clear in 2008.

Clearly the banking lobby is now on top of things and is managing to dominate the debate. Before the crisis, banks used to refer to growth and economic expansion as an argument to stave off regulation. Today, they refer to the opposite – the danger of an even deeper economic crisis as a
result of regulation. It seems as though the time when financial markets can be reined in effectively, will never come.

But it’s important to note from the battle so far that the scaremongering about the economic crisis is but one element of the banks’ campaign, and the Commission’s motivation. Equally important is the emphasis put by both on the competitiveness of banks vis-à-vis US banks. In fact, it seems the determination to strengthen the single market, including through harmonization of capital requirements, is of more concern to the Commission than avoiding systemic risk in the future.

This has left the European Parliament and the Council with a draft which needs considerable improvements in order to meet the weak international Basel standards. At the time of writing, the compromise considered in the Council might in fact be a small improvement, but it would still fail to meet the international level. This leaves the European Parliament with a major responsibility. However, here too, the financial lobby is clearly at work. No less than 3,000 amendments to have been tabled – a clear sign of the presence of resourceful lobby groups. Though it cannot be ruled out just yet, the chances are slim that the new rules on banking for the European Union will even be as strong as the weak Basel rules.

While this may paint a gloomy picture, it is hardly the end of it. If the critics are right, Basel III leaves fundamental problems unsolved, so there is a strong chance that it will backfire and initiate or form part of a new crisis. Also, there’s a stark contrast between the way banking regulation is dealt with by the Commission and demands of millions of people in Europe who are paying dearly for the banks’ adventures. That resentment is unlikely to vanish and could change the picture in the future.

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1 For a list of states represented in the BCBS see; http://freerisk.org/wiki/index.php/Basel_Committee_on_Banking_Supervision
4 http://www.europeanfoundation.org/my_weblog/2009/03/the-european-commission-endorsed-de-larosi%C3%A8res-report.html
7 Reuters, 4. October 2009.
9 Cited from Lall (2010). Page 35. This study was published by Morgan Stanley and Oliver Wyman. The latter was later to be involved in the fight of the financial sector against the financial transactions tax, see Corporate Europe Observatory; “Lobbying to kill off Robin Hood”, March 2012. http://www.corporateeurope.org/publications/lobbying-kill-robin-hood
11 Quoted from Lall (2010), page 37.
12 http://www.ft.com/intl/cms/s/0/c0074548-9b47-11df-baae-00144feab49a.html#axzz1sx6Ejg00
The proposal comes in two parts: a directive (COM (2011) 453) and a regulation (COM (2011) 452. In the following CRD refers to the Directive, CRR to the Regulation, CRD/CRR to both.


Corporate Europe Observatory has documents in its possession that should have been included in the documents handed over in connection with a request for access-to-documents on Basel III, a clear indication that documents are being withheld.

8% of so called 'risk weighted assets', which means an assessment of the risks associated with the investments is an important part of the calculation. This will be explained further down in the text.


Minutes from GEBI meeting, 1. June 2011.


Lall (2010), page 7.

CNBC: “Banks already slipping through new capital requirements”, 6. February 2012,
http://www.cnbc.com/id/46281847/Banks_Already_Slipping_Through_New_Capital_Requirements

Letter from Michel Pèbereau to Commissioner Michel Barnier, 8. April 2011.

Letter from Christian Clausen (EBF) to Commissioner Michel Barnier, 8. April 2011.

Minutes from the GEBI meeting, 14. June 2011.


Letter from Guido Ravoet (EBF) to Commissioner Michel Barnier, 4. June 2010...

Stefan Ingves, address to European ideas network seminar on long term growth, 19-20. January 2012.
http://www.bis.org/speeches/sp120120.htm

Ibid.