Banks' strategies and business models: capital myths and realities

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Executive summary

Regulation and supervision continue to take priority over other strategic imperatives at many banks. In these banks the challenge of implementing regulatory requirements and responding to supervisory initiatives has crowded out other drivers and has inhibited strategic thinking and innovation. Banks that fail to identify and implement clear strategic priorities within the regulatory and supervisory environment will struggle to succeed.

Regulatory reform should be nearing completion. Nine years after the start of the global financial crisis we should be seeing:

- the completion and consistent implementation of the regulatory reform agenda across jurisdictions
- banks completing their adjustment to these new regulatory requirements
- no further increases in regulatory capital requirements
- economic growth supported by the lending capacity of strongly capitalized banks
- capital markets and new entrants to the banking sector filling any shortfall in bank lending and other banking services.

The reality looks very different.

The regulatory reform agenda remains incomplete. Although considerable progress has been made, some important initiatives remain at the design or calibration stage.

International standards have not been implemented consistently. The new standards have not been implemented in all jurisdictions. Implementation to date has been inconsistent. In some cases super-equivalent requirements have been added by national authorities.

Banks have strengthened considerably their capital and leverage ratios. Most major banks now meet the Basel 3 capital and liquidity standards. But these data do not tell the full story.

Many banks continue to experience low profitability, high non-performing exposures and high cost to income ratios, although these weaknesses are unevenly distributed within and across countries.

Many banks still need to adjust further to meet the other regulatory reforms ('Basel 4') being introduced in addition to Basel 3. Some of these additional reforms will place **significant further demands on banks' capital positions.** For example, the latest Basel Committee proposals on risk-weighted assets could **increase the capital requirements of major international banks by $350 billion**. Banks also need to meet the demands of more intensive and more challenging supervision.

Regulatory and other uncertainties create challenges for many banks, impairing their ability to launch new strategies and business models; to make the necessary investments to upgrade or replace aging IT systems; and to respond to the competitive pressures from new bank and non-bank entrants and from financial technology disruption more generally.

The prospective exit of the UK from the European Union (Brexit) has added to the regulatory uncertainties facing UK and foreign banks operating in the UK, or passporting into the European Union from the UK; heightened the immediate pressures on the profitability of these banks; and more generally weakened the economic environment in the UK, Europe and globally.

These pressures and uncertainties also continue to constrain the ability of some banks to increase their lending in support of the wider economy, although the extent of this differs significantly across countries and regions.

In Europe, bank lending remains subdued. Banks in Europe have strengthened their capital position (CET1 capital ratios of major European banks increased from around 6.5 percent in June 2011 to just below 12 percent in June 2015), but this was achieved in part by banks reducing the size of their balance sheets and by shifting out of riskier lending and trading activities (risk weighted assets fell by nearly 20 percent over the same period). Elsewhere, banks have continued to expand their balance sheets at the same time as improving their capital ratios.

Capital markets can fill only some of the gaps. Smaller companies in particular face challenges where alternative lending platforms and bond markets may not be available as an alternative to bank lending.

This paper unpacks six myths about regulation and its impact on banks.

01 There is no Basel 4, and there will be no further significant increase in capital requirements.

02 The regulatory reform agenda is almost complete.

03 International standards provide a level playing field globally.

04 Banks are in a strong position because they have adjusted to meet Basel 3 requirements.

05 Banks with stronger capital ratios lend more.

06 Capital markets can fill the gaps left by the banks.

What do banks need to do?

Banks need a dynamic process to facilitate their adjustment to new regulatory and supervisory requirements. The process of adjusting to new regulatory requirements is not simply about completing compliance requirements. Banks need to craft dynamic processes and maximize the use of next-generation analytics in order to track regulatory changes as they emerge. This requires a sophisticated approach to tracking, analyzing and responding to regulation and supervision across all the jurisdictions in which an international bank operates. Although the bulk of the reform agenda is now known, significant uncertainties remain.

Banks' strategies and business models also need to respond to many commercial challenges.

- Identify profitable and unprofitable business activities as a first step towards securing a viable and sustainable future, and identify where there may be scope to maintain or push up interest margins and fee income. Complexity and leverage are no longer the answer.

- Achieve significant cost reductions while also investing in data, technology, digital capacity and financial innovation. Mergers, acquisitions and simplifying organizational structures may all have a role to play here.

- Respond to the competitive threats posed by financial technology firms by expanding banks' own use of innovative technologies, including for compliance.

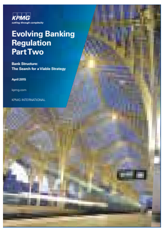
- Address the 'trust agenda' around ethics, culture and conduct.

- Meet the challenges posed by wider macroeconomic influences. The current economic environment of low interest rates, slower growth and heightened market volatility creates an immediate challenge, as does the uncertainty over what the 'new normal' macroeconomic conditions might look like.

The key issue for banks is to identify paths through these challenges to a viable and sustainable future. For many banks a return to growth and a viable level of profitability remains highly uncertain.

There is a read-across to other parts of the financial sector. Some regulatory priorities for banking have been (or will be) applied to other types of financial institution, while the impact of regulatory pressures on bank behavior has consequences for the markets in which other financial institutions operate.

Further insights



Evolving Banking Regulation Part 2: Bank Structure – The Search for a Viable Strategy
KPMG International
April 2015

Evolving Banking Regulation Part 3: Data and technology – the regulatory and business challenges
KPMG International
October 2015

Evolving Banking Regulation Part 5: Conduct and Culture
KPMG International
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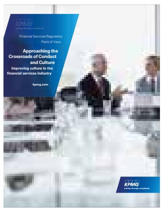


Approaching the Crossroads of Conduct and Culture: Improving culture in the financial services industry
KPMG in the US
August 2015

Real Time Compliance: Transformation to proactive insights
KPMG in the US
May 2016

Unpacking the myths...

Myth One

There is no Basel 4, and there will be no further significant increase in capital requirements

The Financial Stability Board (FSB) and the Basel Committee have stated repeatedly that "there is no Basel 4", only a finalization of Basel 3; and that in revising the standardized and internal model-based approaches to risk exposure weightings the Basel Committee "will focus on not significantly increasing overall capital requirements".

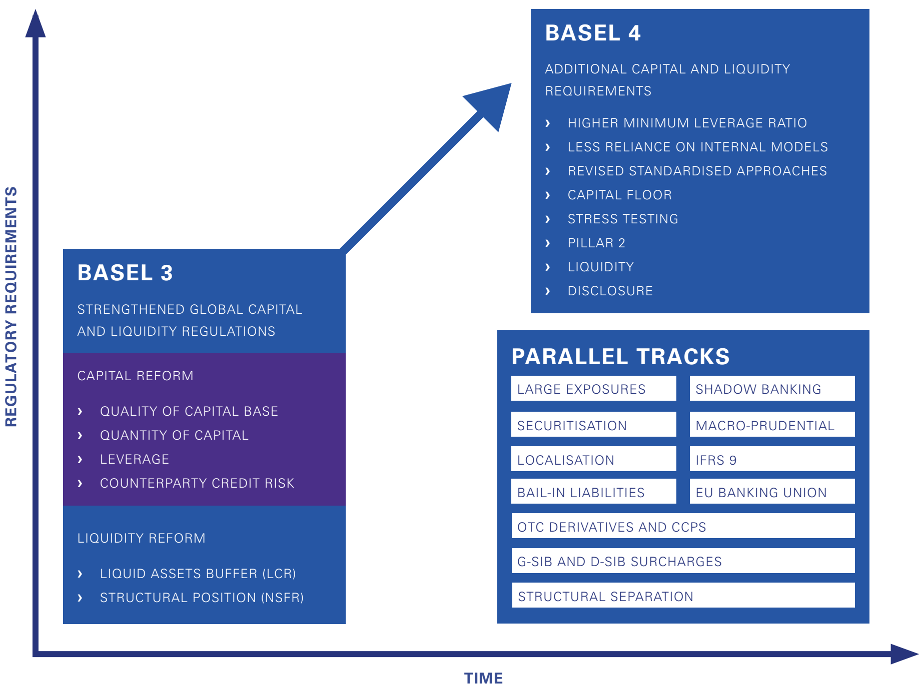
The reality – there is, in effect, a Basel 4; and it will significantly increase capital requirements

Since 2013, KPMG member firms have presented Basel 4 as a combination of regulatory initiatives, including:

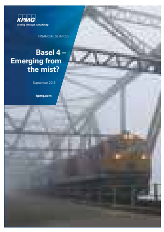
- the 'RWA (risk weighted asset) inflation' resulting from new standardized approaches and constraints on the use of internal models across credit, market and operational risk, and the proposed new capital floor
- the use of stress testing to set capital requirements
- the application of super-equivalent minimum leverage ratios by individual national regulators
- macro-prudential policy measures, where countries such as Norway and Sweden have led the way in the application of multiple macro-prudential instruments.

These initiatives will significantly increase many banks' capital requirements and overall funding costs, and potentially reduce their lending to the wider economy.

Emergence of Basel 4



Further insights



Basel 4 – Emerging from the mist?
KPMG International
September 2013

Basel 4 – Revisited
KPMG International
October 2015

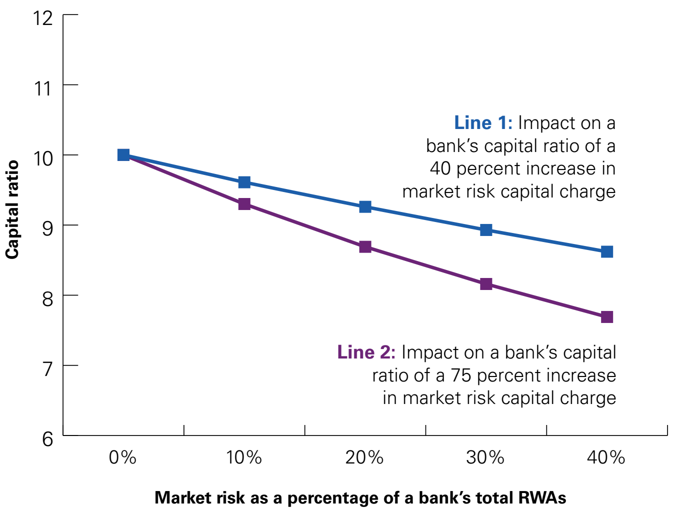
For example, the Basel Committee's latest proposals to reduce complexity and to remove excessive variability in RWAs (see box on page 8) will increase significantly the risk weighted assets of many banks. This could reduce the CET1 capital ratios of banks that have made substantial use of internal models to calculate regulatory capital requirements by around 2 percentage points. The largest impacts are likely to be on:

Credit risk – banks currently using internal ratings-based models to calculate risk weights on exposures where this option will be removed (including large corporates) or constrained (residential mortgages).

Market risk – banks with relatively large trading books. The Basel Committee estimates that the revised framework will increase market risk capital requirements by 40 percent on a weighted average basis. For most banks this will have a limited impact, since market risk typically accounts for less than 10 percent of total RWAs. However, the revisions will have a material impact on banks whose market risk accounts for a larger proportion of RWAs. For example, if market risk accounted for 30 percent of a bank's RWAs then a 40 percent increase in market risk capital requirements would inflate the bank's total RWAs by 12 percent, and reduce its capital ratio from, say, 10 percent to 8.9 percent.

A KPMG in the UK survey of 12 global systemically important banks undertaken in February 2016 found that nearly half (five) of them expected market risk capital requirements to increase by 50-75 percent, and two expected an increase of more than 100 percent.

Impact of higher risk weights on market risk



Operational risk – although the latest proposals are expected to have a smaller impact than earlier proposals (under which some global banks could have faced increases of up to 70 percent of their operational risk capital charges), the impact remains significant for some banks. If operational risk charges are 15 percent of a bank's total capital charges, a 40 percent increase in the operational risk capital charge would increase total RWAs by 6 percent, and reduce the bank's capital ratio from 10 percent to 9.4 percent.

Capital floor – the specification of this floor remains uncertain. But if a bank's use of internal models generated a 40 percent RWA saving compared with the standardized approach then a floor that wiped out half of those gains would reduce the bank's capital ratio from 10 percent to 8.3 percent.

The CET1 capital and the RWAs of the 100 major international banks in the Basel Committee's monitoring exercise sample totaled around €3.5 trillion and €30 trillion respectively at end-June 2015. If the Basel Committee proposals generated a 10 percent increase in RWAs then these banks would have to increase their CET1 capital by €350 billion to maintain their capital ratios; or alternatively reduce their RWAs by €3 trillion. This is not a trivial adjustment – it is equivalent to a reduction of around €7 trillion of balance sheet assets (assuming an average risk weight of 40 percent).

The Basel Committee's proposals are likely to have a larger impact on banks in Europe than in the United States or Asia Pacific. RWA densities (RWAs as a proportion of total assets) indicate that banks in Europe have made more use of internal model-based approaches to drive down their risk weighted assets than banks in other regions. RWA densities average around 35 percent for banks in Europe, 50 percent in Asia Pacific, and nearly 60 percent in the United States. This may explain the cautious approach of the European Commission to the latest standards being proposed by the Basel Committee.

Some supervisors in Europe have suggested that lower Pillar 2 capital requirements could offset the impact of these tougher Pillar 1 requirements. But this will not provide a full offset for many banks, because the Pillar 1 revisions may be much larger than the current Pillar 2 add-ons, and because many of these add-ons reflect other considerations such as concentration risk, interest rate risk in the banking book, the impact of stress tests, and governance and control weaknesses.

These new and proposed standards – combined with related regulatory and supervisory initiatives regarding risk data aggregation and reporting, stress testing, recovery and resolution planning, expected loss provisioning under IFRS 9, the definition of default, and Pillar 3 disclosures – will also have a significant impact on:

- the implementation costs of systems and controls, data aggregation and reporting
- reduced incentives for banks to develop internal models and to improve their risk management
- incentives for banks to adjust their business activities to reflect less risk-sensitive regulatory approaches.

Basel Committee revisions to credit, market and operational risk, and the capital floor

In response to variations across banks in risk exposure weightings that do not seem to reflect the underlying risks, the Basel Committee has been seeking to eliminate or constrain the use of internal models by banks for the purposes of regulatory capital calculations.

On **credit risk,** the proposed standards will:

- Remove the option for banks to use internal model approaches to calculate RWAs for some types of exposure - to banks and other financial institutions, large corporates, equities, specialized lending, and credit valuation adjustment risk. These will become subject to the standardized approach to credit risk.
- Constrain remaining internal models by removing the option to use the A-IRB approach for exposures to medium-sized corporates; setting model-parameter floors to ensure a minimum level of conservatism (including a 10 percent loss given default floor for residential mortgage exposures); and limiting the ways in which banks can estimate probability of default, loss given default, exposure at default, maturity and credit risk mitigation parameters.
- Revise the standardized approach to credit risk, which will increase risk weights on some types of lending, including real estate exposures with high loan-to-value ratios or where repayment is materially dependent on the cash flows generated by the property securing the exposure.

On **market risk**, the final Basel Committee framework, due to come into effect in 2019, will introduce:

- A revised internal models approach designed to capture tail risks more effectively by replacing Value at Risk calculations with an Expected Shortfall measure of risk; capture market illiquidity risk through liquidity horizons based on stressed market conditions; calculate internal model and standardized approach capital charges at desk level, with stricter requirements on profit and loss modeling and on model validation; and constrain the capital-reducing effects of hedging and portfolio diversification.
- A revised standardized approach that places greater reliance on 'risk sensitivities' as inputs into capital charge calculations; calibrates standardized risk weights to stressed market conditions using an Expected Shortfall methodology and varying liquidity horizons; calibrates a standardized default risk charge to the credit risk treatment in the banking book; and introduces an add-on for residual risk in more sophisticated/complex instruments.
- A tighter boundary between the banking book and the trading book to reduce arbitrage between these two books.

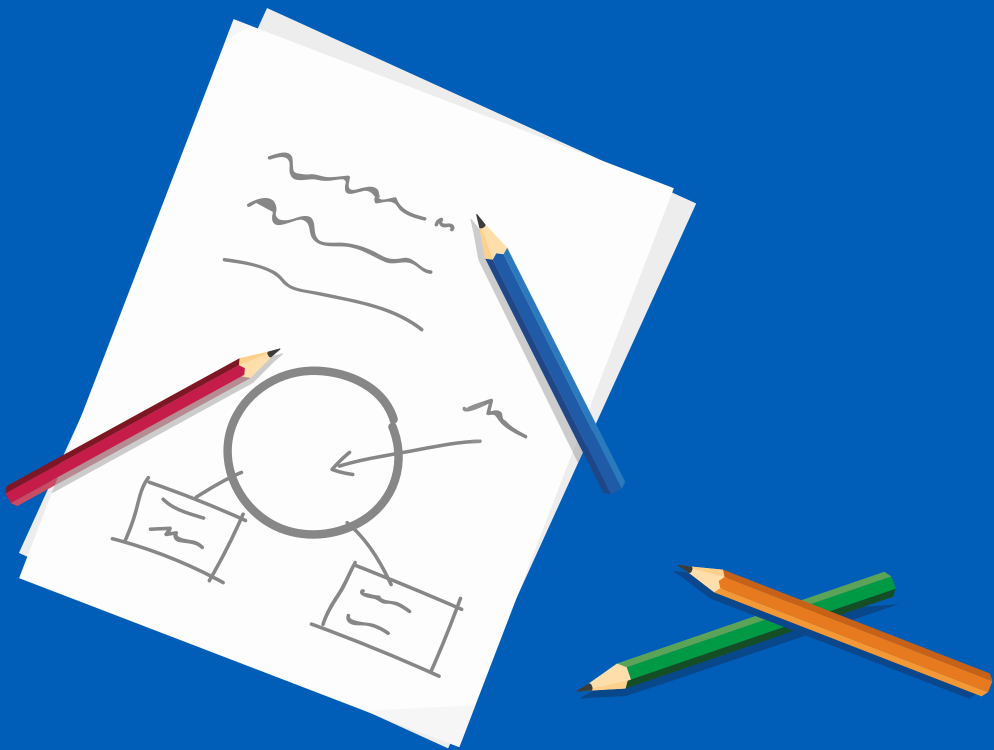
On **operational risk**, the Basel Committee is proposing to withdraw the use of internal models for calculating regulatory capital requirements for operational risk, and to introduce a single Standardized Measurement Approach. Larger banks will be allowed some recognition of bank-specific loss data, so banks with low operational risk losses will benefit from a lower operational risk regulatory capital charge, but they will not be able to base their calculations on external data, forward-looking scenario analysis information, or data on business environment and internal control factors. Equally, banks that have been subject to large conduct fines in recent years will be subject to higher operational risk capital requirements for the next ten years.

The Basel Committee has also proposed a **capital floor** to limit the extent to which the use of internal models for credit and market risk could reduce capital requirements below the capital required under the standardized approaches.

Implications for banks

Significant shifts in some banks' business models are already under way in response to these current and prospective pressures on capital, costs and risk sensitivity. These shifts are asymmetrically distributed across regions and in some cases within countries. Some banks have already withdrawn from, or scaled back their activity in, some lending and trading markets and in some geographic regions. These trends are likely to be reinforced by the latest Basel Committee proposals.

These regulatory changes are coinciding with other structural changes in financial markets (including technological innovation) in ways that affect the ability of banks to provide intermediation services. The cost of bank finance is increasing and its availability is decreasing in some markets. Liquidity is declining in corporate bond markets. Investment banking activity is becoming increasingly concentrated among a few major investment banks.



Myth Two

The regulatory reform agenda is almost complete

The FSB's latest reports to the G20 have emphasized the full and consistent implementation of past G20 agreements, rather than new regulatory initiatives.

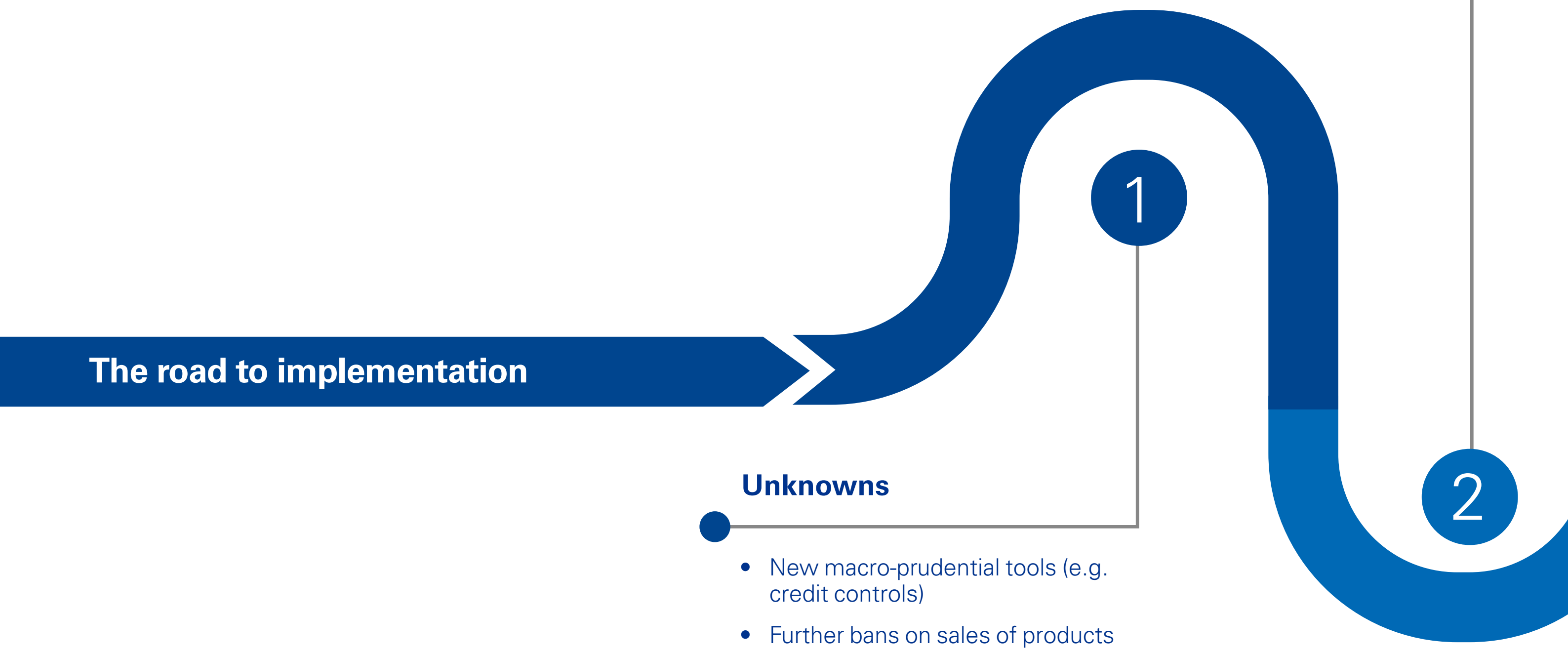
The reality – there is still a long way to go, loading additional costs and uncertainties on banks

Considerable progress has been made by national authorities and by banks on implementing the regulatory reform agenda.

Our regulatory road map shows that an increasing number of regulatory reforms have moved across to the 'Calibrated' or 'Implementation' stage. These include final calibration of the minimum leverage ratio, the market risk framework and the total loss absorbing capacity requirement for G-SIBs; the setting of capital surcharges for D-SIBs in Europe; progress on resolution, bail-in and resolution funds in individual jurisdictions; and the revised Basel Committee corporate governance principles.

Under development

- Revised credit and operational risk weightings
- Capital floor
- Risk weightings for sovereign exposures
- Capital requirements for simple securitizations



Unknowns

- New macro-prudential tools (e.g. credit controls)
- Further bans on sales of products to retail consumers
- New regulation in response to financial technology innovation

The volume of unfinished business is diminishing as more regulations are moving through the design and calibration stages to implementation, and fewer regulatory reform initiatives remain at an earlier development stage.

3

Designed

- D-SIB designation and capital surcharges (some countries)
- Macro-prudential tools (some countries)
- Pillar 3 disclosure (phase 2)

4

Calibrated (implementation date)

- Leverage ratio (2018)
- NSFR (2018)
- IFRS 9 (2018)
- Haircuts on non-centrally cleared securities financing transactions (2018)
- Revised IRRBB standards (2018)
- Revised market risk framework (2019)
- TLAC for G-SIBS (2019-2022)

5

Implemented (usually on phased-in basis)

- Basel 3
- G-SIB designation and capital surcharges
- D-SIB designation and capital surcharges (most countries)
- Stress testing
- Risk data aggregation and reporting principles for G-SIBs
- Risk weights on exposures to CCPs
- Capital treatment of securitizations
- Macro-prudential tools (some countries)
- Liquidity Coverage Ratio
- Large exposures
- Pillar 3 disclosure (phase 1)
- National structural separation legislation
- Resolution and bail-in powers (some countries)
- Basel Committee corporate governance principles
- FSB risk governance and risk appetite principles
- FSB guidance to supervisors on assessing risk culture
- Remuneration
- FSB and IOSCO principles for interest rate and FX benchmarks
- Central clearing of OTC derivatives

However, a number of important regulatory initiatives remain at a preliminary stage, including:

- some components of the Basel Committee's revised standards on credit, market and operational risk, and the capital floor
- the development of revised capital and large exposure standards for sovereign risk exposures
- the evolution of the capital regime in response to IFRS 9
- resolution strategies and the specification of total loss absorbing capacity for banks other than G-SIBs
- the continuing evolution of macro-prudential policy measures
- potential regulatory responses to financial technology innovations.

The detail of these initiatives has not been finalized, and implementation dates stretch well into the future. Brexit introduces further uncertainties here to the position of banks operating in the UK or passporting from the UK to the European Union.

Total loss absorbing capacity (TLAC)

TLAC requirements have been finalized for G-SIBs. In addition to minimum regulatory capital requirements, G-SIBs will have to hold long-term debt (subordinated, unsecured and with a minimum residual maturity of at least one year) that can be written down or converted into equity, in order to absorb losses and recapitalizes a failing G-SIB.

G-SIBs must hold TLAC equivalent to at least 16 percent of RWAs and 6 percent of the total exposures used to calculate the leverage ratio from 1 January 2019, and at least 18 percent and 6.75 percent respectively from 1 January 2022. For G-SIBs headquartered in emerging market economies these deadlines take effect from 2025 and 2028.

The quantitative impact assessment published by the Basel Committee shows that at end-2014, G-SIBs would need to issue an additional €755 billion of TLAC to meet both the 18 percent of RWAs and 6.75 percent of total leverage exposure minimum ratios.

Although these standards were developed for G-SIBs, some national regulators may extend them in some form to at least D-SIBs. For example, the European Union is applying a broadly equivalent requirement to raise minimum own funds and eligible liabilities (MREL) to systemically important banks.

MREL will be set as the sum of two components:

- a loss absorption amount to cover losses, based on minimum going-concern capital requirements
- a recapitalization amount to enable a bank (or parts of it) to meet the conditions for authorization and to maintain market confidence following resolution.

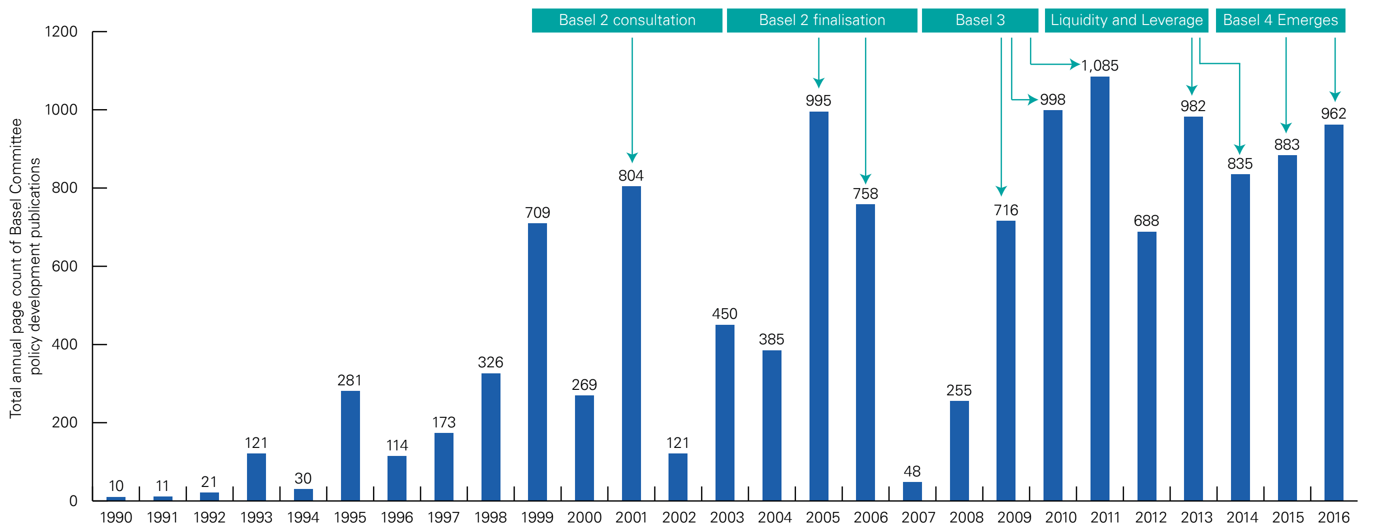
For systemically important banks subject to a bail-in strategy the recapitalization amount is likely to be at least equal to existing minimum capital requirements. Converting this amount into equity would enable a systemically important bank to continue operating in resolution until it was sold or restructured.

For a non-systemically important bank, the recapitalization amount would be based on the regulatory capital required to support only the critical economic functions of the bank.

The working assumption of the European Banking Authority is that small banks should not be required to hold any recapitalization amount because they would be subject to liquidation rather than resolution, with eligible depositors being protected through a deposit guarantee scheme.

Setting MREL requirements on a bank-by-bank basis creates considerable uncertainty over the amount of additional bail-in

The relentless pace of policy development by the Basel Committee



* The June 2016 data have been annualized (6 months data multiplied by 2)

debt that banks will have to issue, and over the impact of such additional issuance on the overall cost of bank funding and the pricing and availability of bank lending.

Sovereign risk exposures

In addition to its current proposals on credit risk, the Basel Committee is reviewing the treatment of sovereign risk exposures. If the Basel Committee were to follow the same logic it has applied to other types of credit risk this could result in:

- withdrawing the internal models based approach to calculating risk weights
- revising the standardized approach. The current standardized approach is risk-sensitive to the extent that risk weights depend on external credit ratings, with a zero risk weighting on sovereign debt rated at AA- or higher. Other measures of risk (for example the ratio of government debt to GDP) would generate different weightings
- withdrawing the exemption from any risk weighting on domestic sovereign exposures in local currency
- imposing a limit on large exposures, regardless of risk weighting.

The magnitude of some banks' holdings of government (and government agency and local authority) debt, and the use of these assets to meet liquidity and collateral requirements, highlights the potential impact of any revisions to the current treatment of sovereign exposures. Higher risk weightings or large exposure limits could require banks to raise additional capital or divest part of their sovereign debt holdings. Large-scale shifts of this nature could also generate significant debt management pressures on some governments.

For example, the European Banking Authority's 2015 transparency exercise (using end-June 2015 data) found that 105 major EEA banks held €1.5 trillion of domestic sovereign debt and a further €1.5 trillion of non-domestic sovereign debt, split equally between the sovereign debt of other EEA countries and of countries outside the EEA. This compares with these banks' CET1 capital of €1.4 trillion. In the United States, the Federal Reserve reports that at a comparable point in time (May 2015), US banks held $2.1 trillion of domestic sovereign debt and an additional $1.5 trillion in agency-backed securities, compared with CET1 capital of $1.5 trillion.

A simple example illustrates the potential impact of changes in the sovereign risk weight. Consider a bank with risk weighted assets of 100, an initial capital ratio of 10 percent, and sovereign exposures that are currently zero risk weighted. The impact on this bank's capital ratio of revised risk weightings would be:

Impact on capital ratio of higher risk weights on sovereign risk

Sovereign debt holdings:	**10**	**20**	**30**
New risk weight:			
10%	**9.9%**	**9.8%**	**9.7%**
30%	**9.7%**	**9.4%**	**9.2%**
50%	**9.5%**	**9.1%**	**8.7%**

This illustration, and the impact of central bank interventions such as the ECB's Asset Purchase Program, suggest that bank holdings of sovereign debt could be sensitive to even small changes in the regulatory capital framework.

IFRS 9

The IFRS 9 treatment of provisioning is due to come into force from 2018. It will replace the 'incurred loss' approach to loan loss provisions with an expected loss approach. Expected losses are calculated using twelve months' expected losses at the inception of a loan, and lifetime expected losses following any significant deterioration in loan quality since origination.

This shift will require some banks to begin holding provisions against performing loans and loans that are deteriorating but still performing. This is likely to result in significantly higher loan loss provisions than under current accounting standards. Higher provisions will in turn have a negative impact on profits, and hence on CET1 capital.

Supervision

In addition to regulatory initiatives, supervisors in many countries are increasing their pressure on banks through:

- Challenging the viability and sustainability of banks' businesses through an assessment of profitability drivers and the impact of continuing low interest rates
- Close monitoring of any moves by banks towards aggressive search-for-yield strategies, loosening of credit standards, or lax pricing strategies
- Maintaining a close oversight of credit risk and non-performing exposures
- Conducting more in-depth and specialized examinations on risk data aggregation and reporting, including a focus on banks' progress in completing large-scale infrastructure projects, in closing gaps in terms of data accuracy and the ability to adapt data processes to meet ad hoc requests, and in establishing clear risk data ownership and responsibilities over quality controls
- Pressing banks to improve their governance, conduct and culture, including a greater focus on senior management responsibilities
- Making more use of Pillar 2 and stress test related capital add-ons, even as Pillar 1 capital requirements have been enhanced
- Developing more sophisticated approaches to testing banks' resilience to cyber security risks
- Beginning to review the risks inherent in various types of financial technology innovation.

Implications for banks

The uncertainties arising from the unfinished regulatory reform agenda complicates banks' strategic planning and choice of business model. The viability or otherwise of some options will depend on the eventual outcome of regulatory decisions that have not yet been finalized.

Meanwhile, much of the supervisory pressure coincides with banks' own efforts to improve their profitability, governance, culture and risk management. Supervisory pressure may even accelerate much-needed investment and shifts in governance, culture and strategy.

Banks face challenges in responding to these parallel developments in supervision and regulation; and in responding to the subtle uncertainties regarding the full scope of regulatory and supervisory requirements. For example, supervisors may conclude that banks must increase their Pillar 2 capital to cover risks associated with financial technology innovation and/or cyber security.

The risk management and compliance challenges associated with these developments are also significant. It will take years for banks to implement fully the data and technology enhancements required to implement fully the regulatory reforms.

Meanwhile, the regulatory reforms are being developed at a point of great change in the financial intermediation model. The availability of advanced technology solutions hold the potential for increasing the effectiveness and efficiency of the lending process.

Myth Three

International standards provide a level playing field globally

The FSB continues to emphasize the importance of achieving the "full and consistent implementation" of regulatory reforms. This objective is routinely endorsed by the G-20.

The reality – inconsistent implementation of international standards inhibits the ability of international banks to meet the needs of their international clients

The full and consistent implementation of international standards remains a challenge. Important areas of divergence include:

- **Resolution** – The FSB's own progress and peer review reports highlight differences across jurisdictions regarding in particular the implementation of regulatory reforms for OTC derivatives and the FSB's 'key attributes' for effective resolution.

- **Basel 3 implementation** – Basel Committee peer reviews show significant divergence in some jurisdictions in the implementation of Basel 3. While the Basel Committee makes it clear that its standards are minimum standards and regulators are free to impose tougher standards, this facilitates differences across jurisdictions imposing a 'minimum standard plus' in different ways.

- **Capital surcharges** – The roll out of capital surcharges to D-SIBs has been uneven. Jurisdictions have exercised discretion in designating which of their banks are of domestic systemic importance, and in determining the capital surcharges that will apply to them.

- **Super-equivalence** – Some jurisdictions have introduced – or are introducing – different types of super-equivalence in the setting of minimum capital, leverage, liquidity and total loss absorbency requirements; different approaches to stress testing; and different expectations for recovery and resolution planning, and resolution strategies.

- **Macro-prudential policy** – National authorities have made varying use of macro-prudential instruments.

- **Localization** – The trend continues towards the localization of requirements, as jurisdictions require some types of activity undertaken by foreign banks to be through subsidiaries rather than branches, which are then subject to local capital, liquidity and resolution requirements.

- **Cross-border cooperation and coordination** – Post-crisis improvements in coordination among supervisors and resolution authorities remain largely untested.

Implications for banks

Such divergences are not new. Basel 1 and Basel 2 were never implemented in a completely consistent manner internationally. The definition of default, accounting valuation standards and the provisioning process to cover non-performing loans were not subject to international consensus-based standards.

But today's divergences are more significant. They bring into question the effectiveness of an ever-widening range of international standards, many of which depend on consistent implementation to underpin cross-border application. They also increase materially the cost of doing business for internationally active banks.

Myth Four

Banks are in a strong position because they have adjusted to meet Basel 3 requirements

Data from the Basel Committee and the European Banking Authority show that most major internationally active banks are meeting the (fully phased-in) Basel 3 and EU Capital Requirements Regulation standards for capital, leverage and liquidity.

At end-June 2015 almost all major banks met the Basel 3 minimum CET1 capital and leverage ratios. These banks also met the transitional minimum Liquidity Coverage Ratio of 60 percent, although some banks remained short of the 100 percent minimum that will apply from 2019 (2018 in the EU). Around one-quarter of these banks were below the 100 percent minimum Net Stable Funding Ratio (NSFR) that will apply from 2018.

Major European banks are well behind major banks elsewhere in the world on the leverage ratio and the NSFR. In Europe the average leverage ratio is 4.2 percent, against 5.2 percent internationally; and the average NSFR is 104 percent, against 112 percent internationally.

The reality – adjustment is hiding other weaknesses

While these data are encouraging, and some reassurance may be taken from these headline ratios, they may be a poor measure of the true strength of these banks. Assessing bank health solely on the basis of regulatory ratios may provide an incomplete picture.

First, these data cover only the Basel 3 capital requirements (the 4.5 percent minimum CET1 capital ratio, the capital conservation buffer of 2.5 percent, and any G-SIB capital surcharge). They do not cover other significant capital requirements, which may reveal significant shortfalls in banks' capital positions:

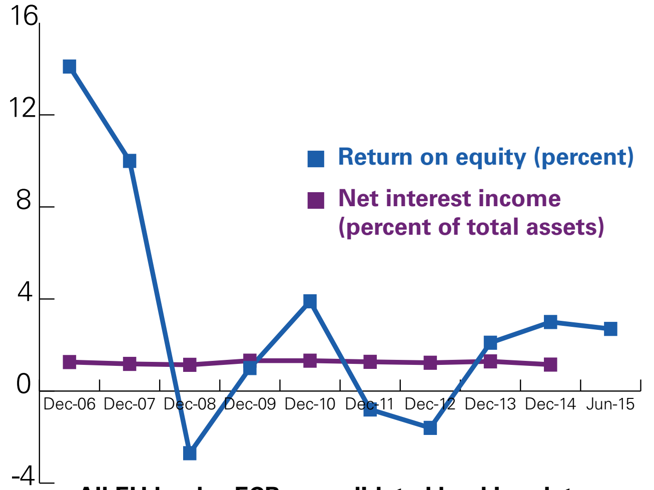
- D-SIB capital surcharges
- other systemic risk buffers
- stress testing and other Pillar 2 capital add-ons
- macro-prudential buffers such as the counter-cyclical capital buffer
- the impact of RWA inflation from revisions to credit, market and operational risk, and the capital floor
- national super-equivalence (as in the US, UK, Netherlands and Switzerland) in setting a higher than 3 percent minimum leverage ratio
- the impact of IFRS 9.

Second, many European banks remain trapped in a vortex of a weak economic environment of low or negative growth and low interest rates; low returns on equity; weak net interest margins; a high level of non-performing exposures; high enforcement and remediation costs of misconduct; rising compliance costs; and limited progress on reducing cost to income ratios.

Although the level of non-performing exposures may have flattened out, in Europe the €2 trillion overhang (unevenly distributed across banks and countries) will take a long time to off-load, especially when banks are seeking to clean up these exposures during a prolonged period of weak economic growth.

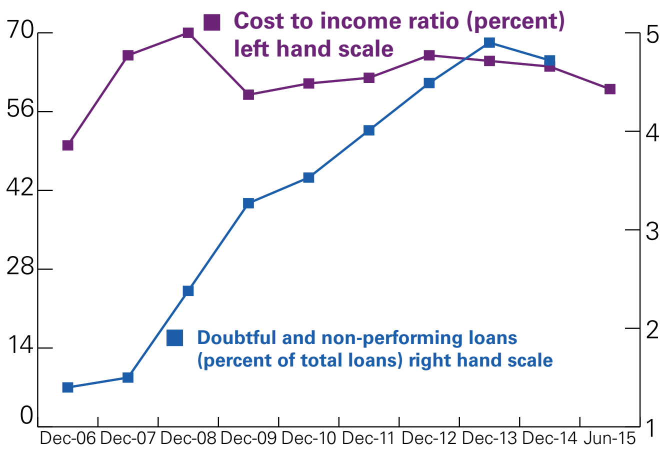
Third, the patience of investors should not be over-estimated. When this patience wears thin banks will find it more difficult to raise capital and may be forced to take more rapid measures to reduce their balance sheets, restructure and change strategic direction.

Weak return on equity and net interest income in Europe



All EU banks, ECB consolidated banking data

High costs and high level of non-performing loans in Europe



All EU banks, ECB consolidated banking data

Implications for banks

The message for banks here is clear. They need to identify a strategy and adopt a business plan that addresses the weaknesses that are holding back the development of a viable strategy, the restoration of sufficient profitability and a return to sustainable growth, or risk the intervention of investors or supervisors.

Particular challenges for banks are to finance evolutionary change amid significant uncertainties surrounding regulatory and supervisory requirements, and to find ways of using advanced financial technology innovations to increase operational efficiencies and to improve credit risk assessment processes.

Myth Five

Banks with stronger capital ratios lend more

Policy makers setting high capital requirements on banks frequently claim that banks with stronger capital ratios lend more. They assert that such banks should have the ability to borrow more, and at more favorable rates, thus amplifying the funding available for onward lending into the wider economy.

The reality – stagnant bank lending, in particular in Europe

The reality in Europe is that while banks' capital, leverage and liquidity ratios have increased sharply since the onset of the financial crisis, bank lending has remained flat on average. Many European banks have achieved higher capital ratios in part through balance sheet reductions, and a shift away from riskier lending and trading activities. These banks have shifted the balance of their lending from corporate lending to residential mortgages, and have increased sharply their holdings of sovereign debt.

Balance sheet reductions (which have reduced the need for wholesale funding), a shift away from longer term lending and a shift into higher quality liquid assets have also improved these banks' liquidity ratios.

The downward spiral in many European countries of low or negative economic growth and weak bank lending is likely to continue as capital and other regulatory requirements increase and as the burden of non-performing exposures remains significant. This in turn makes it more difficult for these banks to deliver viable and sustainable credit creation strategies. This also has a significant impact on bank customers in terms of the availability and price of credit and other banking services, in particular where alternative sources of finance remain under-developed; and more broadly on the ability of banks to contribute to the wider "jobs and growth" agenda.

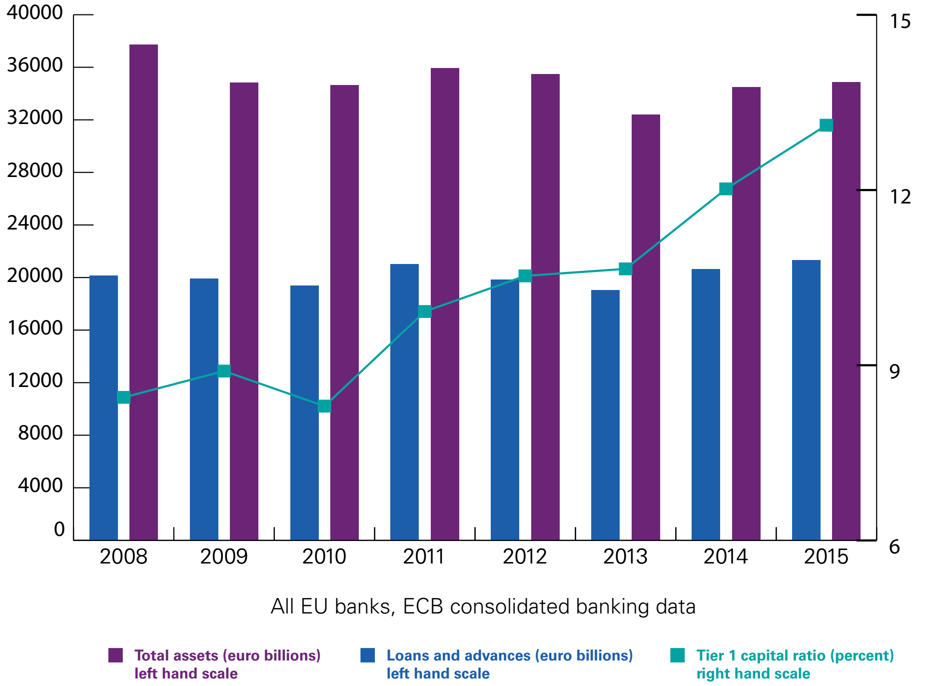
Elsewhere, in countries experiencing relatively strong economic growth and confidence in the prospect of future growth, banks benefit from a combination of strong demand for borrowing, profitable lending opportunities, the ability to build capital from both profit retention and raising fresh equity, and potentially a lower cost of funding as the probability of bank failures is perceived to decline (although deposit insurance may weaken this link). The resulting positive correlation between bank lending and capital ratios in these countries may therefore reflect a cyclical correlation with wider economic conditions.

Banks in the United States have increased their lending significantly since the financial crisis, and many have begun to benefit more recently from improved profitability. The 2016 Annual Report from the Financial Stability Oversight Council reports solid loan growth and decreased delinquency rates across all major segments of the US credit market, except student loans. The growth was broad-based, covering both domestic and foreign banks. Banks continue to provide the majority of mortgage originations and mortgage servicing, although non-banks are increasing their share of both markets. Corporate bond issuance remains robust as well, due to low interest rates.

Some banks in parts of the Asia Pacific region may face a more severe constraint on their lending when higher capital and liquidity requirements are fully implemented. This is because, unlike most other banks globally, they are still continuing to grow their balance sheets very strongly – often by 20 percent or more per annum. Raising the capital and liquidity required to support this growth – while at the same time seeking to meet higher regulatory minimums – will be a considerable challenge for banks in this region.

In such an environment, another round of regulatory capital increases for banks – as implied by the Basel 4 reforms - will generate unwelcome and possibly counter-productive pressures within bank-dominated economies.

Stronger capital ratios but subdued lending in Europe



Implications for banks

Ever more highly capitalized banks will not automatically undertake ever higher lending. The additional cost of capital funding will make bank lending permanently more expensive, thereby constraining the extent to which banks can support the wider economy. Some policymakers welcome this shift, since they view pre-crisis levels of bank intermediation as having been excessive.

In Europe, additional supervisory pressure will increase incentives for banks to find viable asset disposal opportunities for their non-performing loans.

Banks in economies with alternative sources of credit for the economy (such as the United States, with its deep securities markets, diversity in non-bank lenders, and new technology-driven intermediation innovation) will be required to innovate their business models to address these domestic competitive pressures.

Myth Six

Capital markets can fill the gaps left by the banks

One key driver of the European Union's Capital Markets Union (CMU) project is to reduce the reliance of borrowers on bank finance, particularly in the infrastructure project and SME sectors. Increased reliance on capital market financing could permit cross-border liabilities to be shared by markets across a more diversified investor base while providing growth-enhancing funding to companies and projects.

The reality – capital market development will be a slow process

Capital market finance will not replace bank lending in Europe in the near term. The various initiatives clustered under the CMU project in the European Union are proceeding slowly, with extended timetables for decision-making. The UK exit from the European Union may have an impact on the CMU proposals, given the relative importance of UK capital markets to executing the project over the coming years.

During 2015 the Basel Committee and the European Banking Authority proposed lower capital requirements for simple, transparent and high quality secularizations. The objective was to increase the transfer of performing loans to capital markets, freeing up bank balance sheets for fresh lending. The Basel Committee proposals were not finalized until July 2016. The final standards retain significant non-neutrality in the capital treatment for these instruments, with higher capital overall (by more than 50 percent) for securitized assets relative to unsecuritized assets that remain on a bank's balance sheet, and they may not generate significant securitization of SME loans.

In the near term, capital markets are likely to be an alternative to bank finance in Europe mostly for large corporates and infrastructure projects. Alternative investors may be unwilling to participate in private placement markets for SMEs. If banks remain keener to lend to consumers (secured and unsecured) than to SMEs then SMEs may continue experiencing restricted access to both bank lending and capital market financing.

Other components of the CMU project seem likely to generate continuing uncertainty as fresh legislation may be needed in areas such as prospectuses, venture capital, insolvency regimes, personal pensions, securitizations (beyond their regulatory capital treatment), covered bonds and investment funds, at a time when the European Commission is reluctant to press ahead with yet more legislation.

The responses to the European Commission's call for evidence on the unintended consequences of the post-crisis legislative agenda may also lead in due course to revised or additional legislation. For example, there is some momentum in Europe for a more proportional approach to banking regulation, with a less burdensome regulatory regime for small banks and small investment firms.

One emerging alternative to bank financing of a more global nature is the growth of alternative lending platforms. This sector has grown rapidly in many countries, which may be due in part to the higher costs and heightened risk-aversion of some banks in lending to SMEs in particular. Regulators are taking a measured approach to writing new rules for this sector, not least while it remains relatively small in comparison with bank lending. However, the rapid expansion of this sector may result in a tougher regulatory stance, particularly with respect to consumer protection.

Conclusions for banks' strategies and business models

Banks' strategies and business models need to respond to the shifts and uncertainties in regulation and other commercial and economic pressures.

The six myths explored here will not disappear. They will continue to drive regulation and the business landscape for banks. Banks need to plan accordingly.

Some banks, especially in the United States, have made progress here. But many banks still need to craft new strategic plans and to reshape their business to match the new environment.

Key strategic issues include:

- identifying and targeting profitable – and prospectively profitable – activities
- eliminating non-core or over-risky lines of business
- reducing costs and seeking opportunities to increase margins and non-interest income
- embracing the digital revolution and the financial technology opportunities in distribution and customer interaction
- a relentless focus on serving customers and clients, and meeting changing customer and client needs, attitudes and demands
- crafting a strategy to respond to new and evolving risks.

These strategic considerations should then drive the development of new business models which can take advantage of the new opportunities and dislocations which change creates, while preventing the loss of value to new entrants and disruptors.

Abbreviations

A-IRB	Advanced Internal Ratings Based
CCP	Central Counterparty
CET1	Common Equity Tier 1
CMU	Capital Markets Union
D-SIB	Domestic Systemically Important Bank
ECB	European Central Bank
EEA	European Economic Area
FSB	Financial Stability Board
G-SIB	Global Systemically Important Bank
IFRS	International Financial Reporting Standard
IOSCO	International Organization of Securities Commissions
IRRBB	Interest Rate Risk in the Banking Book
LCR	Liquidity Coverage Ratio
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NSFR	Net Stable Funding Ratio
OTC	Over the Counter
RWAs	Risk Weighted Assets
SME	Small and Medium-Sized Enterprises
TLAC	Total Loss Absorbing Capacity

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