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The EU banking package on the verge of being put to the test

Florian Heider: At its core, the EU banking package is a multi-issue package. However, in terms of changing the cost of credit and its impact on the real economy, the new rules on credit risk and the output floor are the most relevant

The European Parliament and the European Council agreed on the EU banking package at the end of June. This package of reforms is the implementation of Basel III, which sets out critical rules for the capital adequacy of banks in the euro area and is due to come into force between 2025 and 2026. A multi-year process that began in October 2021 with a proposal from the European Commission preceded the agreement between the European Parliament and the Council.

Banks may deviate from the standard models and use their own statistical models to calculate their capital requirements. These internal models must be regularly updated and monitored by supervisors. However, as these models are highly complex, the EU banking package also introduced an output floor. This is intended to reduce possible deviations between the internal and standardized models. Banks using internal models must calculate their capital requirements using the standardized approach.

From 2025, capital calculated using internal models must be at least 50 percent (gradually increasing to 72.5 percent by 2030) of capital calculated using the standardized approach. The change will, therefore, only affect banks that currently use internal models and whose calculation results deviate significantly from the standardized approach.

Reassessments will be noticeable in the area of real estate and unrated corporate loans

The EU banking package will lead to far-reaching reassessments of credit risk and the associated risk-weighted assets (RWA). This will be particularly noticeable in the area of real estate and unrated corporate loans. For example, project developments in commercial real estate financing will have to be backed by 150 percent equity in the future.

Even if the output floor only affects a subset of banks, it will only lead to higher capital requirements. Changes in credit risk will also lead to an overall increase in capital, although the effects may be reversed depending on a bank's business model. The European Banking Authority (EBA) has published initial estimates and expects an average capital increase of 15 percent. The burden on large banks is significantly higher than on smaller banks, partly because large banks rely more heavily on internal models and are, therefore, more affected by the output floor.

However, this increase does not necessarily mean that borrowing costs will explode and spill over into the real economy. First, many banks are currently over-capitalized, so that? an increase will sometimes lead to higher capital costs. Second, there are numerous exemptions. Only time will tell how much capital requirements will increase. Third, there are additional transitional solutions until 2032, so even if there is an increase in borrowing costs, it will not be a one-time event but spread over seven years.

While capital requirements have traditionally been at the core of the regulatory framework to achieve a resilient banking system, these requirements have some limitations.

The most significant risk to banks is not insolvency but illiquidity

First, the regulatory framework for capital requirements has become increasingly complex. Weaknesses have been identified, and, as a result, the requirements have been repeatedly improved without being simplified at the same time. In the meantime, the rules have become difficult to understand, and the burden on banks to comply with the rules has increased.

Second, capital requirements can only be one component of bank regulation. The most significant risk to banks is not insolvency but illiquidity. Even solid banks can get into trouble if demand deposits are withdrawn on a large scale, and more liquidity must be needed. That is why liquidity regulation under Basel III is an essential component that complements capital regulation.

Third, a bank's capital is only an actual buffer if its assets are of high quality. Regulation tries to cover this by risk-weighting different assets. But here, it often needs to catch up to reality, as the current improvements show. And yet, there are still areas for improvement, such as the lack of capital requirements for government bonds. The example of Silicon Valley Bank shows that a bank with a solid capital ratio can quickly become insolvent if it is exposed to high-interest rate risk in government bonds and mortgage loans.

However, the situation in March also showed that the current regulatory framework is well suited to regulating the European banking system. Both the problems at Silicon Valley Bank and those at Credit Swiss have endangered the system on a large scale, but that is no reason to rest on our laurels. Further improvements in banking regulation will be needed in the future.

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