European banks face a substantial capital crunch in 2014 with total capital shortfalls expected to be in the region of €280bn.

November 2013
Headlines

- European banks face a substantial capital crunch in 2014 through the combined impact of Basel III capital ratio requirements, Leverage Ratio requirements, the ECB Comprehensive Assessment, and possible further national regulatory discretions.

- Total capital shortfalls are expected to be in the vicinity of €280bn in Europe.

- Traditional capital ‘mitigation’ responses will not come close to closing this gap. We estimate that new equity of up to 2/3 of that shortfall (c. €180bn) will be needed.

- There will be disruptions and adjustment costs, but concerns about economic viability under the additional capital load (including at product level) are unfounded – reduced leverage is bringing down the cost of bank equity and this trend will continue.

- As economies rebuild, banks should switch from asset contraction to capital expansion... investors should welcome this switch.

- Although the environment for capital raising is becoming more favourable, €180bn is a lot for the market to absorb in the short term so the competition for new capital will be fierce, so banks in need of capital should take heed.
In brief

1. The Basel Committee’s release in June 2013 of a consultative document on the Leverage Ratio (LR), together with the impending Eurozone-wide ECB Comprehensive Assessment and the ongoing drumbeat from national regulators, have triggered a great deal of industry angst.

2. With the LR as currently proposed, it will become the de-facto determinant of regulatory capital for many banks and, in doing so, ratchet up the industry-wide shortfall in regulatory capital above and beyond that dictated by risk-based capital requirements.

3. The key industry concerns are that this will undermine the efficacy of the risk-based capital regime, shift the competitive landscape, and lead to a variety of adverse knock-on effects such as to impede credit supply and drive up prices in secured lending markets. It may even induce perverse responses from banks such as to reduce their liquidity buffers and invest in riskier assets to boost their returns.

4. In the Eurozone, just as capital demands are being pushed up by Basel III (including the LR and through the exercise of national discretions) there is every likelihood that the ECB Comprehensive Assessment will further exacerbate the capital shortfall. The combined impact of these measures – Basel III capital and leverage ratios and the ECB Comprehensive Assessment – will be a capital shortfall of c.€277bn for European banks.

5. While concerns about market disruptions, distortions and adjustment costs are legitimate in the short run, in the longer run they are overstated. Assuming the ECB Comprehensive Assessment draws a stronger line under the banking crisis, and once banks have made further progress in restructuring their balance sheets, our view is that their funding and capital costs will rebalance and subside, and that this will ultimately restore them to economic profitability and re-level the playing field1. This applies equally at the product level.

6. Even in the short run, we believe too much is made of the dilutive effects of raising additional capital (whether in response to RWA, LR, ECB or national supervisory pressure). The crisis has revealed that performance enhancement through financial leverage, as well as being potentially calamitous, is substantially an illusion for equity investors. This is because the higher equity returns come hand-in-hand with higher equity risks and therefore higher equity costs. It follows that the supposed costs of financial de-leverage, in terms of RoE dilution, are also largely illusory.

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1 Although banks may end up with different capital structures, this will be offset substantially through having different capital cost structures.
Nevertheless, we expect that banks faced with a capital shortfall will again work through the usual balance sheet restructuring menu of technical mitigation ('paper' changes), business/operational mitigation (e.g. netting and other forms of balance sheet compression), asset restructuring (sale or runoff) and liability restructuring (capital raising/restructuring).

Of these, we believe the usual last resort of liability restructuring will prove to be the dominant response because other measures will not go nearly far enough. We see up to two-thirds of the Tier 1 capital shortfall (c. €180bn for European banks) being met by capital raising or restructuring, partly out of necessity, but also on merit: We believe there is growing investor acceptance of the new lower risk – lower cost – lower return paradigm; a gradually improving confidence in the nascent economic upturn; and a growing recognition of the value of having the balance sheet capacity to invest into this upturn. In this environment, the frictional costs of being undercapitalised far outweigh the frictional costs of being overcapitalised (to the extent that the latter exist at all).

Liability restructuring will take many forms including ordinary equity issuance, AT1 securities issuance, internal capital restructuring, asset backed structured finance/securitisation transactions and more radical holistic balance sheet restructures.

For banks in scope of the ECB Comprehensive Assessment, although the process will not conclude until late 2014, there is little merit in deferring action until then. The ECB announcement gave pointed encouragement to taking action sooner rather than later, presumably to mitigate the risk of market disruption/volatility at that time and to avoid the need to resort to national back-stops. Banks have an interest in avoiding this scenario too. For banks outside the ECB scope, but which nonetheless need to raise capital, similar logic applies – they should take their opportunities while they can.

In Europe, Barclays, Deutsche Bank, Credit Suisse and Nationwide have all recently announced capital raising initiatives, partly in response to leverage concerns. We expect a lot more to follow. In addition, as demonstrated by the recent placement by Lloyds in the UK, governments will also be looking for early opportunities to offer their stakes back to private investors as confidence builds.

We also think investors should give them a decent hearing – forced de-leverage on the asset side leaves money on the table, and if investors are put off by the dilutive effects of de-leverage on the liability side they can always re-lever their own portfolios.

In summary, while de-leverage take 1 was all about asset contraction, in de-leverage take 2 the emphasis needs to shift to capital expansion.

While concerns about market disruptions, distortions and adjustment costs are legitimate in the short run, in the longer run they are overstated.
What’s changed?

The banking crisis triggered a comprehensive review of bank prudential regulation, leading to (i) a tightening of the risk-based capital requirements and (ii) the introduction of a variety of additional measures to stabilise the industry, covering liquidity, funding and leverage.

Since Basel III came into view, most of the focus – in terms of bank responses – has been on (i) as banks have sought to offset the impact on their regulatory capital loads under the guise of ‘RWA optimisation’ programmes.

With the Basel Committee’s recent publication of a consultative document on the Leverage Ratio (Revised Basel III Leverage Ratio framework and disclosure requirements, June 2013), and the coincident publication by US regulatory authorities of a Revised Supplementary Leverage Ratio (RSLR), the regulatory community has sent out a stark reminder of its determination to see banks de-lever as well as de-risk.

Although the market has been quick to latch onto suggestions that the Leverage Ratio (LR) is intended only as a back-stop (albeit a short back-stop) to the risk-based capital regime, and has so far directed most of its critical reaction at the respects in which it might become the de-facto ‘front-stop’, there are reasons to believe the regulatory community is running a more nuanced agenda. The clue to this is in the first paragraph of the consultative document which emphasises the importance of regulating leverage per se, as opposed to the need to back-stop the existing risk-based regime (see Exhibit 1).

The key concern here is not so much the fact of excess leverage (a concern which would be difficult to explain in the context of ostensibly adequate risk-based capital) but the potential for pro-cyclical damage to be caused to the underlying economy when funding markets get spooked and force an abrupt correction. In this light, the fact that the consultative document goes on to describe the LR as a back-stop to the risk-based regime should not be taken to mean that it is intended always to take the back seat in setting capital requirements.

Exhibit 1

“An underlying feature of the financial crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while maintaining strong risk-based capital ratios. At the height of the crisis, the market forced the banking sector to reduce its leverage in a manner that amplified downward pressure on asset prices. This deleveraging process exacerbated the feedback loop between losses, falling bank capital, and shrinking credit availability.”

Meanwhile, it won’t have escaped regulators that, though they may calibrate the LR to take the back seat to risk-based capital for the average bank, for many (non-average) banks, it will become the defining factor in setting their capital requirements. Nor will it have escaped them that, with the risk-based capital ratio and the LR acting in close concert, overall bank capital levels in the system will end up being ratcheted up significantly. Nor, indeed, will it have escaped them that, by publishing their target ratios at this stage of the process, and with some regulators and plenty of pundits calling for more stringent ratios than the 3% indicated in the BCBS paper (the Swiss and UK authorities being the latest to signal tougher ratios), markets are effectively already holding banks to a higher set of standards. We suspect regulators won’t be displeased with any of this, as it all contributes to their over-riding agenda of forcing banks to hold more capital to replace or buffer the implicit state guarantee.

In time they might reflect that a more straightforward, less distorting and less disruptive means of doing this would have been to increase the risk-based capital ratios (in our view risk remains the only coherent way in which to regulate bank capital, and leverage), and maybe to insert a ‘long back-stop’ LR to mitigate model risk. But for now it is unrealistic to expect many concessions from the consultation process, and it is therefore prudent to plan for a regime which drives regulatory capital on two fronts. We could call this a ‘dual front-stop’ scenario.

Under this scenario, the ratchet effect will drive a very material shortfall. The most recent BIS and EBA Quantitative Impact Studies (QIS) show an incremental Tier 1 capital shortfall of €43bn for European banks to meet a minimum 3% leverage ratio, on top of €195bn to meet the new risk-based Tier 1 capital requirements.

Meanwhile in the Eurozone, the move to a Single Supervisory Mechanism (SSM) is being accompanied by a ‘Comprehensive Assessment’ of c.130 banks across Europe before the European Central Bank (ECB) assumes its role under the SSM in late 2014. The Comprehensive Assessment will encompass a Supervisory Risk Assessment, an Asset Quality Review (AQR) and a programme of Stress Tests, all conducted during 2014. The purpose of the AQR is ostensibly to flush out any remaining ‘bad news’ (potential credit losses in the pipeline that are not yet provided for under prevailing accounting standards), while the Stress Tests will assess their resilience to future shocks. Although it is not yet clear what the technical manifestation of the Comprehensive Assessment will be – i.e. what mixture of capital deductions and additional capital charges will be mandated – one way or another it is inconceivable that the process will not result in a call for more capital (the credibility of the process, the SSM and the ECB all depend on it). As such, banks found wanting will certainly face a further squeeze on their balance sheets. A recent report by Deutsche Bank has estimated the likely aggregate capital hit – on a subset of the 130 in-scope banks – from one widely anticipated and now strongly signalled feature of the AQR (the designation of accounts > 90 days past due as ‘non-performing’) to be in the region of €39bn. This does not take into account any further capital charges arising from the Supervisory Risk Assessment and Stress Test legs of the Comprehensive Assessment.

The potential aggregate impact of these Tier 1 capital shortfall components is shown in Figure 1 above.

2 Swiss finance minister calls for tighter leverage rules – Financial Times 5th November 2013. UK exchange of letters between Chancellor George Osborne and BoE Governor Mark Carney, 26th November 2013.

3 A recent suggestion, from Sir John Vickers, former chairman of the UK Independent Commission on Banking, was a doubling of capital requirements from 10% to 20% of RWAs – Sir John Vickers speech to Regulatory Policy Institute, reported in Financial Times 9th Sept 2013.

4 In September 2013, the Basel Committee and the EBA both published updated QIS estimates of capital shortfalls relative to full implementation of the Basel III framework. Risk-based Tier 1 capital requirements are calibrated as 8.5% of RWAs plus G-SIB buffers where applicable.

5 European Banks Strategy: Benchmarking impairments ahead of the asset quality review, Deutsche Bank Markets Research, 3 September 2013.

6 Recognising that the €39bn estimate from the AQR does not capture the full population of in-scope banks, and does not capture the potential impact of the Supervisory Risk Assessment and Stress Test legs, the total impact of the ECB Comprehensive Assessment could be substantially (say 50%) higher. Likewise, with the LR impact calibrated to the ‘minimum’ 3% standard suggested in the BCBS consultation paper, leaving open the possibility that national supervisors will tighten their regimes further with respect to the LR, together with other instruments under their discretion, the overall impact could be very substantially higher.
The LR (and, in the Eurozone, the ECB Comprehensive Assessment) will therefore trigger a fresh wave of de-leverage activity on one or other (or more likely both) sides of banks’ balance sheets.

De-leverage has been the dominant post-crisis mantra, but for various reasons, and with some exceptions (including the emergency government re-capitalisations at the height of the crisis, and the spate of capital raisings that followed the EBA stress tests in 2011), much of what has taken place so far (in the name of ‘RWA optimisation’) – and the preferred response by banks – has been on the asset side (reducing assets, or reducing their risk weightings).

While considerable progress has been made in improving risk-based capital ratios, when viewed through the lens of the LR, progress has been less impressive. This is partly because the de-leverage has obviously been targeted at the higher risk, more RWA intensive, end of the spectrum which carries no particular advantage in LR terms. Worse still, because much of it has not involved asset shrinkage at all, but rather RWA ‘mitigation’ measures in the form of model changes, operational changes (e.g. central clearing of derivatives), and various risk transfer mechanisms (e.g. the purchase of credit protection), these forms of ‘quasi de-leverage’ will be of little or no benefit in terms of the LR, depending on the outcome of the consultation process.

The significance of this is illustrated clearly by the fact that, for a cross section of 16 major US and European banks we have studied, while their RWAs fell by an average of 6% in 2012, their underlying assets fell by only 1.7%.

In contrast, financial (i.e. liability side) de-leverage has so far been less favoured, owing to bank (and, by proxy, investor) concerns about Return on Equity (RoE) dilution, weak underlying earnings (limiting scope for capital generation through earnings retention), and a general lack of investor appetite for bank stocks (effectively driving fresh equity issuance off the agenda).

There are signs however that conditions are changing on all of these fronts.

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5 Five of the sixteen banks studied had a differential between RWA and underlying asset changes of over 8 percentage points and two had a differential of over 12 percentage points. All of this subgroup of five reported substantial RWA reductions (more than 10% on average and over 20% in one case) and all but one had positive underlying asset growth.
Firstly, investors are arguably becoming more accepting of the low leverage/low risk/low return paradigm that is the new reality. To some extent this could be them just coming to terms with the facts, but the evidence that equity costs are subsiding, as both leverage and underlying asset risks diminish, could help to explain why stock prices, and market-to-book valuation multiples, are recovering even as absolute RoE expectations adjust downwards. While tax effects have traditionally been viewed as favouring leverage, the prospect of tax changes\(^8\) and heightened credit spreads on debt funding (particularly in a bail-in world) has substantially offset, if not reversed, this position.

In our August 2012 report, ‘Banking Industry reform – a new equilibrium’\(^9\), we highlighted an emerging downward trend in bank equity costs to a new ‘equilibrium’ range of 8%-10%, through a combination of reduced bank asset risk and reduced leverage. A year on, Figure 2 above confirms this trend, with the estimated CoE for the same cross section of 16 US and European banks used in our earlier study dipping into our target range in 2013\(^{10}\).

This is a crucial development, underscoring the importance of looking at the impact of de-leverage, and the cost of alternative de-leverage strategies, in terms of Economic Spread (RoE less CoE) as opposed to headline RoE.

Secondly, as earnings grow on the back of underlying economic recovery and banks make further progress on the cost front, earnings retentions should help to replenish capital stocks organically. In their recent Q2 and Q3 results presentations the banks have been very careful to predicate any resumption of dividend growth on first meeting capital ratios.

Thirdly, with confidence in underlying economic conditions gradually returning, helping to allay concerns about greater-than-expected credit losses in the pipeline (the AQR notwithstanding), and even bringing the prospect of asset and earnings growth back into view, banks are sensing the opportunity to break out of the asset de-leverage spiral by tapping the capital markets again.

Following the emergency recapitalisations of 2008/9, and the brief spate of capital increases on the back of the 2011 EBA stress tests, banks have been relatively slow to respond to the Basel II.5 and Basel III changes starting to come on stream from the end of 2011. We are now (belatedly) seeing a significant upturn in capital issuance activity from European banks with announced ‘discretionary’ capital raisings so far in 2013 (c. €63bn) more than double the total for 2012 (c. €30bn), helped no doubt by a recovery in bank stock prices\(^{11}\).

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\(^8\) These include the downward trend in marginal corporation tax rates, and more targeted modifications to the tax code – such as the UK tax breaks on AT1 capital – to offset the leverage bias.


\(^10\) Our Q3 2013 estimate uses a risk-free rate (RFR) of 2.2%, an equity market risk premium (EMRP) of 5.75%, and a composite 1 year equity beta of 1.32 (down from 1.55 at Q4 2012). Looking ahead, with substantial further de-leverage in the pipeline, we see scope for the CoE to fall well into our target range. Although the RFR is expected to go higher, particularly in the US, this is likely to be moderated by continued softness in Europe and its impact should also broadly be offset by further gradual reductions in the EMRP. This will leave bank asset risk and leverage as the key drivers.

\(^11\) For the 16 US and European banks in our CoE analysis, aggregate market-to-book ratios have gone from 0.75 in Q4 2012 to 0.89 in Q3 2013, and the proportion boasting a ratio of >1 has gone up from 25% to 44%.
So, in summary, while we expect banks once again to work through the cascade of capital ‘mitigation’ options (lobbying; technical mitigation; business/operational mitigation; asset restructuring; liability restructuring) – echoing the approach taken to RWA optimisation – this time we expect them to reach the liability restructuring conclusion more quickly, through the combined logic of necessity, good sense, and opportunity. To re-cap:

**Necessity** – because traditionally preferred responses will not make as much impression this time. With lobbying, the writing is on the wall and the political pressure to increase lending is mounting. Technical and operational mitigation efforts will be hampered by the intentional transparency and catch-all simplicity of the LR (at least relative to modelled RWAs). With asset de-leverage, although there is still a lot in the pipeline, most saleable assets have already been earmarked as part of pre-existing RWA reduction programmes. If it turns out that these planned disposals do not help leverage ratios they will need to be reassessed. For example, while the spotlight may now shift to non-performing loans (NPLs) – those being the focus of the AQR and a lingering source of anxiety for would-be investors – banks may not get much change, in capital terms at least, from further NPL disposals12. In the performing loan categories, doubtless there is still some portfolio rationalising to be done. However, we believe this will be at the margin (more to realign product and customer strategies than as part of a wholesale balance sheet restructuring programme) and again is unlikely to yield much capital benefit in LR terms.

**Good sense** – because, relative to the very real costs and opportunity costs of de-leverage on the asset side13, and the operational and compliance costs of running regulatory capital mitigation programmes (not to mention the evident futility of much of it – regulators are ultimately determined to drive up capital levels one way or another, and the evidence is that ratios are going up, not down), the economic costs of liability restructuring, to the extent they exist at all, start to look like very good value. This is particularly so when you consider what a strong capital position buys in terms of the opportunity to invest into an economic recovery14.

**Opportunity** – because the renewed investor confidence in underlying economic recovery has somewhat lifted the cloud over banking, so going to the market for fresh capital is no longer the laughable proposition it was a year or two ago. With recent announcements by Credit Suisse, Barclays and Deutsche Bank, to name a few, and of course the move by the UK government to place part of its stake in Lloyds, successful precedents have already been set15. Of course while confidence is returning, the market’s appetite is not infinite, it may not yet be ready to absorb the tide of new issuance we see coming. Of course it also remains vulnerable to macroeconomic and sector-specific16 setbacks and volatility, especially with the eventual winding in of the Quantitative Easing (QE) programmes in the US and UK. So banks seeking to go down this road will need to engage with investors, have their prospectuses in good shape, and take their opportunities while they can.

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12 Asset sales would have to realise better than 97% of book value to be of any use in LR terms, otherwise the P&L and therefore capital hit would effectively wipe out the capital relief.

13 Valuation haircuts on asset disposals; operational costs of running non-core structures and programmes; earnings and growth options foregone on sold or discontinued businesses; and stranded operating expenses that do not shift with the disposed assets.

14 In fact this argues for raising capital well in excess of regulatory requirements.

15 Building societies and other mutuals may have more limited options for capital raising, although Nationwide’s planned issuance of Core Capital Deferred Shares sets a precedent for overcoming this constraint.

16 The fragility of the economic recovery, the recent wave of regulatory fines for product mis-selling and Libor fixing scandals, and the new probe on FX, suggest that confidence – not capital – is still the real scarce commodity.
Figure 3 below illustrates our hypothesis for how we would expect the c. €277bn capital shortfall shown in Figure 1 above to be closed, across the broad categories of Rule Changes (lobbying); Technical & Operational Mitigation (paper changes, netting and other forms of balance sheet compression); Asset Restructuring (sale or runoff); and the balancing figure of Liability Restructuring.

Figure 3 – Closing the capital gap: hypothetical balance of measures

- Total capital need: €142bn (5% of €180bn)
- Rule Changes (lobbying): €14bn (20% of €70bn)
- Technical & Operational Mitigation: €55bn (10% of €55bn)
- Asset Restructuring: €28bn (65% of €28bn)

Source: PwC Analysis
While we have no doubt that the equity market could ultimately absorb this, and substantially more if required (this is not new money, after all, just a substitution of one form of capital for another), €180bn is clearly a big number to get away in a relatively compressed timeframe. It is more, for example, than has been issued in aggregate since the beginning of 2010—a period that includes the market responses to the last set of EBA stress tests in 2011. To put this in perspective, Figure 4 below plots total announced European bank capital issuances, including government bailouts, for each year since 2007, relative to our suggested liability restructuring target of €180bn.

There are two inferences to draw from this:

1. Banks which are in a (relatively better) position to issue new equity sooner rather than later should give this serious consideration—there are potential competitive advantages in going early, and downstream scenarios from leaving it until later that are worth avoiding17; and

2. Liability restructuring cannot and should not just mean ordinary equity issuance and profit retention, particularly for those banks that might still struggle on this front. They will have to consider a range of additional/alternative liability restructuring measures to close this gap.

Figure 4 – European bank equity issuance 2007 – 2013 (€bn)
And whether they have to look at alternatives or not, they may find it advantageous to do so as there are potential efficiencies to be had from taking a more finessed approach. These include tax efficiencies on certain classes of capital instrument\(^{18}\), capital usage efficiencies from internal capital restrucrurings and issuance strategies\(^{19}\), and economic cost efficiencies from tapping into specialist investor appetite for the risk/return properties of segregated asset pools. As there are interdependencies and cross-benefits associated with each of these, we see them being explored and executed under a coordinated ‘programme’ approach to liability restructuring.

Aside from increased issuance of CET1 and AT1 capital, in de-leverage take 2, we see three specific developments on the liability restructuring front:

1. Intra-group structures (involving some combination of internal capital, asset, or risk transfer) to make best use of existing group capital resources. This is a particular focus for international banks facing multiple and potentially volatile local regulatory capital demands. Inter-company issuance of AT1 securities, a somewhat more flexible means of transferring capital internally, is an example of the sort of thing that could help.

2. A gradual resumption of issuer and investor interest in the traditional securitisation market, possibly involving a combination of the American and European models\(^{20}\), essentially using funding structures to help drive de-leverage (essentially a hybrid of liability and asset restructuring). In this case we see the choice of structures being determined, firstly, by the balance of needs between RWA relief and LR relief and, secondly, by how the target assets segment across core versus non-core and performing versus non-performing dimensions. However, given the history of these markets, we would expect regulators and investors to look carefully at the strategic context and to insist on simplicity, transparency, alignment of interests and evidence of legitimate risk-transfer.

3. The potential emergence of new structures aimed at getting qualifying capital onto the balance sheet as opposed to pushing existing assets and exposures off it. As an example, there are good economic grounds\(^{21}\) (and, for that matter, good public policy grounds\(^{22}\)) for portfolios of bank assets to be housed in subsidiary structures into which new tranches of minority equity could be subscribed. The key advantage of this, in terms of regulatory ratios, is that minority equity in these structures could potentially count towards overall group capital resources, thereby improving capital ratios through the numerator and reducing the need to tackle the problem through the denominator (and the possible self-defeating consequences that could stem from that\(^{23}\)).

A logical extension of these developments might ultimately see banks substantially breaking the balance sheet ties altogether for their core equity holders and repositioning themselves as relationship, origination, distribution, customer service and administrative engines for assets held in separately capitalised vehicles or outside the core banking system altogether. The prospect here is of multiple categories of banking investor emerging – investors in banking assets; investors in core banking franchises; and investors in high-growth start-ups, service providers etc. This may well be an already established and separately driven trend anyway, which the latest regulatory developments are just helping to propel, wittingly or unwittingly.

Of course most banks will want to look at all this pre-emptively as going concerns. But, realistically, there may be some banks that do not make it through the rigours of the Comprehensive Assessment in their current forms. In which case, we could easily see some variation on these liability re-structuring (or indeed more wholesale balance sheet restructuring) themes, in a more distressed setting.

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17 The latter include having to raise capital or sell assets in less favourable circumstances, and being lumbered with the conditions that would undoubtedly accompany the exercise of national back-stops.
18 As in the case of the expected UK tax breaks on AT1 issuance (e.g. deductible coupon payments, exemption from bank levy, no witholding tax) some are specifically designed to incentivise this sort of thing – it makes sense for tax authorities to give something back from the debt tax shelter they are asking banks to forego, by way of an inducement to fund themselves with more risk-bearing capital instead.
19 Bearing in mind that the capital tests generally apply at subsidiary legal entity as well as group levels, putting the capital where it is needed and being able to move it around is unquestionably a good place to start.
20 Traditionally, the emphasis of asset backed structured financing, such as securitisation, has either been to get assets off the balance sheet (typical of the North American market), or to derive debt funding benefits for assets still on the balance sheet (more commonly used in Europe).
21 These include tapping into differentiated investor groups (such as private equity and sovereign wealth funds) to broaden and deepen the investor base (i.e. mitigating reliance on ordinary equity markets); potentially also alleviating the ‘toxic drag’ and general balance sheet drag that arguably continue to handicap some banks’ share price performance; without causing undue disruption to operations or customer relationships.
22 Likewise, opening up sources of new private sector capital, and also curtailing some of the externalities that come with other forms of de-leverage such as undermining asset prices, restricting credit supply to the economy, and fuelling too-rapid growth in shadow banking.
23 Such as crystalizing capital losses, reducing earnings and ‘stranding’ operating expenses.
Insofar as banks are genuinely capital constrained, the Comprehensive Assessment and LR proposals, on top of existing Basel III requirements, pose some significant challenges in the short term (i.e. until they can restructure on one or other side) and this has far reaching implications in terms of:

- Pricing and liquidity in key markets, notably mortgages and repos/SFT which have a high asset (as opposed to risk-weighted asset) intensity.
- Potentially forcing further asset de-leverage, distorting existing re-structuring programmes, or curbing new lending.
- Frustrating other aspects of the reform agenda, e.g. driving down the volume of quality assets held for liquidity purposes; adding further friction to the capital structures of international subsidiaries; and countering the attractiveness of investing in other risk-reducing reforms (e.g. margining, clearing, securitisation).
- Incentivising holdings of marginally higher risk assets (including through embedded leverage).

Although touted as a ‘simple’ measure, there remains for now a high degree of complexity and uncertainty in the definition and application of the LR. Likewise, although the ECB has set out the broad terms of the Comprehensive Assessment, its precise manifestation in terms of capital supply and demand impacts, the timeframe and means by which resulting gaps will be closed, and what impact this will have on the European banking sector and real economy, all remain very unclear.

Furthermore, even at its simplest, the addition of the LR to the ‘problem set’ for capital constrained banks – having now to deal simultaneously with risk-based capital ratios, leverage ratios, liquidity ratios, net stable funding ratios etc., across multiple business lines, jurisdictions and timeframes – has added substantially to the complexity of their decision making24. Together with the existing frictions imposed by the recovery and resolution agenda (in particular ring fencing and the pressure to move from branch to subsidiary structures), this compounds the risk that the industry will be set back in its ability to resume normal service and so underpin and fuel the economic recovery.

We expect all of this to mark out clear winners and losers in the short term, as it will bear differently on different banks. Hence, a key issue for all banks to consider is how they will be impacted relative to their peers and competitors in terms of (i) cross-jurisdictional differences in minimum ratios (net of differences in accounting bases/exposure definitions); (ii) having greater or lesser than industry average concentrations of business activities that fare poorly under LR versus RWA driven capital requirements (e.g. collateralised derivatives; securities finance; high quality structural investments; activities requiring high liquidity buffers); and (iii) being worse or better placed than their peers to respond with liability-side solutions.

24 We are seeing a lot of focus now on the establishment of new functions, processes and models to help banks ‘optimise’ their portfolios and businesses to the new set of regulatory and market constraints they’re faced with.
On the basis of current plans and proposals, big questions have arisen about the overall thrust and coherence of the package that is Basel III (specifically how the LR will operate alongside risk-based capital measures, liquidity and funding requirements). Between that and the Comprehensive Assessment, the European banking industry is facing another turbulent couple of years on the de-leverage/restructuring/reform fronts.

But, for all that, these challenges, frictions, market distortions and competitive biases are only short term phenomena, resulting from the legacy of an over-levered banking industry, and the continued urgency of the policy and regulatory response, versus the lead time required for banks and their investors to adjust themselves to that response.

As ever with major pieces of regulation, the pain is largely in the transition rather than in the end state. On this occasion, however, there is a chance to take a somewhat less painful path: with economic confidence gradually returning; bank valuations returning towards – in some cases through – par (market to book); and investors more or less reconciled to the reality (if not yet fully sold on the merits) of a less levered bank sector, there is a chance for banks to make a virtue of necessity and restructure their capital.

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