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TRENDMACRO LIVE!

On the Basel III Rule Change

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Lorcan Roche Kelly

Four more years, and lower liquidity standards: risk to EA bank profits wanes.

The Basel Committee on Banking Supervision yesterday released the latest iteration of the Basel III rules. This update is positive for the banking sector as it unwinds some of the more stringent rules in the original Basel III directive that had been a direct threat for future bank profitability.

- Banks now have until 2019 to fully implement the new directives, a four year extension from the previous 2015 deadline. This will particularly benefit peripheral euro area banks as they would have been under most pressure to meet the liquidity targets under the original rules.
- Not only do the banks have more time, they also have less to achieve. The new rule expands the definition High Quality Liquid Asset (HQLA) to include a lot of instruments that aren't particularly high quality:
    - Corporate debt rated as low as BBB-
    - RMBS rated AA or better
    - Equities
- While haircuts on the new HQLAs are as high as 50% -- and they cannot make up more than 15% of total HQLAs, *after haircut* -- their inclusion does make the HQLA criteria more flexible.
- HQLAs are needed by banks to preserve liquidity coverage ratios as they meet outflows -- withdrawals of funds by depositors -- during times of stress, so liberalizing the definition helps banks pass stress tests. In more good news for the banks, the assumed outflow rate in the stress test models has been reduced from 5% to 3% on insured retail deposits, and from 40% to 20% on corporate assets. Rather bafflingly, previously there had been a 25% assumed outflow rate for secured central bank funding. Sensibly, this has now been reduced to zero.

Taken together, the additional four years to meet new directives, the liberalized definition of HQLA, and the reduced modeled outflow rate mean that the pressure on banks to continue to deleverage has substantially reduced.

Peripheral euro banks -- who would have struggled to reach the original directives -- will be the biggest benefactors, a view confirmed in the

Update to strategic view

EUROPE FINANCIAL STOCKS: The latest iteration of Basel III rules takes pressure off bank deleveraging, with peripheral euro banks likely the biggest benefactors. Banks have been given more time to do less. This slowdown in the mandated shrinkage of their balance sheets -- or even possible balance sheet expansion for those who had already complied with the more stringent directives -- will feed through to their bottom line. Despite reaching levels not seen since the LTROs, we still like peripheral euro area financials, particularly large banks in Spain, Italy and Ireland.

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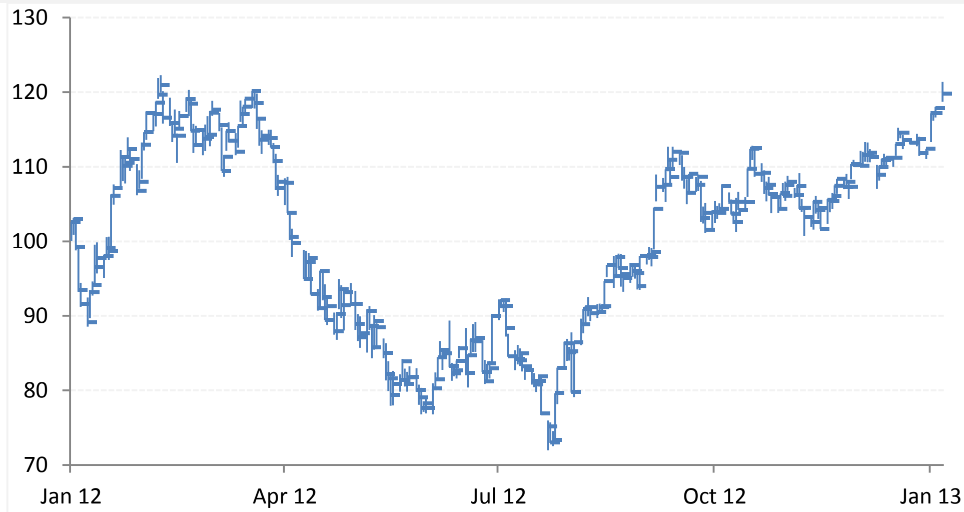
markets this morning as the STOXX EA bank index finally broke through the post LTRO euphoria level of a year ago (please see chart below), something we have been calling for since September (see "Europe Beyond Draghi's Promised Land" September 13, 2012).

STOXX 50 euro area bank index



Source: Bloomberg, TrendMacro calculations

- We continue to like large Spanish, Italian and Irish financials. The only possible event risk on the horizon for them is the coming Italian election (see "On Monti's Resignation" December 10, 2012), which at the moment seems unlikely to cause a major shift in policy.
- Banks in the UK, Switzerland and Sweden had already done enough to meet the original 2015 deadline, so there is probably less upside there from this announcement -- indeed, they are an example of how no good deed goes unpunished in the surreal world of bank regulation.

Bottom line

The latest iteration of Basel III rules takes pressure off bank deleveraging, with peripheral euro banks likely the biggest benefactors. Banks have been given more time to do less. This slowdown in the mandated shrinkage of their balance sheets -- or even possible balance sheet expansion for those who had already complied with the more stringent directives -- will feed through to their bottom line. Despite reaching levels not seen since the LTROs, we still like peripheral euro area financials, particularly large banks in Spain, Italy and Ireland.

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Recommended Reading

Lunch with the FT: Robert Caro
Sarah Gordon
Financial Times
January 4, 2012

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