

Non-Technical Summary for: Capital Floors, the Revised SA and the Cost of Loans in Switzerland

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In December 2014, the Basel Committee issued two consultative documents BCBS 306 and BCBS 307 proposing changes in how banks calculate capital. The proposals include new rules for the capital of less sophisticated banks that use Standardised Approach (SA) regulations and a set of capital floors for advanced banks that employ the Internal-Ratings Based Approach (IRBA). (For information, all banks in Switzerland except UBS, CS and one cantonal bank are SA banks.)

The proposals have multiple objectives including (i) improving comparability of capital across banks, (ii) reducing discrepancies between the use of capital floors by different countries, and (iii) reducing the reliance of capital on agency ratings (an objective particularly important to the United States following the adoption of the Dodd-Frank Act which prohibits such reliance).

The proposals will have profound effects on the relative distribution of capital across jurisdictions, banks and types of loan. They are likely also to boost overall capital levels substantially. Important aspects of the distributional impact appear to result from a piecemeal calibration of the rules rather than a fully thought-through set of changes to relative capital.

To our understanding, the effects of the rule changes remain opaque to the industry and probably also to regulators. The Basel authorities are currently performing a Quantitative Impact Study (QIS) in which they ask banks to evaluate how the new rules would affect their capital calculations. However, we understand that many banks are finding it difficult to assess the impact accurately because of a lack of relevant data. In any case, the results of the QIS will remain confidential.

To shed light on what the proposals will mean, we have performed a detailed analysis of their implications for the Swiss loan market. In this, we study the effects on 37 individual banks, breaking down results by different loan categories. We then re-aggregate the findings which we report for Large banks, Cantonal banks and Other banks.

Our analysis consists of two steps. First, we calculate the impact on the capital that banks will have to hold against loans in different categories. Second, we estimate the effect on the spreads that banks would charge for making loans in these categories. This latter step involves estimating banks' cost of funding given their regulatory capital requirements.

Our results reveal dramatic and in some cases, we suspect, unintended effects of the proposed regulations. Capital for corporate loans within Switzerland would be substantially boosted by the rule changes whereas capital for residential mortgages would fall for SA banks (while increasing for IRBA banks). IRBA banks would be required to hold substantially greater capital whereas capital for SA banks would in many cases fall.

Changes to capital levels matter for the rest of the economy to the extent that they affect the lending rates that banks charge. To reveal the implications for lending rates, we study how bank loan spreads (over and above Treasury yields) would be affected.

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Spreads reflect bank funding costs. Banks finance a given loan using a combination of deposit and equity funding. The latter is considerably more expensive to a bank, dollar for dollar. The volume amount of equity funding that a bank requires for a loan is determined by the regulatory capital a bank is required to hold. Changes in regulatory capital requirements, hence, alter bank funding costs and feed through into the interest rates banks demand from borrowers.

The figure below shows the percentage change in capital that Swiss banks will have to hold under the new regulations against their loans to Swiss borrowers. We focus on four key loan categories: exposures to banks, corporate loans, commercial mortgages and residential mortgages. Corporate and commercial mortgage capital increase substantially. Capital for residential mortgages hardly changes (although this reflects offsetting rises and falls in increases in IRBA and SA bank capital for residential mortgages).

Figure: Percentage changes in capital

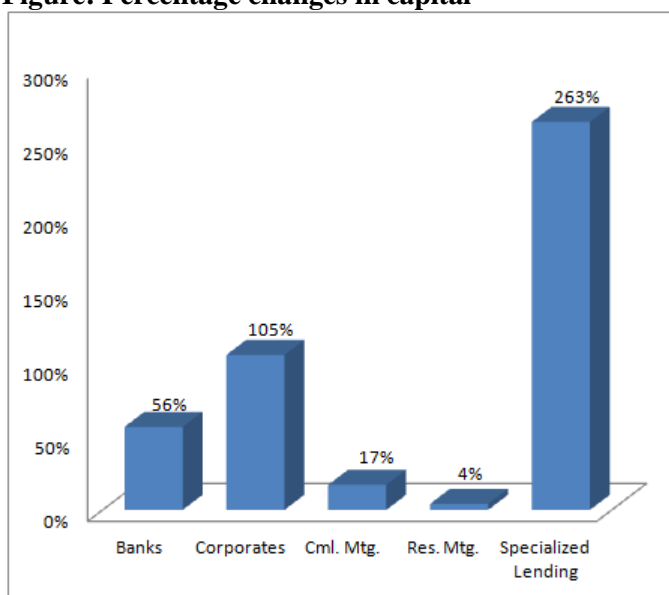


Table: Increases in spreads (in basis points) resulting from changes in capital rules

	Banks	Corp.	CML. Mtg.	Res. Mtg.	Specialized Lending	Wtd. Avg.
CET1 capital target						
Wtd. Avg. of IRB Banks	3	60	57	9	70	30
Wtd. Avg. of IRB and SA Banks	7	45	14	2	70	11
Total capital target						
Wtd. Avg. of IRB Banks	6	103	90	15	121	51
Wtd. Avg. of IRB and SA Banks	11	73	22	3	121	19

The table shows weighted average estimates of *changes* in bank lending spreads that would result from the adoption of the new bank capital rules. Estimates are presented for two assumptions about the relevant definition of equity capital: Common Equity Tier 1 (CET1) or Total Capital.

The increase in the cost of lending due to the spread change is CHF 1.3 billion or CHF 2.1 billion per annum (depending on which of the capital definitions is employed).