Banks' Adjustment to Basel III Reform

A Bank-Level Perspective for Emerging Europe

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Basel III reform relies on **higher capital quality and higher capital ratios**.

However, initial concerns about **potential macroeconomic costs**.

Strategies of capital accumulation:

1. Issue new equity (benign)
2. Cut dividend payments (benign)
3. Increase retained earnings by
   a) Higher operating efficiency (benign)
   b) Increase lending margins /spreads (costly)
4. Reduce risk-weighted assets by
   a) Shifting portfolios towards less risky assets (costly? benign?)
   b) Cutting the size of the loan portfolios/assets (costly)

Ex-ante assessment of potential macroeconomic costs

- Macroeconomic Assessment Group (2010) and Basel Committee on Banking Supervision (2010)
  - 1 pp increase in capital ratios would raise spreads by around 15 bps, pushing down lending volume by approximately 1.5 percent.

Ex-post assessment **did not support initial concerns**.

- Cohen (2013) and Cohen and Scatigna (2014)
  - Focused on 94 world largest banks.
  - Mainly retained earnings used to accumulate capital.
  - Both lending spreads and lower dividend payouts used.

Our work

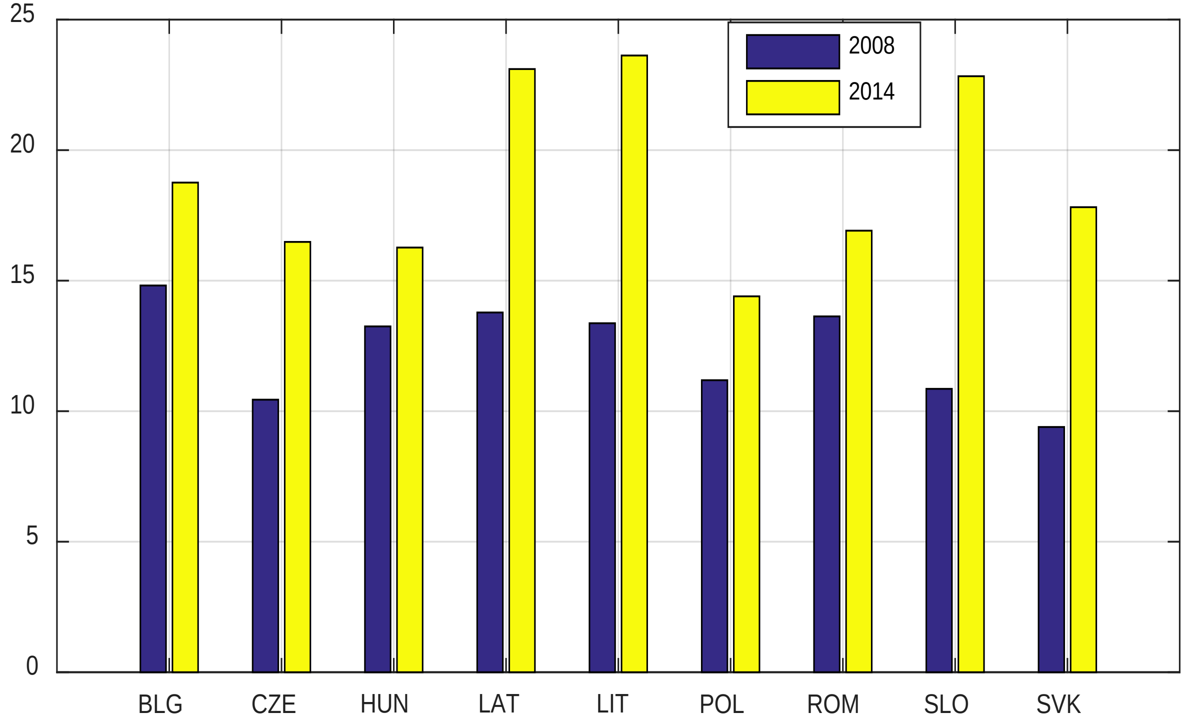
- **Identify strategies of capital accumulation** followed by commercial banks, ...
- ... applying the analysis of Cohen and Scatigna (2014) to ...
- ... nine emerging markets countries in the EU – BLG, CZE, HUN, LAT, LIT, POL, ROM, SLO, SVK.

- Five largest banks in each country – above 50 percent in all countries.
- Balance sheets and income statements data in 2008—2014 collected from Bankscope.

Forthcoming IMF WP – **Michal Andrle** (IMF), **Vladimir Tomsik** (CNB), and **Jan Vlcek** (CNB)

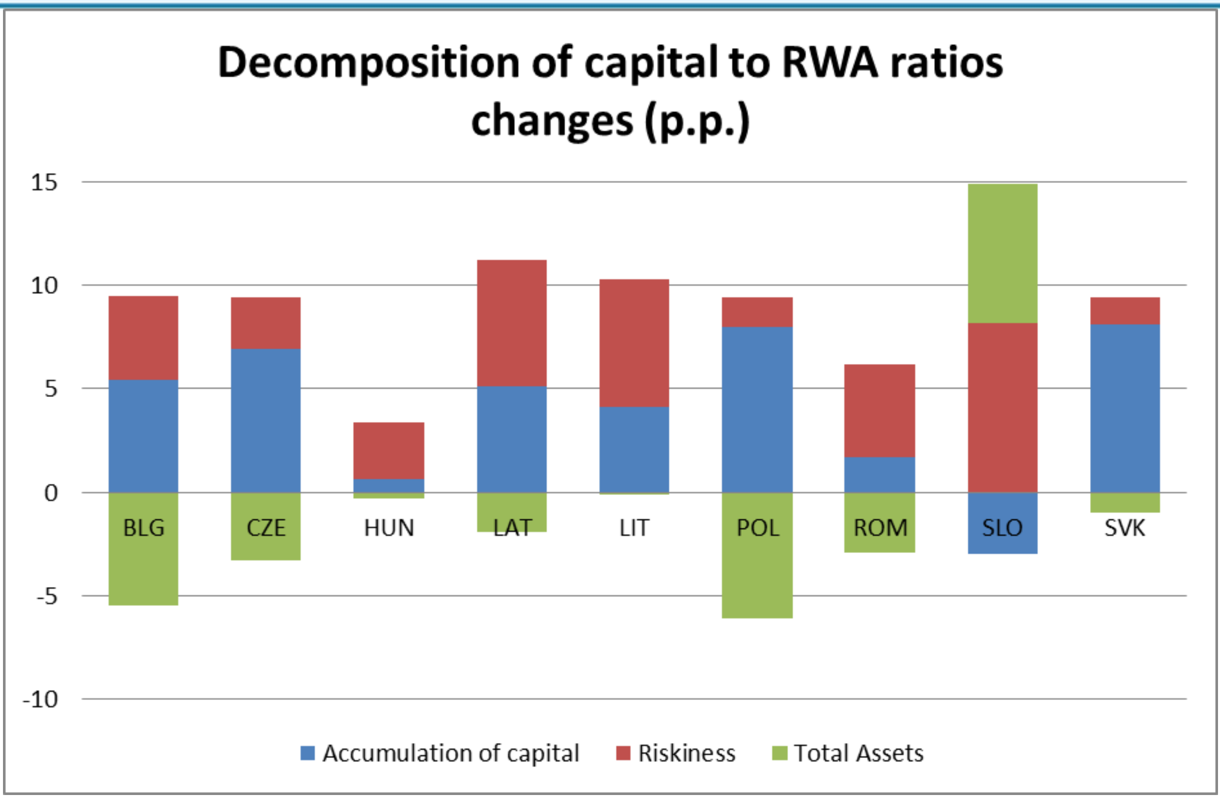
Capital to Risk Weighted Assets

Capital to Risk Weighted Assets (percent, Basel II definition)



- The share of **capital to risk weighted assets (CAR) increased in all countries**, from the level of around 10—15 percent in 2008 to about 15—25 percent in 2014.
- However, capital ratios differ in levels as well as in dynamics across countries.

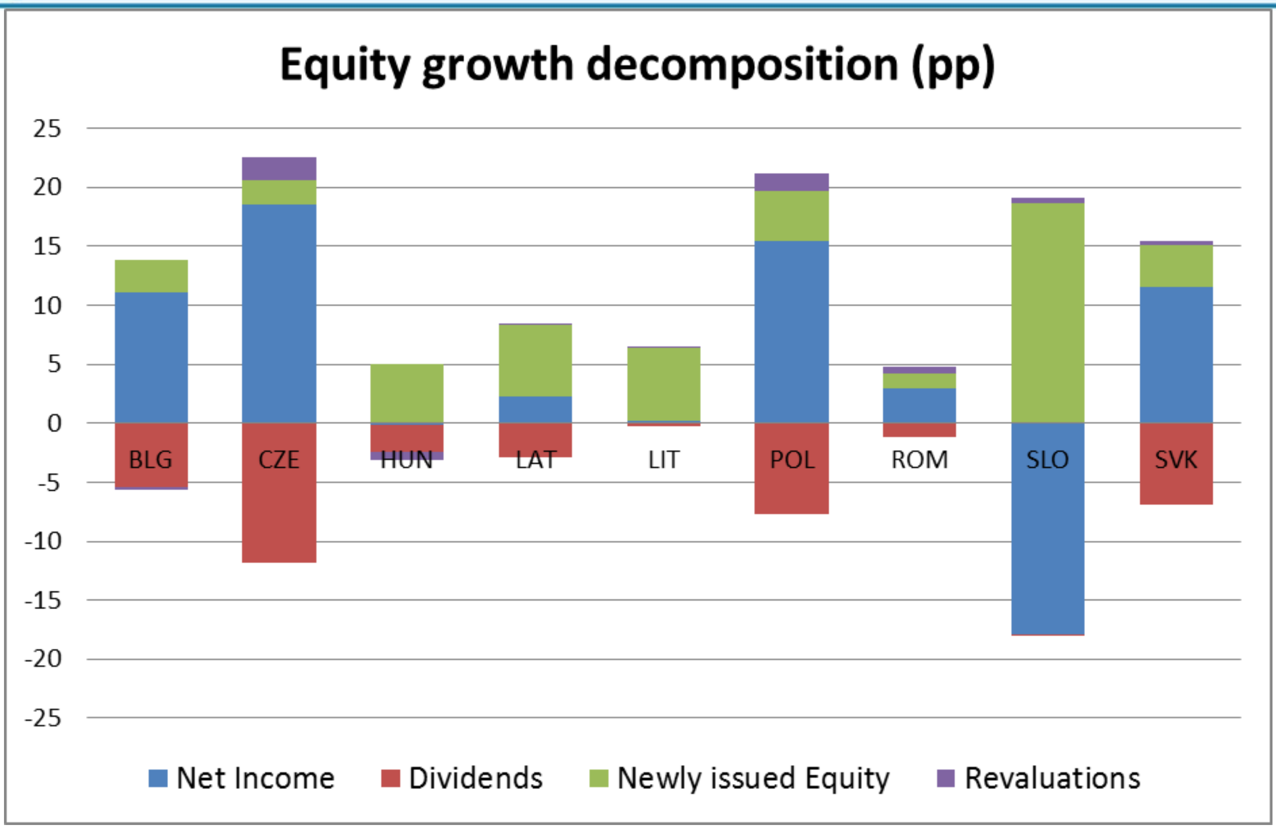
CAR Change Decomposition



Banks raised capital ratios mainly through

- **Accumulation of capital** (positive blue bars) and …
- … **reduction of the riskiness** of their portfolios (positive red bars, strategy 4a) on the back of **increasing size of their balance sheets** (negative green bars).
- **Conclusion**: The most costly strategy (strategy 4b), the reduction of assets, did not take place (except SLO).

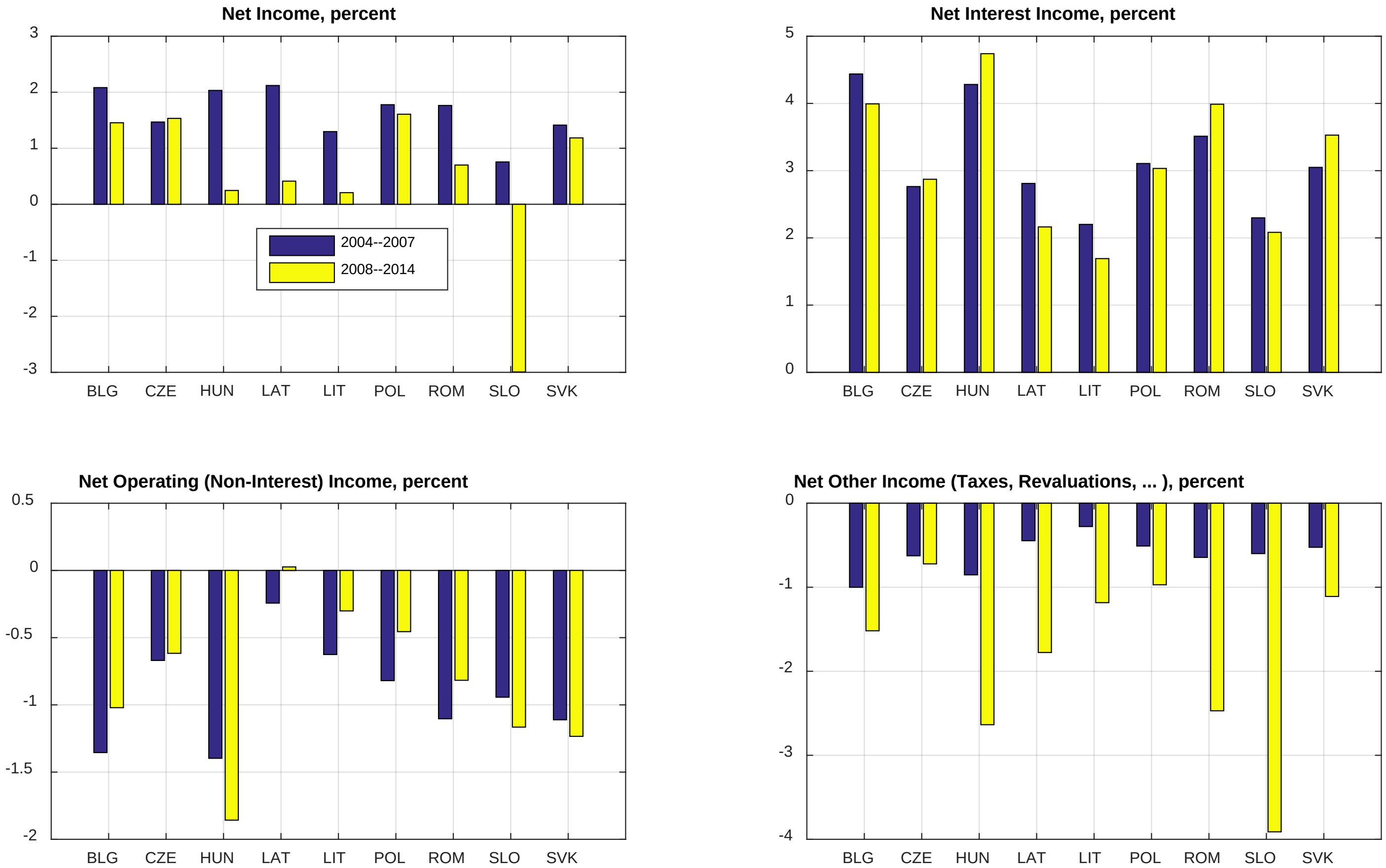
Capital Accumulation Decomposition



- Profitable banking sectors used **retained earnings** (strategy 3) to accumulate capital.
- Less profitable or banking sectors facing losses rely mainly on newly issued equity (strategy 1).
- Banks seem to be reluctant to reduce dividends (strategy 2), keeping the dividend payout ratio mostly stable along time.

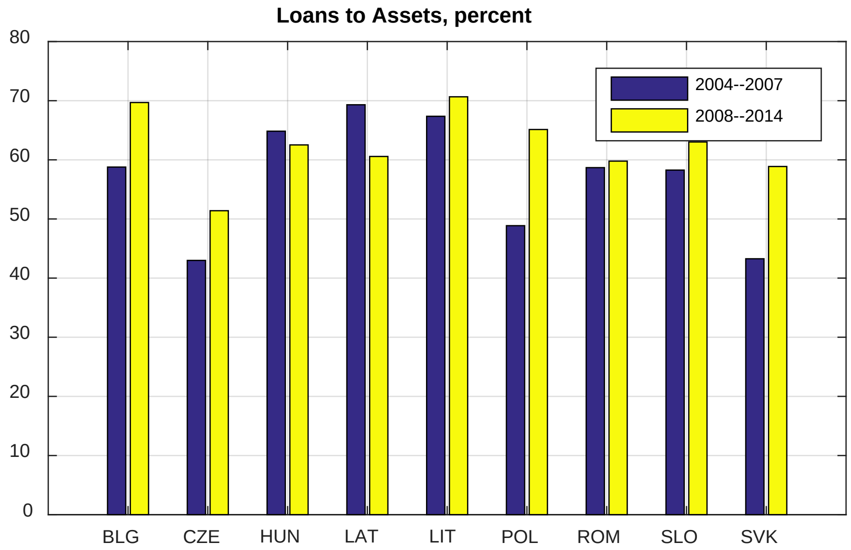
Net Income Decomposition

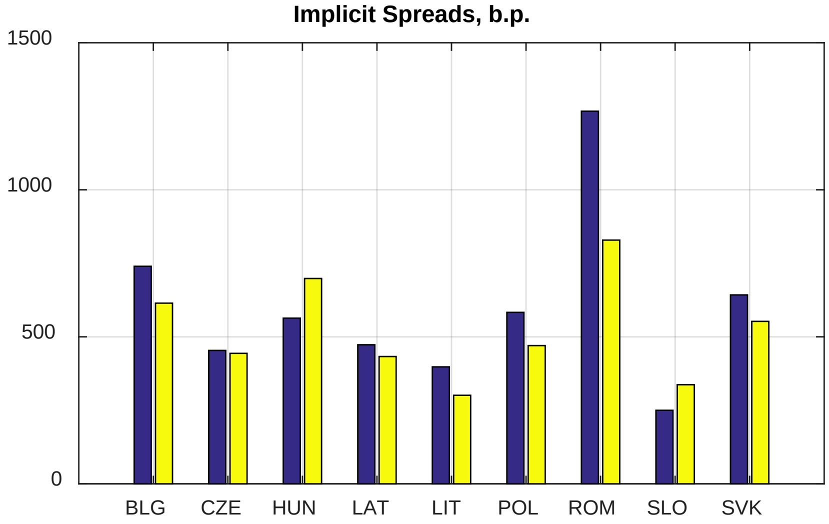
CZECH NATIONAL BANK



- Profitability (net income on assets) declined in most of countries.
- While the evidence on net interest rate income is mixed, ...
- ... lower operating costs (strategy 3a) were not able to offset higher losses from revaluations and taxes.

Net Interest Income Decomposition





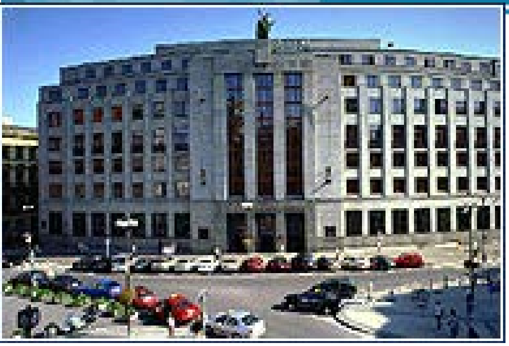
- Banks in the examined countries did not reduce the share of loans in total assets. Strategy 4b was not followed.
- We do not observe an increase of implicit lending spreads in 2008—2014 above the pre-crisis average, except HUN. Strategy 3b not followed.

Summary Findings

Banks **accumulated capital using benign strategies** from macroeconomic perspective.

Concerns that banks would shrink their balance sheet by reducing their lending **did NOT materialize**.

- CAR increased mainly through
  1. Retained earnings, and
  2. Lower riskiness of assets.
- Retained earnings generated by net interest income and higher operational efficiency.
- Only banking sector struggling with profitability resorted to the issuance of new equity or shrunk the size of their balance sheets.



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Analysis is described in details in the forthcoming **IMF WP 2016 „*Banks' Adjustment to Basel III Reform: A Bank-Level Perspective for Emerging Europe*“**, authors are Michal Andrle (IMF), Vladimir Tomsik (CNB), and Jan Vlcek (CNB)