Could Basel III 'endgame' provide a rare opportunity for European banks?

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You don't have to search very hard to see reports that business is flowing towards US financial markets. This is not the case and much more nuanced analysis is required, especially in regard to listings with European markets hosting two of the largest global IPOs this year. Regardless, from listings to market structure changes like T+1, many voices suggest US financial markets are about to pull ahead of Europe.

While European financial markets face challenges like all markets globally, there is a golden opportunity emerging for European banks' securities finance businesses to counter this narrative. As a result of banking regulation changes, specifically the Basel III 'endgame' proposals, US banks will come under severe capital constraints. Although the specifics of the US Basel III updates are still being worked out, the regulation in its current form could offer a rare opportunity that could see some securities financing business move the other way across the Atlantic for a change.

Basel III 'endgame' biting

Looking specifically at the implications for securities finance transactions, there are notable changes ahead. US banks will face new minimum haircut floors for certain securities financing transactions that do not apply to their transatlantic cousins under the EU implementation or the UK proposals. In essence, this will see the introduction of minimum amounts of collateral banks must receive for stock borrowing, lending, repo and similar transactions based on the riskiness or volatility of the asset used as collateral. The minimum amount applies to banks for certain securities financing transactions with unregulated financial institutions (UFIs) that are not centrally cleared. Failure to meet the haircut floor for in-scope uncleared transactions means those transactions are treated as unsecured and therefore not available for credit risk mitigation, offset against a risk weighted asset calculation (RWA).

In plain English, this means that the US banks will face much higher capital requirements for those transactions. There are some exceptions, but without going into details, these are operationally complex to manage. In the past, when certain business functions have become too expensive to conduct due to a range of external factors, the result has often been a difficult decision between increasing fees or closing certain desks to focus on less capital intense activities.

US banks under pressure

There are some unexpected outcomes, including a knock-on impact to foreign businesses that have traditionally been supported by US banks. For example, the UK insurance industry has been a considerable source of securities financing business for US investment banks. If Basel III 'endgame' is introduced as it is currently slated, it will put significant pressure on the ability of the banks to continue business as usual. Aside from being a potentially difficult process for the US banks, it could hinder the ability of businesses to borrow from the markets.

This is where Europe's banks can play a supporting role. Yes, Europe and the UK will have their own version of Basel III updates. But current estimates show the impact will not be as detrimental, with expected capital increase for UK banks at 3%, 7-9% for EU banks against a staggering forecast 19% for the largest US banks. As such, UK and European institutions will be able to step in and play a greater supporting role in securities financing transactions and help buy-side firms in the market, without having to hold more capital to do so.

The European opportunity

Planning is needed, in particular European banks need to appraise the quality of collateral optimized as credit risk ready under the final version of the rules. To get to this position, banks can adjust their asset holdings to concentrate their balance sheet in less risky assets to reduce the risk weight making an asset more usable from a collateral perspective.

Also important is that RWAs matter when pricing securities finance transactions. Reducing the RWA on the agent bank side is essential to reducing the capital surcharge of the assets available for using as collateral. Funds provide a good source of collateral but can carry an intimidating 1250% capital surcharge on RWAs. To get ahead, optimizing the funds from a RWA perspective will be key to plugging the securities lending gap.

Thankfully, this is possible under Basel rules. Having regular access to the latest data is necessary to "look through" or decompose a fund to accurately classify and price it as collateral, based on its underlying assets, enabling the bank to reduce the RWAs and implied surcharge. While banks do engage in this process to some extent, the new rules stipulate "the financial information must be sufficient … to calculate the risk-weighted asset amount for each exposure held by the investment fund as if each exposure were held directly" by the bank.

The problem is the look though process is too often achieved by manually scraping data from asset management websites, which is inefficient and often results in inaccurate and untimely data; crucially beneath the threshold for adopting "look-through approach". In addition, the data and process should be validated by either a custodian or the asset managers themselves on at least a quarterly basis. But data providers with relationships with these asset managers and custodians can provide this information in a timely fashion removing this as a barrier to utilizing the funds from a collateral perspective.

With a year to go before Basel "end game", now is the time for European banks to put a strategy into place to capture more business because of this regulatory shakeup. In doing so, they can put themselves in a position to step in and play a critical role in securities financing markets, while many US banks are forced to reconsider their operations.