Basel III could lower big banks' ROE by 20%: Fitch

By Editor Test *Tue, May 22, 2012*

For financial institutions, Basel III creates a tradeoff between declining ROE, which might reduce their ability to attract capital, versus stronger capitalization and lower risk premiums, which benefits investors, says Fitch Ratings.

Analysts at Fitch Ratings in New York and London released a report last week summarizing the environment that faces the world's 29 largest financial institutions as they prepare for the higher capital requirements of the so-called Basel III rules promulgated by the Bank of International Settlements.

The report, "Basel III: Return and Deleveraging Pressures," reflects the urge by global banking authorities, in the wake of the global financial crisis, to reduce the risk profile of financial institutions that are so large that governments would have to support them—i.e., "bail them out"—if they were in risk of insolvency.

The Federal Reserve endorsed the Basel III rules last December and said that it would apply the rules to all U.S. financial institutions with more than $50 billion in assets. The new rules will be implemented between the end of 2012 and the end of 2018.

Timetable for meeting Basel III targets

The 29 global systemically important financial institutions (G-SIFI) might need to raise roughly $566 billion in common equity in order to satisfy new Basel III capital rules, according to a Fitch analysis based on year-end 2011 figures.

That represents a 23% increase relative to the aggregate common equity of $2.5 trillion of these institutions, which as a group represent $47 trillion in total assets. Basel III will not be fully implemented until six and a half years from now, but banks face both market and supervisory pressures to meet these targets earlier.

To address these shortfalls, banks will likely pursue a mix of strategies, including retention of future earnings, equity issuance, and reducing risk-weighted assets (RWA). Absent additional equity issuance, the median G-SIFI would be able to meet this shortfall with three years of retained earnings, which might constrain dividend payouts and share buybacks.

New capital requirements would hurt ROE

This potential capital increase could reduce these banks' medium return on equity (ROE) by more than 20%, from about 11% (their experience over the past several years) to approximately 8% to 9% under the new rules.

Basel III thus creates a tradeoff for financial institutions between declining ROE, which might reduce their ability to attract capital, versus stronger capitalization and lower risk premiums, which benefits investors.

Banks that continue to pursue ROE targets in the mid-teens (e.g. 12%–15%) would have to reduce expenses and raise prices on borrowers and customers where feasible, Fitch said. Banks may also seek to increase ROE through riskier activities that maximize yield on a given unit of Basel III capital, including the use of new forms of regulatory arbitrage.

How G-SIFIs might respond

G-SIFIs face a trade-off, with higher capital requirements potentially offset by competitive advantages stemming from their official status as systemically important institutions. Some investors and counterparties might perceive these institutions as more likely to receive government support in a distress scenario. This perception, coupled with the G-SIFI's higher capital standards, could in turn reduce funding costs and stimulate business flow from more risk-averse customers. Conversely, institutions that deem G-SIFI status as a regulatory burden might seek to reduce or limit their size and complexity in order to avoid this designation.