Bloomberg

# European Banks Challenged by Basel III Versus Solvency II

By Kevin Crowley - Mar 28, 2011

European banks are being forced to sell more long-term bonds as regulators seek to prevent another financial crisis. European insurers say their own regulator will stop them from buying such debt.

Basel III's liquidity rules mean European banks may need to raise as much as 2.3 trillion euros ($3.2 trillion) in long-term funding, according to New York-based McKinsey & Co. Insurers, the biggest buyers of such debt, are being dissuaded from buying long-term bonds under the European Union's Solvency II rules, which makes them more expensive to hold.

"The two bits of regulation are at tension with each other," said Simon Hills, an executive director at the British Bankers' Association, which represents more than 200 lenders from 60 countries. "One bit is saying you should have more funding with a longer duration and the other is saying watch out when buying this stuff if you are an insurance company. It's a big problem for banks."

European Commission President Jose Barroso called for a new system of financial regulation built on "common ground" among countries, regulators and international organizations following the worst financial crisis in 70 years. His efforts, which were supported by leaders such as Germany's Chancellor Angela Merkel and President Barack Obama, are being undermined by mismatching rules for banks and insurers, say industry executives and lobbyists, who are pushing to relax the new regulations.

## Bank Shortfalls

Basel III, due to be implemented in 2019, proposes requiring banks to hold enough cash or liquid assets to meet liabilities for a year. The aim is to wean banks off the short- term funding from other lenders that dried up during the crisis and sent Lehman Brothers Holdings Inc. into bankruptcy.

European banks will have a long-term liquidity shortfall of 2.3 trillion euros in eight years based on current business models, according to McKinsey. That's about half the banks' total capital and liquidity deficit under Basel III. U.S. banks' deficit is about 2.2 trillion euros, McKinsey said.

To make up these shortfalls, banks will have to issue more bonds with durations of more than one

year or increase retail deposits, the management consultant said. In the past 12 months, European lenders sold $893 billion of debt with durations of five years or more, according to data compiled by Bloomberg.

Insurers hold about 60 percent of banks' subordinated debt, making them the largest purchasers of bank bonds, according to Paul Achleitner, finance head of Munich-based Allianz SE (ALV), Europe's biggest insurer.

## Solvency II

The European Union's Solvency II regulations, due to be implemented in 2013, may change that. The rules make holding long-dated corporate bonds more expensive for insurers, at a time when banks are planning on selling record amounts of debt.

Without selling corporate bonds, banks may be forced to increase borrowing through loan notes from other banks, boost longer-term deposits or lend less, said Simon Willis, a London- based analyst at Daniel Stewart Securities Plc.

It's more likely that the Basel Committee on Banking Supervision will soften the proposed rules to allow banks the freedom not to back their liabilities with assets of the same duration, said Simon Maughan, co-head of European equities at MF Global Ltd. in London.

"By removing duration mismatching, you are condemning many of them to an unprofitable future," he said. "Politically, it will not wash."

## Lloyds's Funding Needs

Lloyds Banking Group Plc (LLOY), Britain's biggest mortgage lender, is the U.K. bank most in need of increasing its long- term funding, Maughan said. About half of the firm's 298 billion pounds ($477 billion) of wholesale funding has a maturity of less than one year, Lloyds said in a presentation last month. Sara Evans, a Lloyds's spokeswoman, declined to comment.

In the euro zone, banks' ability to tap the bond markets is more determined by the credit worthiness of the country in which they operate rather than their wholesale funding profiles, according to Maughan. Banks in Greece, Ireland and Portugal will face the greatest difficulties, he said.

Solvency II provides the amount of capital insurers need to hold against corporate bonds is directly proportional to their maturity date, regardless of their relative returns, according to a report by Morgan Stanley and Oliver Wyman Group, a New York-based consulting firm.

Firms must hold 8.2 percent of the face value of a five- year bond in reserve in case the issuer defaults and 16.5 percent for a 10-year bond, despite the longer-dated bond returning just 200

basis points more over its life, the report said. Currently, European regulations only force insurers to hold capital against their liabilities, not their assets.

## Insurers Push Back

That makes it "unattractive" for insurance companies to invest in long-dated bank debt, said Allianz's Achleitner. "You have a situation where the demand for capital is going up, but the supply of capital - in a deleveraging environment and rightfully pushed by regulatory concerns - will actually go down," he said.

Andrew Moss, chief executive officer of London-based Aviva Plc (AV/), the U.K.'s biggest insurer by sales, said insurance companies are lobbying Brussels to relax the new rules.

"The capital required for holding long-dated corporate debt is something that needs looking at," Moss said. "We're still in a debate with the European Commission around that. I'm not alone in the insurance community with that thought."

EIOPA, the Frankfurt-based organization designing Solvency II for the European Commission, said the rules didn't incentivize insurers to invest in longer or shorter-term bonds.

## Asset of Choice

Capital charges may be "more significant" on long-term bonds because of their increased volatility, Carlos Montalvo, an executive director at EIOPA, said in an e-mailed response to questions. EIOPA is "investigating the issue," he said.

Bonds with a three- to five-year durations will "become the asset class of choice for European insurers owing to the better expected return on economic capital versus other asset classes," according to the Morgan Stanley-Oliver Wyman report.

Insurers typically buy bonds to fund long-term liabilities such as pensions that can require payments to customers for as long as 30 years.

Instead of buying bonds to match the duration of the liabilities, insurers may purchase shorter-dated debt and "use interest-rate swaps to hedge out the duration," according to Emily Penn, an associate director at Royal Bank of Scotland Group Plc (RBS), which helps insurers manage their investments.

## Consumer Impact

Using interest-rate swaps in place of corporate bonds would lower the insurers' investment return and therefore reduce the payouts to customers, Penn said. Annuity customers would be particularly affected by the rule changes, she said.

The fallout of Solvency II's capital charges may also encourage insurers to hold more government bonds as they are classed as free of risk, according to Legal & General Group Plc (LGEN), the U.K.'s biggest seller of annuities. The lower return will mean a 15 percent cut in pensioners' income should the regulations be implemented as planned, the insurer estimated.

"If providers have to invest more in gilts than corporate bonds, the consumer will end up paying more for an annuity or receiving less in pension income," CEO Tim Breedon said in an e-mailed response to questions. "This would be a poor outcome for consumers."

Even without the new Solvency II rules, bank regulators are struggling to win over insurers as buyers of new securities designed to bolster their capital base.

The insurance industry has a "limited appetite" for contingency convertible bonds, or CoCos, which are designed to convert into equity and will absorb losses in a crisis, the Association of British Insurers said in January. That's because the securities don't have the growth potential of equities or the protection against declines of bonds, the ABI said.

Insurers' unwillingness to buy CoCos, combined with the Solvency II capital requirements on long-term bonds, mean the industry is unlikely to be the answer to banks' funding needs, according to Antonello Aquino, a London-based credit analyst at Moody's Investors Service Ltd.

"The demand for bank debt will decrease because of these two forces," he said. "This may force the banks to seek other types of funding."

To contact the reporter on this story: Kevin Crowley in London at kcrowley1@bloomberg.net

To contact the editor responsible for this story: Edward Evans at eevans3@bloomberg.net;

®2011 BLOOMBERG L.P. ALL RIGHTS RESERVED.