Basel III implementation could cost 170,000 jobs in construction

FIEC uploaded general comments to the European Commission's online consultation regarding the implementation of the Basel III reforms. Basel III is an international agreement, of which the elements have to be transposed into EU law. If the EU opts for a one-to-one implementation, the reforms would basically result in increased capital requirements for banks. To meet these requirements, banks would need to adjust their balance sheets by either reducing the size of their assets or by raising additional capital. In short, financing conditions for the real economy might worsen.

The construction industry would be affected in three ways: financing of real estate activities, of small and medium-sized enterprises and of construction projects. We estimate that stricter financing conditions could lead to a loss of 170,000 jobs in construction at European level and therefore pledge for a proportionate implementation taking into account the specific circumstances of the European economy.

The Implementation of Basel III: FIEC General Comments

According to the recent European Commission's Autumn Economic Forecast, the construction sector is one of the "three elements [that] are seen as an insurance for the euro area against falling into recession." Like the whole European economy, and even more due to the size of the projects, the construction sector heavily relies on banks for corporate financing, project financing and loans for real estate activities. Against this background, FIEC is concerned by the latest Basel III reforms which are to be transposed into EU law. In general terms, to meet the increased capital requirements that will be triggered by the reforms, banks will need to adjust their balance sheets either by reducing the size of their assets or by raising additional capital of which the costs could be passed on to the price of their financing. Due to the significance of the construction industry for domestic growth, a deterioration of its financing conditions would go hand-in-hand with adverse socio-economic effects.

More precisely, FIEC regards the implementation of Basel III from three angles mainly:

1) <u>Financing of real estate activities</u>

According to the European Banking Authorities' impact assessment, real estate portfolios, residential and non-residential, will figure among the most affected by the Basel III rules. For instance, for residential real estate financing, the amount of risk-weighted assets (RWA) will be 2,6 times higher in comparison to the current treatment, due to the application of the output floor of 72,5%. In a similar vein, banks specialised on mortgage loans will experience a large increase in capital requirements with the output floor being the most contributing factor, according to the EBA. A recent study by *Copenhagen Economics* shows that higher capitalisation costs will lead to higher lending rates and fees for banking customers. For instance, homeowners would need to pay additional €4,400 of mortgage interest for a typical 25-year loan. That corresponds to 2% of the average costs of new housebuilding.

One of the reasons for the construction sector being growth supportive are the good financing conditions, especially for real estate activities. Non-residential building and new housebuilding account for more than 50% of the construction industry's main activities. With households dedicating a significant part of their income to housing, increased financing costs will either lead to a a diminution of the surface of newly constructed houses or a reduction in new housebuilding. The consequences for the construction industry would be the same. In case of a one-to-one implementation of the Basel reforms, we estimate new housebuilding to decrease by 2% which could cost 100.000 jobs in construction at European level.

2) Financing of small and medium-sized enterprises (SMEs)

Particularly SMEs heavily rely on bank lending for their economic activities and are at risk to be severely impacted by a change of banks' behaviour. An SME tailored implementation of the Basel III standards is of utmost importance for FIEC since 95% of the construction companies are SMEs with less than 20 employees. The Basel III reforms do not foresee an SME supporting factor as this is currently the case in EU legislation. Instead, they introduce a preferential treatment for exposures to SMEs. However, SME financing would be severely affected. *Copenhagen Economics* estimate that for a bank loan of €2,5 million, SMEs' expenditures for interest rates would on average rise by €4,400 per year. We expect these stricter financing conditions to lead to a loss of 25.000 jobs in construction SMEs.

SMEs need particular support as they have more difficulties in financing themselves on the capital markets. Furthermore, late payment being still a problem for this kind of enterprises, they need a favourable access to bank lending in order to manage their cash flows. Therefore, FIEC advocates for combining the Basel III reform with the SME supporting factor contained in the CRR2 to ensure an actual preferential treatment for SMEs.

3) Project financing

According to the European PPP Expertise Centre (EPEC), the annual value of large public projects with participation of private financing amounts to €15 billion. The Basel III standards exclude specialised lending, including project finance, from the risk calculation by internal rating methods which leads to a significant increase of RWA for these activities.

For example, for a loan financing the construction of a motorway the amount of RWA would be 2,8 times higher compared to the current treatment. We expect this stricter treatment to lead to a reduction of 25% of the amount invested annually, i.e. €3,7 billion. In the view of budgetary constraints for Member States, private finance plays an important role when it comes to infrastructure financing. We expect the potential reduction of financing activities in this field to lead to a loss of 45.000 jobs in construction at European level.

The Basel III reforms are an international agreement and thus a compromise between countries with different economic models. According to our estimate, a one-to-one implementation of the Basel III standards will result in the loss of at least 170.000 jobs in construction at European level. Strong European banks and favourable financing conditions are not only a cornerstone for the construction industry but for domestic growth in the EU in general. FIEC therefore pledges for taking its aforementioned concerns into account and opting for a tailored approach and a proportionate implementation.

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