

**Risks and balance sheets:  
challenges for European banks**

I will present my remarks under two headings:

1. the largest Eurozone banks fare well when compared with other regions;
2. however a number of smaller European banks - notably those engaged in real estate financing - have still much to achieve to strengthen their position.

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**I. The largest Eurozone banks fare well when compared with US, UK or Swiss banks**

A widely held view is that the Eurozone banking system is much more vulnerable, in terms of size, riskiness and capital, than banks in other regions.

As far as the largest banks are concerned (the three to five largest by country) this view is misconceived.

- a) Size. Graph 1 shows that, after de-netting US derivatives<sup>1</sup>, US large banks balance sheets are, generally, of the same magnitude (but sometimes, significantly bigger) as those of European banks. And this comparison does not take into account the huge impact of GSEs in taking mortgage credits out of US banks balance sheets, a facility that has no equivalent in Europe. Nor does it take into account the higher liquidity provided to the US banking system versus Europe (graph 2)

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<sup>1</sup> contrary to the US, the EU accounting rules do not allow european banks to net their derivatives contracts, which results in inflating their balance sheets.

b) Risk

If one looks at the evolution since 2005 of the annual costs of risk as a % of total bank loans (for the five largest banks in a number of European countries versus the US), chart 3 shows that the US and UK banks have accounted for the highest costs. This is the result, in part, of the relatively higher riskiness of their credit portfolios and of the undercalibration of risk assessment and provisioning in the run up to the crisis as well as of weak surveillance.

This is also true for Risk Weighted Assets as show in graph 4<sup>2</sup>.

c) Losses

Graph 5 shows the magnitude of bank writedowns (from 2 Q 2007 to 1 Q 2011): America: 887 billion euros; Europe (492) while the EU has a total banking system some 3 times larger. It also stresses the relatively low offsetting of losses by capital injections in the US (66%) as compared with Europe (94%).

Graph 6 underlines, for some individual countries and a small sample of banks, the very significant differences in losses cumulated on a yearly basis from 2008 to 2010 (in billion euros): France: 1,6, UK: 15, US: 20, Switzerland: 26.

Consequently, state aid (in form of capital) **at its peak** (end of 2008) was strikingly diverse: France: 20 billion euros, UK: 64 billion £, US: 459 billion \$ (see Table 7).

d) Capital

Graph 8 shows that US banks have apparently reached somewhat higher core (common equity) Tier 1 ratios than in the Eurozone on average (10% versus 8,5%) but the chart does not take into account further reweightings.

Furthermore, graph 9 shows that European banks have registered the highest rate of increase of their Tier 1 ratios since 2008 (while US banks were already highly capitalized in 2008, which, by the way, did not prevent the crisis). The rates of capital increases are impressive over the last two years (UK: 43%, Italy: 38%, France: 32% against 14 % in the US).

In total, from 2007 to 2009, the Eurozone top 50 banks have raised 120 billion euros of new capital.

One should also note that thanks to relatively low pay-out ratios (around 33% for typical European banks) retained earnings, have run high and have contributed significantly to strengthening capital ratios (see table 10).

On the whole, after de-netting of derivatives in US banks, leverage ratios are also quite similar in both groups (see chart 11).

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<sup>2</sup> but this graph is somewhat misleading because it does not include the « reweightings » that will occur at the end of 2011 under Basle 3 (this is particularly the case, for example, of Swiss banks, D.B. Goldman Sachs that are “under weighted” in the graph).

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## **II. But a number of medium size eurozone banks have still much to achieve in terms of restructuring**

We know that a number of banks in the Eurozone (in particular the Landesbanks in Germany, the Cajas in Spain, the Irish Banks ) are under capitalized. Graph 12 shows the spectacular explosion of non performing loans in Spain.

These banks must be restructured.

### **a) Banks stress tests**

I will concentrate my remarks on one essential issue: the one of banks stress tests.

Last year's experience has not gone well. A major Irish banking crisis followed the positive test and that has undermined the credibility of the whole exercise.

We cannot afford another mishap.

It is good that the new stress test exercise includes severely deteriorated assumptions on growth and market developments. But, in my view, that is not enough.

We all know that the interlinkages between banks and sovereign debt are creating major doubts and problems for the stability of the system and for the Eurozone.

So if we want to allay those doubts and convince markets that we are addressing this fundamental issue, we have to be extremely rigorous and firm in the way we conduct the stress process.

Ideally, the stress tests should take into account the losses or profits imbedded in all bond holdings in banks balance sheets. The net losses should be deducted from the reference point i.e. Core Tier One and reduce the "buffers" accordingly. This market-based method would help to detect potential bank weaknesses. In my view, it should be applied regardless of the chosen accounting classifications, be they in trading books or in banking books ("available for sale" or "held to maturity").

The capital shortfalls that would appear in banks would have to be corrected swiftly.

I know that the common view presently prevailing is less ambitious. Negative buffers in "available for sale" holdings are accounted for but do not trigger automatic and immediate regulatory recapitalisations. (Such a process is to be staggered from 2013 to 2017). Assets held to maturity are most often valued at historical cost. Besides, the case for a sovereign debt restructuring is debatable and market prices are not a proper indication for assessing the value of the debt.

Be it as it may, supervisors - and the newly created EBA - should at least:

- use common definitions for capital (the Basle 3 common equity definition);
- encourage those banks that have small buffers (let alone negative ones) above the core tier one threshold, and have significant marked to market losses in their banking books, to recapitalise as swiftly as possible;
- check the valuation of assets held to maturity in banking books, and see to it that adequate impairments are made on a homogeneous basis;
- be transparent on the balance sheet figures and disclose separately bank by bank, type of assets by type of assets, country by country, the holdings in trading books, bonds held to maturity and bonds available for sale.

This would have three major advantages:

- transparency,
- it would accelerate necessary and overdue bank restructuring,
- it would allay the confidence issue and the pressures of the market that are affecting both banks and sovereigns.

Spain has started biting the bullet and the Irish stress test seems to be pretty rigorous. This goes in the right direction but must be pursued.

- b) *The objective is not only to publish realistic results of stressed tests, but, more importantly, to take the necessary measures* to repair what has to be fixed. This may imply public capital injections, but not necessarily. Mergers and acquisitions should be the major instruments of that restructuring game.

Here, I would like to raise a question. If “big is bad” and must be heavily taxed (SIFIs) as the present fashion goes, how can we solve the following contradiction? Small and medium size impaired banks are presently the ones creating a systemic problem in the Eurozone. How can large healthy and well diversified big banks be in a position to make acquisitions and help to restructure an ailing system if regulation discourages them from expanding their size and tends to dismantle them? (In particular, the progressive “taxation” system that is contemplated will deter “non global SIFIs” from moving to the higher and more taxed “buckets” and will therefore jeopardize consolidation). This raises the question of the legitimacy of a reform that hits two of the strengths of the continental European universal banking system: on the one hand sufficient size (not 5 times GDP!) which promotes efficiency and diversification, on the other hand, which is a factor of stability. On the whole, this well run universal banking system came out unscattered from the crisis. Why should we penalize it?

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To conclude, I would like to stress a few points. First, regulators have been focusing, up to now, on deleveraging. But not enough attention is paid to “de-risking”. We are looking more at the size of balance sheets (with increasing regulatory disregard for risk weighting) than at the quality of assets, the resilience of banking models and the diversification of risks. It is time to look at the denominator of capital ratios and to discriminate more between good and riskier assets. More homogeneity is needed in calculating RWAs.

Actually, the nature of the business models should be a major criterion for assessing a bank’s riskiness. Banks that have an investment activity (CIB) that exceeds 50% of total Group revenues, appear to require more care and capital than those which contain that activity around 30% (BoA, HSBC, BNPP, SG, Crédit Agricole ). (See graph 13).

Under the profitability constraints<sup>3</sup> that are compounded by capital and liquidity reforms, this deleveraging priority leads inevitably to a reduction in lending (to SMEs<sup>4</sup> in particular) or to a search for more profitable - but riskier - assets in banks balance sheets. (We know from experience that “more and more capital” raised at high cost can have the opposite effect from that intended as excess capital is often diverted in more questionable assets).

Secondly, liquidity reforms will have to be seriously overhauled if we are to keep a reasonable balance between safety on the one hand and efficiency in the medium-long term financing of the economy on the other hand. Present proposals do not achieve such a balance.

Lastly, the importance of monitoring the - presently non regulated - shadow banking system, which is prospering, should be emphasized (chart 14).

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<sup>3</sup> an increase of capital from 7% to 10% for the GSIFIs would, in fact, reduce their return on equity by a third. Negative consequences on access to new capital and on lending would be significant.

<sup>4</sup> the existing regulatory framework (capital, accounting, liquidity rules) is not neutral towards long term lending to enterprises. “It is not by chance that in the US the Basle III approach was never applied to medium-small sized commercial banks” (See R. Masera “The Basel III global regulatory framework: A review - 2011).