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A FEW THOUGHTS ON THE EFFECTS OF REGULATION ON THE EUROZONE BANKS AND ECONOMY

To start with, we should not forget that the 2007-2008 financial crisis was, basically, created by a massive credit expansion and leverage. This was the result of lax monetary policy.

When interest rates get close to zero- or become even negative in real terms-, there is always a tendency to over-borrow and, for the lenders ,to tighten risk premiums and to engage in more hazardous projects.

When housing prices started to collapse in the US , thus revealing the scandal of the subprime euphoria, liquidity dried up . This resulted in the failure of many financial institutions that had inordinately relied on short term market liquidity.

Central Banks had no other choice then but to intervene heavily, i.e. to buy assets that the markets had stopped refinancing. That allowed the system to survive.

This is where regulation comes into play.

Regulators, who had failed to foresee and to prevent the crisis, were anxious to repair their reputation. They wanted to convince politicians that, through tighter regulation, they would make the repetition of such a crisis almost impossible.

Indeed, the regulatory system has been significantly strengthened over the past years. The thrust was to increase capital requirements on banks in order to allow them to absorb major losses in case of turmoil. Capital was multiplied by 5 in terms of legal requirements, and by more than 2 in actual terms. This is a watershed. Never in the almost thirty years history of the Basel Committee, had regulators engaged in such a radical increase in the equity base of the banking system.

In addition, the Basel Committee has instituted liquidity constraints - short and medium term- that are intended to provide banks with sufficient cushions of immediately marketable assets and to avoid maturity mismatches between banks funding and assets and thus to reduce their dependency on wholesale money markets.

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All this is good, inasmuch it increases the resilience of the banking system and therefore reduces the risk of the return of such a major upheaval.

But the devil is in the details. And there are some problems that must be dealt with: those of possible inconsistencies and unintended consequences of some aspects of regulation.

1) Firstly, the pace of adjustment has been extremely fast. While capital requirements were initially planned to gradually enter into force by 2019, the “fully loaded” Basel III rules are already applied at least in Europe., since 2013

This has a cost. Indeed, putting more capital against assets held on the balance -sheets, reduces bank profitability. Equity is expensive and hard to raise . And whether a bank can (which is not always possible) raise fresh capital on the market , or has to rely on reduced dividend pay-outs to buffer its reserves, the result, in both cases, is less return on equity. The banking sector, at large, is today less attractive to shareholders than most other parts of industrial activities. More regulation looming ahead- and more uncertainty on additional possible measures- is not helping in this regard.

2) Second, the problem for continental Europe is particularly acute.

Three quarters of its economy are financed by banks and one quarter by the markets. In the US, the proportions are the reverse .One can understand that putting the regulatory emphasis on banks, is bound to have a deeper effect on the financing of the European economy than it is the case in the US.

Actually, the regulatory impact on Europe is more than three times bigger. This is because a number of US smaller institutions , like regional or community banks, are not submitted to exactly the same rules(in particular on liquidity) as European banks which have all to abide by all the Basel requirements. This makes a difference especially for the financing of SMEs.

This situation is somewhat odd. The crisis was triggered ,as the result of the subprime scandal, by very large banks following the anglo-saxon :”Originate and Distribute” model. Their heavily securitized financial products, most of them opaque and over rated, had contaminated the whole system.

Most of these banks were huge and had focused their activity on market trading. They had to be saved because of their systemic importance and ramifications. That is why

the increased Basel capital requirements on market related operations, in terms of risk weighted assets ,made a lot of sense. That was also the case .of liquidity rules

But continental European banks were different: they had much smaller market related activities.(accounting for some 25% of their revenues against, typically, 50% for the others) and they kept on their books credits to households and non financial enterprises. Those loans were NOT the cause of the crisis.

However, because of the “one rule fits all” nature of the Basel capital requirements, and the fact that the risk weighting of “normal ” loans to clients was increased (albeit less than for market operations), the regulatory adjustment imposed on “universal” banks was all the more severe that the profitability of credits , in particular to SMEs, was generally lower than that of trading transactions.

The end result is that the financing of the economy has been significantly more affected than in counties where market finance is more important.

Of course, the policy mistakes and the macro economic disruptions that prevailed between 2000 and 2009 in a number of “peripheral” countries of the Eurozone have compounded the problems of a number of those economies and created the perverse link between banks and sovereigns.

3) Deleveraging is becoming a serious problem.
   All different forms of bank regulation have triggered deleveraging effects:
   - Pure investment banks with scarce deposits, have had to reduce heavily their trading assets;
   - Non dollar based – European – banks slashed their dollar franchises;
   - Universal banks- that could not raise massive capital lest share holders be wiped out, and that had reduced dividends to the bone, had to resort to deleveraging.

The latter phenomenon is taking worrisome dimensions : since 2012, loans to enterprises of the eurozone have been reducing , on average, by 3% in annual terms. The most affected countries are the ones of the so called “periphery”(Italy: -5%);

Of course, much of that deleveraging is caused by the weak economy and by the high level of non- performing loans. But a more detailed analysis shows that banks are also reducing their loans because of regulatory reasons.

Indeed the conjunction of a huge and rapid increase in capital requirements (a doubling in a couple of years) , of risk weighting rules that hurt risk taking , as well as of liquidity constraints (LCR) that encourage holding " zero weighted" assets (as government bonds) and will deter banks from long or medium term lending (which will be the inevitable result

of the NSFR) is going to profoundly change the traditional conditions of the financing of the Euro zone economy.

The result of this regulatory trend can be summed up in the following way:

-stronger capacity of banks to absorb losses;

-more difficulties for them to engage in loans to SMEs (the biggest generators of jobs);

-shortening of credit maturities;

-disincentives for financial institutions to hold long term investments on their balance sheets (Basel rules on banks and Solvency 2 on insurance companies);

-organization of a shortage of collateral and destruction of repo markets…..

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When one thinks of the traditionally predominant role played by banks in financing the European economy and of the primary importance of insurance companies in buying and holding long term investment, one can only ask the question: "Are the above mentioned new regulatory consequences really what Europe needed in order to grow on a sound basis?"

The crisis resulted from an excessive expansion of credit in an environment of low interest rates and scarce equity. Low interests are still there and don't seem to generate much growth at least in Europe. As far as equity is concerned, it is continuously being discouraged by taxation and financial regulation .Loans to SMEs were in no way the cause of the crisis. Nonetheless, they are among the first victims of the new financial regulatory system. A world of sophisticated, complex and opaque financial products chased by the originating financial institutions themselves for the sake of higher yields with no consideration to risk has been the nexus of the financial disaster. Are we sure that the new stringent capital rules combined with ultra low interest rates, are not pushing banks and non-banks into the same appetite for riskier- but more profitable - assets? The question cannot be escaped.

So it is by a strange irony of history that continental Europe is turning to securitization.

If banks are not in a position to lend long term, how can infrastructure projects be financed? The answer is to be found in project financing by vehicles organized by institutional investors

on the basis of securities sold on the markets with some forms of credit enhancement if needed. But European insurance companies are deterred from holding such securities…..

Similarly,If bank credit to SMEs is getting too difficult, the solution –which Eurofi is advocating- is to securitize prime quality loans extended to them and to pass them on to the markets. Here also, regulation is not friendly: distinguishing the best credits from the others is not part of the operational framework of regulators who continue to penalize, capital wise, AAA SMEs versus large corporations with the same ratings. If we want to alleviate the balance sheet constraints of European banks and allow them to revive their SME lending, it is urgent to take remedial action and not to treat in the same manner " good" and low quality securitization.

I will finish with a somewhat controversial remark.

Many believe that low interest rates lead necessarily to stronger investment It may be true for real estate markets. But I do not think it is the case in general, especially in highly intermediated economies.

To finance investment, banks traditionally need a spread of 3 to 3,5% between their lending rates and their deposit (or funding) rates. But when Central Bank money is at close to 0% and when long term funds have been squeezed (or"twisted") at 2% or less, the natural tendency for large corporations is to finance themselves directly on the bond markets. That leaves banks (and in particular the smaller ones) with riskier SMEs loans. Given the regulatory disincentives described above, SME lending becomes more problematic and more expensive all the more so if" prime" selection methods – based on reliable data- have not been put in place and been recognized by regulators and Central Banks.

So let us hope that the practical ideas that you have been proposing today in such a convincing way, in order to promote long term finance in Europe, will be followed by action at the political level.

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