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For a truly European Regulation

I - Under the auspices of the Basel Committee the banking system has been significantly strengthened over the years 2008 to 2017.

- The European banks, in particular, have achieved a massive increase in their capital and a reduction in their debt. In relation to GDP their capital has jumped from 14% in 2002 to 24% in 2015, while their debt has shrunk from 22% of GDP in 2007 to 14% in 2016.

- They have also seen a reduction in their deposits (from 60% of GDP in 2008 to 50% in 2016) as well as of their outstanding loans (from 185% of GDP to 165%).

- Risks have fallen overall : RWAs have come down from 12 000 Billion € in 2008 to 10 510 in 2016.

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All these developments are a clear sign of the strengthening of Eurozone banks solvency.

It had previously taken one century to achieve such a more than doubling in banks capital.

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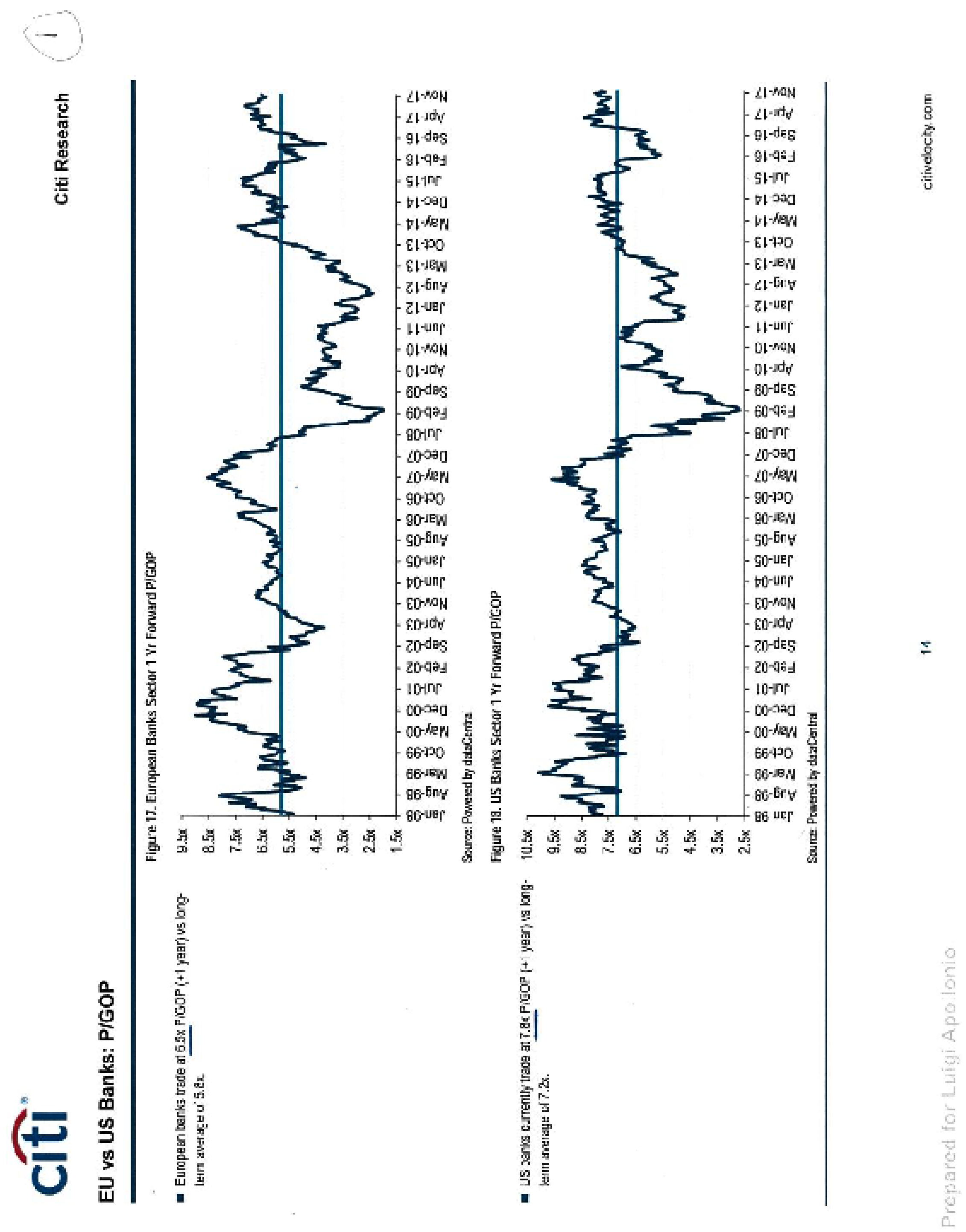
II – But market perceptions of banks are still relatively low.

In spite of an improvement in borrowers solvency since 2016 and a reduction in non-performing loans (NPL) since 2014, the market values poorly the Eurozone banking sector. After some improvement in 2016, there is still a significant gap between the EuroStoxx bank performance and the total EuroStoxx index. One also observes a weak performance compared with US banks : Price/Earning ratio : 6,5x in Europe versus 7,8x in US. (cf **Graph 1)**.

Graph 1

<u>Price on earnings (prices/Gross Operating Profit)</u>

EU versus US banks : P/GOP

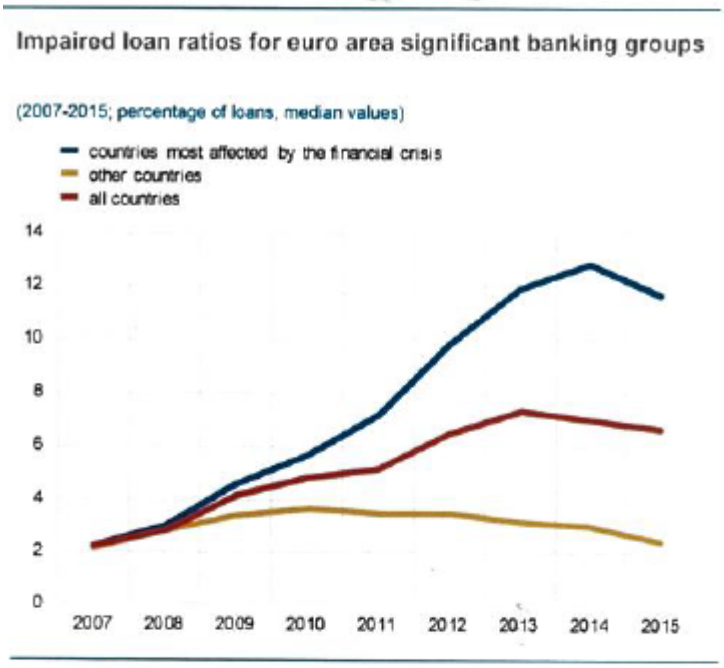


Several reasons explain this :

- The low level of interest rates (QE) reduces the banks margins in a very competitive environment : therefore profitability is low (ROE is on average less than 5% while the cost of capital is more than 10%). By contrast, the US banking system has a significantly stronger profitability.

- The perception of the high level of non-performing loans : although the Eurozone average NPL ratio to total loans is around 6% (with most countries slightly above 2%), the countries most affected by the financial crisis account for levels on average around 12%. These figures - albeit improving – tend to influence market perception **(Graph 2)**.

Graph 2



Source: SNL Financial.
Notes: Based on publicly available data for a sample of 55 significant banking groups. Countries most affected by the crisis include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

- Sovereign risk : in a number of European countries banks hold significant amounts of local sovereign bonds, which is a problem when the countries in question are over-indebted.

- The uncertainty on regulation keeps the investors wary.

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III - <u>Indeed the regulatory package is still under negociation and its weight is increasing.</u>

The "Basel process" is continuously deepening and enlarging its reach.

There are different trends.

- The definition of capital (and in particular of what is considered "common equity") has been tightened and increased. Presently, most G-SIBs have to account for 13,5% of total capital in relation to RWAs.

- The liquidity requirements :

  - Liquidity coverage ratio (100% of liquid assets for 30 days of a crisis),
  - Net stable funding ratio (NSFR) : the rate will impose on banks to resort to massive long term funding in order to better match assets and liabilities,

- The leverage ratio :

  The leverage ratio (presently 3% of total balance sheets) does not take risks into account. Thus it is an instrument that could encourage banks to take more risks.

- The constraints amounting from the new "bailing in" rules that are being negotiated could amount to TLAC ("Total Loss Absorbing Capacity") adding the equivalent of 8,5% of capital to bank requirements (that would then reach, in total, 21%),

- The "Basel4" negociation.

  The purpose was to eliminate excess variability in Risk Weighted Assets (RWAs) produced by internal models.

  In order to "harmonize" the results of individual models, the Basel Committee has decided to create a "floor" : no model should produce riskweightings less than 72,5% of the standard.

But this is irrelevant. Indeed internal models – based on individual historical experience regarding defaults in each category of loans – are bound to result in different calculations between banks.
The issue is therefore not to "equalize" the results in order to reach an arbitrary standard rate. The objective should be for the supervisors to study the models and to assess whether their variable results are justified or not.

But the recent “deal” makes no sense. Certain banks – notably in the US – have very high risk profiles concerning real estate loans (indeed their best mortgages are bought by officially funded organizations like Fannie Mae and Freddy Mac which do not exist in Europe).

Therefore, applying an average risk weight to such loans would not take account of the reality of risk profiles and would thus defeat the principle that regulation should endeavor to reduce risk. Besides, the “floor” as calculated is incoherent in the US : it does not take account of operational risks contrary to Europe.

<u>IV – The impacts on the real economy are hard to measure.</u>

Basically, it is good for the real economy to dispose of a healthy and resilient banking system which could therefore help to avoid the repetition of crises.

No one could disagree.

But I would just share with you a few additional thoughts.

1. <u>Shadow banks</u>

The focus of regulation on the supervised sector allows for regulatory arbitrage and a shift to non-regulated shadow banks.
The shadow banks are increasing their clout in the Eurozone. Indeed in that jurisdiction the total balance sheet of « non-banks » has jumped from 70% of GDP to 90% from 2008 to 2017.

Although such “banks” do not benefit from the hidden subsidy provided by the existence of a Lender of last Resort, the financial risk does not disappear : indeed banks could be caught in “over lending” to hedge funds or non-banks.

It is a fact that non-banks have not been significantly regulated since 2008.

2. <u>The European move towards desintermediation</u>

Financial regulation has triggered a move of European enterprises towards market financing.

The figures are striking :

- The outstanding credit to enterprises has reduced from 96% to 89% of GDP from 2008 to 2014,
- while the outstanding bonds issued by companies has gone up from 12% to 17% of GDP.

This move is explained by the loss of competitiveness of a heavily regulated banking system in a world of low interest rates.

Is this a good thing ?

Experience shows that in recessions and crises, the cost of market financing is volatile and increases much more than that of bank loans.

It is not sure that European enterprises have enough wage flexibility (contrary to the US) to adapt to such higher costs.

3. *Fighting against "too big to fail"*

The focus of regulation has been on big institutions considered as "systemically" vulnerable.
Anglo-saxon regulators were indeed under political pressure, to "punish" the very large institutions that had been bailed out with taxpayers money.

But the continental European experience (most "universal" banks have fared well during the crisis and have not been bailed out) is rather different, and does not seem to justify the very progressive capital rates imposed by Basel.

The real issue is :

Do we need larger international banks in Europe to develop our economy and help to clean up the less profitable elements of the financial system ? If the answer is positive, then do we really want to penalize large banks and ring-fence their liquidity ?

4. Lastly, regulation has not prevented "ring fencing".

Nowadays the banking system in Europe is less "transnational" than it used to be before the crisis : liquidity and capital risk fencing are promoted by national supervisors (at the subsidiary level). This is concerning for the development of Europe that needs a strong transborder financial system and large groups that should be able to centralize their funding.

All in all, regulatory uncertainty, lingering non-performing loans in some countries, heavy concentration of sovereign risks in some banks' portfolios, ring-fencing by local supervisors … are manifestations of a lack of confidence in the banking system and in the Banking Union.

Let us hope that the progress in structural reforms, the cleaning up of non-performing loans … and a pause in regulation will help improve confidence in the system and its future…

Jacques de Larosière

PS Most of the figures referred to in this article have been published by Patrick Artus, Natixis Research (www.research-natixis.com)

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