Speech by Jacques de Larosière, Eurofi Chairman and former IMF Managing Director

THE FUTURE OF THE EUROPEAN BANKING SYSTEM

I am particularly happy to be invited by the ESM to give my thoughts on the future of the European banking system.

The creation of the ESM in 2012 is in itself a major breakthrough in the euro construction. Before the European Financial Stability Facility (EFSF) and the European Stability Mechanism, there was indeed an anomaly in the setting of the European Monetary Union architecture: there was a Central Bank issuing a single currency but no common banking supervision (which has been established with the Single Supervisory System) and no resolution system.

The latter is now being worked upon with the progress on bank resolution (implementation of the Bank Recovery and Resolution Directive and the Single Resolution Mechanism).

The ESM can play, in the achievement of this resolution process, an essential role as a backstop for the euro banking system after the bailing in process and the use of resolution funds, if needed.

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I will divide my remarks into two sections:

I. European banks are engaged in a structural evolutionary process;
II. But the transition must be organized if we want to achieve a reasonable economic recovery in Europe.

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European banks play a major role in financing the economy: banking intermediation accounts for seventy to eighty percent of the financing while in the United States, it is the reverse, markets playing the predominant part.

This has been a traditional feature of the way the European economy has been financed. But things are changing.

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A. The evolving role of European banks

With the 2007 financial crisis, the traditional pattern is changing. Indeed, since 2012, the outstanding loans to the non-financial sector in the Eurozone have been declining by 2, 5% on a yearly average (2, 3% in August 2014).

Total assets of the euro area banking sector have declined to 26,8 trillion euros down from 33,5 trillion in 2008. This represents a decrease of 20% in four years which is a major evolution of the system even if a large part of this decrease has to do with the reduction in derivative positions. The banking sectors in those euro area countries most strongly affected by the financial crisis experienced the most pronounced structural changes.

This deleveraging is, to a large degree, normal. Indeed, bank credit had ballooned in the early 2000 and with the post-2008 recession, demand for credit has fallen, economic agents are compelled to repair their balance sheets and non-performing loans – which are significant, especially in the periphery of the area – do not incite banks to lend more to ailing firms.

But there is also a "supply" problem that is contributing to hold back "good" bank lending in Europe. And that is mainly the result of two factors:

- First, there has been, over the last years, a massive increase (more than a doubling) of the equity base of European banks (in 2013, the median tier 1 ratio of euro banks had increased to 13%). This increase has led to a more stable and resilient banking system in Europe. A similar increase took almost a century to materialize before the crisis. This leap [1] was bound to have structural consequences on the way the banking system functions.
- Second, there has been also a significant reduction in the profitability of banks which is reducing their lending capability.

The IMF has just issued its Global Financial Stability Report stressing that 46 % of Eurozone banks (representing 60% of assets) were unable to support the recovery.

One of the reasons of this weakness, according to the IMF, is that major banks "don't have the adequate capital buffers or **profitability** to support lending growth of 5% a year".

This explanation deserves further analysis.

Weak profitability stems itself in large part from the magnitude of the recent increases in capital buffers. The more banks have to raise their own funds, the less profitable they become. Presently, one can observe that the cost of capital for a bank in Europe is around 10 to 11 %

[1] The Basel Committee had carefully phased in the enforcement of these measures over a period of seven years, until 2019. But markets have pushed banks into almost immediate action, thus compounding the deleveraging problem.

while its return on equity is only in the order of 4% (10% in the US). This return on equity is now at a historically low level.

US banks have improved their profitability thanks in particular to trading fixed income interest and commodities. By contrast, many of those US banks have decided to reduce their lending activities worldwide.

In such a context, EU banks have no other choice but to change their business models:

- They must increase their profitability through internal rationalizations, new technology and efficiency measures – but this has limits in particular in a highly competitive context especially in Europe.[2]
- Hence, they have to turn to more risky assets (but this can only be done within the limits of capital requirements).
- Or if the above two avenues are not enough, they will have to reduce the size of their assets on their balance sheets, i.e. to retrench.

However the story of capital increases is not over. Indeed, the Financial Stability Board (FSB) is pushing towards a new wave of regulations that could cumulate in a significant increase for most large banks of their junior debt and of their equity buffers[3]. This is bound to increase the cost of their lending.

Measures are envisaged on the calibration of the Net Stable Funding Ratio (NSFR)[4], on the increase in the leverage ratio and on the Total Loss Absorbing Capacity (TLAC). Such major increases in bank buffers as those contemplated would inevitably compound and accelerate the deleveraging

[2] On average the operating expenses of the EU banks are about 1, 35% of the assets, i.e. lower than those of US banks (2,81%). Furthermore, in the period 2008-2013, European banks did not widen their lending spreads in a similar proportion than American ones, respectively +22 bp and 34 bp, source BIS

[3] See note issues by Citi Research, "Introducing TLAC", 15 September 2014

[4] The envisaged measures on the NSFR could be costly and anti-economical. For instance, the obligation to cover 50% of 3 months repos by funds extending over one year, would have serious consequences on the liquidity of the short term markets. The "factoring" would also be penalized as well as trade finance, usually of short duration and well collateralized.

and transformation process that is taking place in the European banking system.

Let us be more specific:

- Regarding the **NSFR,** the present shortfall of long term financings calculated by the EBA for the euro area banks amounts to 473 billion euros; in addition, this ratio would significantly reduce the maturity transformation capacities of banks and limit their credit intermediation role.
- On the present basis of 3%, the capital shortfall in terms of the **leverage ratio** would amount to 29, 2 billion euros. But if the ratio were to be raised to, let's say, 4%, the capital shortfall would be significantly more.

  Furthermore, such an increase of the leverage ratio - non risk based - could entail major shifts of the European banks towards more risky assets. This is all the more concerning that Euro banks are the most compelled to increase their profitability. I do not see how such a regulatory measure could not have negative consequences on the structure and quality of bank assets and on the lending to non-financial firms and in particular to SMEs.
- As for the **TLAC**, the idea is to limit eligible "bailing-in" debt to junior instruments. This could compel European banks to transfer on average an amount equivalent to 4% of their RWA into – more costly – junior debt. This would represent a major shock.

According to the IMF, all this "**could have important implications for the capacity and willingness of banks to supply credit to the real economy potentially creating a headwind against the recovery in some countries**".[5]

The IMF states that to ease this problem banks would have to "re-price their credit" (thus helping them to increase their retained profits in order to bolster their capital buffers).

[5] IMF Global Financial Stability Report, October 2014 (Chapter 1: «Improving the balance between financial and economic risk taking".

But re-pricing credit in a very low interest rates environment, in a weak economy and in a highly competitive setting, is not always realistic and can be costly for customers and enterprises. Consequently, there is a serious risk that financial institutions will not be able to expand their lending. The most recent figures published by the ECB on the continuous decline of outstanding loans to non-financial enterprises illustrate this point.

Many believe that low interest rates lead necessarily to stronger investment. It may be true in some cases, like real estate markets. But I do not think it is the case in general, especially in highly intermediated economies. To finance investment, as R. Mc Kinnon has explained, 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 interest rates on long term funds have been squeezed (or "twisted") at 2% or less, the natural tendency for well rated large corporations is to finance themselves directly on the bond markets. That leaves banks (and in particular the smaller ones) with riskier loans, in particular to SMEs and therefore this introduces a bias in the quality of their portfolios.
Given the regulatory disincentives described above, SME lending becomes more problematic and more expensive.

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In sum, regulation is leading EU banks, who are compelled to maximize their profitability, to change the structure of their balance sheets in order to adapt to regulation:

- Credit maturity will shorten (NSFR)
- Long term junior borrowing and constitution of own funds will increase (Basel and TLAC)
- High Liquid Assets (HLA) held on balance sheets will increase (Liquidity Coverage Ratio, LCR).

The macro economic consequences of these incentives are obvious:

- The acquisition of Treasury instruments ("0 risk") is encouraged to the detriment of private loans considered more risky by regulators;
- Given the limits of direct access to financial markets, there can be a trend to increase the cost of loans (which, in turn, if feasible, would depress growth) :
- Outstanding repos will reduce (in particular due to the NSFR constraints) impairing the liquidity of short term markets
- The maturity of loans to enterprises will get shorter.
- The holding of equity by financial institutions (CRD 4, Solvency 2) is being discouraged.

Is this really the pattern we wanted to achieve in responding to the crisis?

As an IMF official recently stressed: "**There is not enough economic risk-taking in support of growth, but increasing excess in financial risk-taking, posing stability challenges"**.

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B. The need for a long term well-organized transition

The transition towards less banking intermediation and more market finance will take time, cannot be rushed and should be very carefully prepared by European decision-makers in order to allow financial markets and non-banking institutions to gradually relay the banking sector.

A number of large banks are already changing their business models and shaping their long term strategy in order to adapt to the new regulatory environment. They are selectively shrinking their infrastructure financing, their fixed income, currencies and commodities activities and in some cases their lending to SMEs.

And they are expanding their role in investment banking, M&A, securities underwriting, as well as in asset management and private wealth.

However, for a long time, the banking sector will continue to be the main financier of the EU economy. The consolidation and

deleveraging process that has already started will have to continue gradually.

The last "Banking Structures Report" 2014 published by the ECB shows, in this regard, that the overall efficiency of the system continues to be improving. Actually, the total number of credit institutions decreased further to 5943 in 2013 down from 6690 in 2008.

The implementation of the banking Union should normally restore confidence in the banking system and therefore allow the resumption of cross border acquisitions or mergers that could be beneficial in terms of efficiency.

On the liability side, we have observed the gradual shift towards deposit funding as well as the reduction of the role of wholesale funding.

As far as profitability is concerned, I have already touched on its considerable deterioration a moment ago, which is of course, directly linked to capital requirements.

The transition towards a more "market financed "economy should not be hindered. And alternative methods should be encouraged.

Let me point here to several mistakes which should be avoided:

- **So-called "structural" banking regulations should not impede the ability of banks to help their clients move towards the market** (banks, on the contrary, should be able to combine classical commercial services and financial market solutions for their clients and not be constrained by artificial internal ring-fencing rules or prohibitions of market-making….).

- **Since non-bank sources of credit will have an important role to play to compensate for constrained lending by banks, those institutions (notably insurance companies) should not be discouraged from holding long-term assets, securitized bank credits, infrastructure assets**….. Unfortunately, as we well know, regulation is making the holding of these different types of assets by non-banks more difficult (Solvency II).

And we have to be realistic. **It is not clear whether non-banks can provide sufficient financing to compensate for the retrenchment by banks.** Even if we can take solace from "the steady rise in securities issued by non-financial companies since 2008, partly as a result of the falling cost of issuing bonds relative to bank loans, this has not been sufficient to off-set the steep decline in bank lending particularly in some euro area economies" (IMF, October 2014).

In this respect, it is important to keep in mind the essential role of SMEs in the European economies. SMEs account for the bulk of employment. They cannot access directly the bond market and therefore they may be the major casualties in this new phase of bank lending retrenchment. It is all the more important, therefore, to:

- Facilitate securitization of credits to SMEs (presently there are still regulatory disincentives), and at least treat, capital wise, in a neutral fashion securitized and non-securitized assets that carry the same risks.

- The last proposal by the Commission in its delegated act on Solvency 2 -albeit improved vis-à-vis the EIOPA initial proposal – still imposes capital charges on investment by insurers in securitized products that are more more than two times those applicable to A, AA and AAA corporate bonds (see annex 1). [i] This would be an incomprehensible deterrent to holding high quality securitized instruments by insurers. We have to be vigilant on this final calibration issue in order to preserve the marketability of such securitized assets.

- Study capital market measures and regulations that would allow, for instance, like it is the case in the US, non-banks to provide credit to the corporate sector and mutual funds to purchase loans (which is not compatible with the UCITs regime in Europe).

In this respect, we must understand that non-banks (insurance companies, investment funds, hedge funds…) are becoming important players that will only gradually increase their market share in credit intermediation all the more so that traditional banking will be made be more difficult.

Without a coherent vision that would carefully encompass the proper sequencing of regulatory measures both in the banking and the non-banking sectors with a view to reviving the transmission of monetary policy and to restoring investment in the ailing European region, the future may well be dark.

This needs a true understanding of the fundamental issues – including structural reforms - in Europe and not the blind enforcement of peace meal regulatory measures that may answer the 'too big to fail' concern but are not adapted to the present realities of our continent.

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Conclusion

The issue of securitization of credits to the private sector could well become a litmus test of the resiliency of the European banking system.

As has been shown above, banks <u>are</u> retrenching from direct intermediation. The largest firms will weather this evolution through their direct access to financial markets. But SMEs cannot. Therefore, given the decisive importance of SMEs in terms of job creation, we absolutely need to organize their indirect access to the markets through good quality securitization. This is urgent given the sluggishness of the European economy. We cannot wait for the outcome of the various working groups set up at the global and EU levels (IOSCO, Basel, European Financial Committee…). In this respect, I do not believe that the recent proposals by the EU Commission live up to the challenge.

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In a region where banks are **<u>the</u>** predominant financing institutions for the economy, the present situation - where insufficient profitability and capital constraints are mutually reinforcing each other - poses a major threat to the revival of the economy as well as to the proper functioning of monetary policy. **Indeed, monetary policy is presently constrained by the impairment of the credit channel**. Banks are, and have always been, the major factor behind monetary creation. So, in present circumstances, the ECB is facing the difficulty of making its loose monetary policy seep into the real economy. The recent fall in inflationary expectations is, in this respect, a sobering sign.

If regulation were to lead to a new major increase of the capital base of the banking system in Europe (perhaps about 50% more requirements) the deleveraging consequences of such a move could well be systemically dramatic.

I**f we want to avoid a prolonged economic recession in Europe with all its repercussions on world growth, it would be wise to sit back and to avoid rushing into pro-cyclical regulatory additional pressure.** It is important to understand, in this regard, that Europe would be more hit by the envisaged measures than any other part of the world given the enormous reliance of its economy on the ability of banks to lend and given the absence of facilities existing in the US for example (GSEs, automatic subordination of debt held by parent holding companies on their banking subsidiaries ……). The risk, here, is to put European banks at a structural competitive disadvantage.

Whatever the immediate unfolding of the envisaged new regulations, it remains that banks in Europe will probably continue to engage in new business models more reliant on fees and less focused on traditional lending.

Although we all want regulation to converge towards a consistent system, we have to take into account the European financial reality, and also the fact that major facilities for banks mentioned above are absent in Europe. Therefore we must develop quickly a new **European** set of solutions. It is for the Commission, the Council and Parliament to conceive such a consistent EU vision and to implement it.

Jacques de Larosière

[i] See Annex I

Annex I

Comparison of capital charges (per year) between holding corporate bonds by insurance companies and the securitized acquisition of high quality assets

Credit rating	Capital charge (per year of duration) for corporate bonds	Capital charge (per year of duration of

		Type A securitization (high quality)
AAA	09 – 1,1%	2,1% (initial proposal by EIOPA : 4,2%)
AA	1,1 – 1,4%	3%
A	1,4 – 2,5%	3%
BBB	2,5 – 4,5%	3%