European Savings Bank Conference
Brussels, October 30. 2013
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A word of warning: banking regulation is about to create pro-cyclical damage

It is a pleasure and an honor for me to open this conference organized by the European Savings and Retail Banking Group.

As Mr. Shackmann Fallis stressed in his recent statement at the Eurofi Forum in Vilnius, savings banks and, more generally, retail banks play a fundamental role in financing small and medium size companies in Europe. These companies are the backbone of the economy: they are responsible for more than 50 % of European employment.
But they are dependent for almost all their financing needs on loans granted by proximity banks, whose business models have proved their efficiency.

Let us not fool ourselves: alternative sources of financing like equity or bonds will never be a substitute for bank financing to SME's. What may be possible for large companies in terms of tapping capital markets is just not available for smaller enterprises.

So, while it is justified to look for alternative sources of finance and try to promote a revival of securitization, this should not distract us from recognizing the major and uncontestable fact: SME's not only need bank lending but they also need an expansion of bank lending if we want to allow economic recovery.

But what do we see?

We see that bank loans to corporations have dwindled in Europe over the past two years.

The ECB reports are telling in the regard. According to ECB statistics, outstanding loans to non-financial corporations are shrinking in the Eurozone. Indeed, their annual gross rates are increasingly negative since 2012:

2012	=	-2.3 %
1st Q 2013	=	-2.4%
2sd Q 2013	=	-3.4%
July 2013	=	-3.7%
August 2013	=	-3.8%

This reflects, of course, the general deleveraging that always follows credit booms. After the crisis, economic agents repay their debts, banks extend less new loans and write off impaired credits.
But if you compare the lending behavior of Eurozone banks with US banks, you observe that since January 2012, the annual growth of credit to US non-financial companies has hovered around 5%, while it has reduced by 2 to 3% in the Eurozone.

What is the explanation of this different evolution?

Of course, the macroeconomic situation plays a major role: while the US economy has been growing at 2.5% in 2012, the euro area is in negative terrain (-0.5%). To the extent that SME's are slowing down, this translates in subdued loan demand.

But demand is far from explaining everything.
Regulation has also played a substantial part in the deleveraging process.
Regulation has led the Eurozone banks to increase significantly their own funds and, therefore, to improve their financial strength. From January 2009 to July 2013, their capital and reserves have gone up by 35% (from 1786 billion € to 2407 billion). Related to their total balance sheets, the ratio of their capital and reserves has jumped by 38% during the same period (from 5.53% to 7.60%).

But this has been accompanied by a massive reduction of banks' balance sheets. Indeed, between May 2008 and July 2013, a shrinkage of 9% of the Eurozone banks' balance sheets has been observed.
This should be no surprise. In an environment where equity is scarce and costly to raise, the normal reaction of banks is to reduce the denominator of their capital ratios (i.e. their lending). The rapidity of the enforcement of the Basel rules (2013 as compared with the initially planned gradual phasing in until 2019) has compounded the problem at the very moment when the European economy was moving into recession.

In sum, since 2011, Eurozone banks have increased their capital but also achieved a major reduction in their assets in order to comply with the capital ratios of Basel III.
This deleveraging is not **only** the result of less demand for credit as is often suggested. It would be a mistake to believe that. A precise observation of data shows that, in addition to demand, many other factors are at play: increased regulatory led risk scrutiny pushing banks to tighten credit standards, the need for banks to increase retained profits in order to boost regulatory equity which leads them to concentrate on the most profitable business (thus, shifting from loans to SME's to other types of operations)... [1]. Furthermore, post-crisis bank concentration results in a more difficult access to credit for the SME clients of the former – absorbed- institutions. More generally, it is a fact that banks' ability to take on new risk continues to be affected by ongoing efforts to rebuild capital bases, to de-risk lending portfolios and to reduce costs (see Bain/IIF).

More worrying than the decline in outstanding loans, is the fall of new loans especially when this fall is accompanied by high rates of turning down of credit application by SME's[2].

[1] *See Federal Reserve Bank of Cleveland: "Why small business lending isn't what is used to be?" August 14th 2013*

[2] *According to the Bain/IIF report (Oct.2013), the fall of new learns has been respectively: -82% in Ireland, -66% in Spain, -45% in Portugal...Even after discounting the "excesses" of the pre-crisis period, the fall is spectacular (even in countries where there was no special credit boom in the SME sector like France, the Netherlands or Italy, the rates of decrease are still very high (20 to 37%).*

In this respect, the case of Spain seems to point to a supply problem: new loans to SME's (less than one million €) have moved from:

21 billion € (monthly flows) in early 2010 to
8.5 billion € in August 2013 (ECB figures)

The last ECB enquiry (covering the period of October 2012 to March 2013) shows that only 40% of Spanish SME's declare they can access bank credit without problems (the average for the Eurozone is 65 %, which is historically low). This looks like a credit crunch in the making.

The recent report by Bain/IIF shows how dramatically new loans to SME's have shrunk from the pre-crisis peak.

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The damage is done but unfortunately, this is not the end of the story.

For the reasons I have just explained, the new liquidity coverage ratio (LCR) to be introduced in January 2015 will become tough on some European banks in an environment where banks have a limited access to bond markets and have to repay the LTRO. The shortfall was estimated at 400 billon € on data as of 31 December 2012 (including the outstanding LTRO).

Besides, according to the EBA[3], the long-term liquidity requirements (NSFR) that are looming, are expected to create a shortfall of 959 billion euros of stable funding among EU banks. Facing up such a shortfall would limit further bank lending and reduce its maturity to the detriment of long term investment, in particular in real estate and infrastructure In the Eurozone.

In addition, the upcoming Bank Recovery and Resolution Directive will entail new constraints for European banks. Contributing to resolution funds would cost the banks 1.5% of their guaranteed deposits spread over a period of ten years according to some simulations. The consequences of the new "bailing in" rules will also imply, for a number of banks, issuing additional subordinated debt that will have a cost impact.

Furthermore, the upcoming Basel leverage ratio (3%) is undoubtedly going to hurt many banks in Europe. A recent study[4] has shown that 46% of banks included in a representative sample would not be able to respect the ratio without further measures. Globally, it is estimated that European banks would have to reduce their balance sheets by 12% (the global figure would be 6%). This would entail a new wave of deleveraging in Europe. This would entail – in addition to the LCR constraints[5] – a new wave of deleveraging.

[3] *See the monitoring report by the European Banking Authority – September 2013*

[4] *Comments in response to the consultative document on revised Basel III leverage Ratio Framework and Disclosure Requirements 20 September 2013 – Global Financial Markets Association*

[5] *The two constraints cannot be added because the LCR will lead banks to reduce their assets, thus improving their leverage ratio. But a bank by bank assessment of the incidence of the two constraints would probably show that given the different distribution among banks of these constraints, there would be significant additionnality*

I should add that, as European banks play such a major role in financing the economy (3/4 against ¼ in the US[6]), it is normal that their leverage is structurally higher. They have always tended to lend a more significant part of their stable funding (deposits and bonds) than in the US. As long as the risk is well managed (and this is usually the case of retail banks like yours with stable clients and no significant capital market activity), there is nothing wrong. But the regulation is a "one rule fits all" and neglects the specific conditions of European banks like the ones you represent.

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So we live in a paradox. With one hand, central bankers are creating abundant liquidity. But, with the other hand, they make bank lending more difficult because of regulation. We should not forget that money created by banks constitutes the bulk of total money supply. Therefore, under present bank tightening rules, the most significant part of money creation is being stifled. It is not strange to see so much ECB created liquidity hoarded by banks into their Central Bank accounts and not used to provide credit to the economy? The main reason is that banks are so constrained by the implementation of the LCR that they have to keep their liquidity at the Central Bank in order to abide by the upcoming regulatory buffer constraints.

The Banking Union is a major project aiming at increasing the strength and credibility of the banking sector in the Eurozone and at reducing the perverse link between the sovereigns and their banks. But, in itself, it will not correct the regulatory issues I have just raised.

Europe needs a consistent macro-economic approach to these issues which factors in the specificity of the EU financing mechanisms, the capabilities of the financial markets and the actual needs of EU economies.

Consequently, it is imperative that the calibration of the NSFR and the time table and of its phasing in should take into account the availability of financial markets to provide long term resources. Since, regulators seek to develop market finance mechanism, the time table of the NSFR should provide sufficient leeway to EU institutions to organize these market mechanisms (EU private placement, safe securitization rules...).

At the moment when EU supervisors –under the aegis of the European Central Bank – will be completing the cleaning up of the balance sheets of European banks in 2014, one should avoid to permanently question the resilience of EU banks by imposing successive waves of regulations.

[6] A significant amount of US bank credit to non-financial enterprises is securitized and held by GSE's (Fannie Mae and Freddy Mac, small Business Administration, etc.).This explains in part why US bank leverage is relatively low compared to Eurozone banks which don't benefit from such publicly backed mechanisms. The US financing model depends on public support for 50% of mortgages

More generally, in the US around 40% of the financing of the economy is held by investment funds, pension funds and insurance companies and 15% by GSEs. These figures are in large part the result of a risk transfer from originating banks. In addition, since the median size of the US 6900 community banks amounts to 165 Million assets according to the American Bankers Association, one can understand why US regulators are reluctant to adopt cost intensive risk- based approaches and prefer flat higher ratios (ie leverage ratio) that could reach levels that are irrelevant for the risk profile of EU banks.

Too many and too complex regulations – albeit well intended individually - can lead to unwanted consequences especially if they are not set in a coherent vision. Absent such a vision, too much regulation can lead, as we see today, to pro-cyclical negative consequences on the real economy.

It is obvious that, in order to soften the blow, many banks will continue to downsize their balance sheets which will add to the pro-cyclical regulatory effects touched on in this paper.

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Some four years lie ahead of us on the road that leads to the final dates for complying with all the different pieces of regulation already adopted or being discussed.

Those few years are essential if Europe is to consolidate its present fragile signs of recovery. More new credit will be needed. Let us note endanger this process by too much pro-cyclical regulation.

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