Andrea Enria's speech at the 5th Santander Central Bank, Sovereign and Financial Institutions Seminar

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# Bank regulatory reforms: Are they having adverse effects?

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Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

## 1. Introductory remarks

More than seven years have passed since the beginning of the financial crisis and the repair of the EU banking sector has achieved major progress. The regulatory action coordinated at the global level has been firm and brought to a more conservative regulation and intense supervision. Banks are today required to reach and maintain significantly higher levels – in terms of both quality and quantity – of capital and liquidity. In addition to setting rules, the EBA has worked to coordinate supervisory actions and

foster convergence of approaches, pushing all EU banks to build up their capital base and monitoring the smooth and timely transition to the CRR/CRD IV framework.

As a result of these policy actions, the banking sector is now much stronger than a few years ago. With the stress tests and the recapitalisation exercises we managed to bring EU banks' capital ratios to levels comparable to, and on a risk-weighted metrics even higher than, their US peers. On the asset side, the overall deleveraging process observed before 2014 has now receded.

Still, the financing flow to the real economy remains weak – or weaker than desired – and it is seen as a key factor slowing down the recovery in the EU, particularly in some countries. In addition, there are indicators pointing to the decline of trading market liquidity, with banks withdrawing from their traditional role of market makers in secondary markets.

And the question is – not surprisingly – whether this is due to too much regulation or to other factors. A popular narrative, particularly among bankers, is that the increase of the capital and liquidity requirements has contributed to – if not determined – a slow economic recovery and to thinner liquidity in key securities markets.

In my talk today I will touch upon these two issues and try to disentangle the intended and unintended consequences of the regulatory reform. I will also attempt to identify the real impediments to bank lending to the real economy.

## *2. The virtuous circle of capital and lending*

I would like to start with some thoughts on the relationship between capital and banks' lending capacity.

Let me focus first on the issue of the timing of the recapitalisation via a comparison between the US and the EU. Following the financial crisis, US banks have significantly increased their capital, also thanks to the Troubled Asset Relief Programme (TARP), with the Congress originally authorising, in 2008, an USD 700 billion envelope, approximately 250 of which committed in programs to stabilise credit institutions. The TARP's target was explicitly to '[strengthen] the capital bases of financial institutions […] [so] to increase […] participants' capacity to lend to U.S. businesses and consumers and to

support the U.S. economy’.[1] Data shows that a result of the immediate capital strengthening, US banks’ capital ratios rose to, by far, higher levels than before the crisis, with the CET1 ratio increasing from about 6 percent in 2008 to 12 percent in mid-2015.[2]

Also in the EU, with the stress test and the recapitalisation exercises, we managed to bring EU banks’ capital ratios to levels comparable to US. Between December 2011 and June 2015, the largest EU banks – those monitored more closely by the EBA – increased their common equity tier 1 (CET1) ratio from 9.2 to 12.5 percent. For the wider sample of banks included in the 2015 EU-wide transparency exercise – whose results were published only a few days ago – only four banks show a CET1 ratio considering transitional adjustments below 10 percent. Banks in a relative worse starting situation improved their solvency to a larger extent. Fully loaded CET1 ratio reached 12.0% in June 2015.

On the asset side, the overall deleveraging process observed before 2014 has now faded away, at least in aggregate terms. While banks have further reduced exposures in certain regions or business lines – such as investment banking – total asset volumes increased by about 5 percent between June 2014 and June 2015 and gross loan volumes grew by about 3 per cent.

According to a rather common line of argument, the main difference between the US and the EU banks is that, in the former, banks would have strengthened their balance sheets through real capital issuances, while EU banks would have enhanced their capital ratios mainly by reducing the denominator, risk weighted assets (RWAs). An adjustment via RWAs is clearly less functional as it could be achieved through a reduction in lending to counterparties attracting higher capital charges, which might in turn reduce the ability of the banking sector to contribute to the recovery; or it could be the result of tweaking of internal models to minimise capital absorption, without a real strengthening of the financial position of the banks.

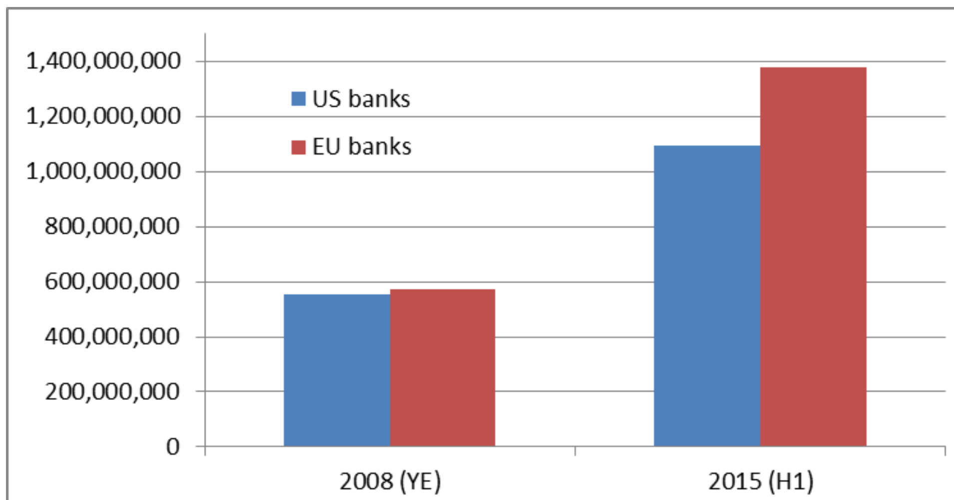
Data contradicts this narrative (Figure 1). In fact, the absolute amount of Tier 1 capital of the top 20 banks in the US and in the EU was approximately the same at the

[1] TARP Research Summary Report “Lending during Recessions”, published by the U.S. Department of the Treasury.

[2] “Quarterly Trends for Consolidated U.S. Banking Organizations – Second quarter 2015”, published by the New York FED, based on the consolidated financial statements for Bank Holding Companies (BHC) and consolidated reports of condition and income for commercial banks.

end of 2008 (EUR 575 bn for the EU banks, EUR 555bn for the US banks), and the EU banks have increased capital more than their transatlantic competitors (+140%, against +97%).

**Figure 1: Tier1 capital – 20 biggest US banks vs. 20 biggest EU banks, 2008 to 2015 (H1)**




The explanation is rather that the frontloaded capital increase pushed by the US authorities in early 2009 has allowed a more rapid strengthening of the US banks, which in turn have accelerated the revitalisation in lending dynamics.

In the EU, there were not such immediate and sharp actions, also for the lack of a common European backstop, but rather supervisory measures spread over the years, with capital ratios growing at a slower pace.

US banks were not only able to restore lending, but also to undertake a convincing de-risking process and to cope with existing and upcoming non-performing assets. Already in 2010, an improvement in the banks willingness to extend new loans was recorded in the "Senior Loan Officer Opinion Survey on Bank Lending Practices" – the US bank lending survey. This trend was similar for all groups of loans considered, including corporate loans to large and small and medium sized business as well as commercial real estate (CRE) and consumer loans. Indeed, loan volumes increased from EUR 2.5 trillion to EUR 3.3 trillion (about 34%).[3]

[3] For the 20 biggest US banks with significant loan business (i.e. excluding GS and MS).

More generally, I think there is a need to clarify the interaction between capital requirements and banks' lending behaviour. Available evidence from several studies suggests a positive correlation between strong capital ratios and banks capacity to sustainably lend into the real economy. A working paper published by the Bank of England, for instance, provides an overview of studies which come to the conclusion that capital levels in general positively correlate with banks' willingness to lending.[4] Similarly, research carried out at Bank for International Settlements concludes – for a sample of global banks – that lending growth and assets were not cut-back as a consequence of stronger capital standards[5]. In addition, banks with higher capital ratios at the start of the process did tend to grow more than the others. It is interesting that European banks in the sample increased lending more slowly than banks based in other countries, confirming the importance of solid balance sheets in supporting the economy.

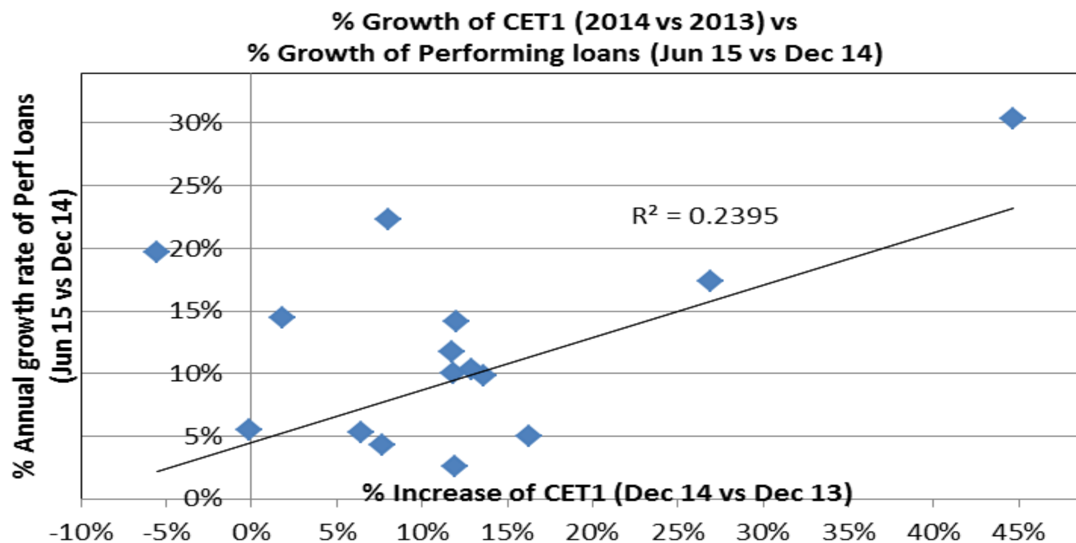
A similar conclusion can also be inferred from our analysis on the SMEs supporting factor. In particular, we looked at the changes in lending to SMEs before and after the introduction of this regulatory treatment and found no material evidence of a positive impact as the result of the capital relief. In fact, access to bank finance did not improve more for SMEs when compared to larger firms and, similarly, there is no indication that SMEs benefited from better financing conditions on loans and credit lines after the introduction of the supporting factor. In my view, opaque balance sheets, high leverage and a high average NPL ratio (18.5 percent at the EU level in June 2015) are likely to be more relevant drivers of the SMEs' difficulties in accessing the credit market.

We have also run a simple analysis looking at the relationship between the increase of CET1 ratio and lending growth in the following period (Figure 2). The results clearly show that banks that increased the most their CET1 ratios between 2013 and 2014 also recorded the highest growth rate of performing loans in the subsequent six months, between December 2014 and June 2015.

[4] Bridges, J., Gregory, D., Nielsen, M., Pezzini, S., Radia, A. Spaltro, M., *The impact of capital requirements on bank lending,* Working Paper No. 486 of the Bank of England, January 2014.

[5] Cohen B. H., *How have banks adjusted to higher capital requirements?*, BIS Quarterly Review, September 2013.

**Figure 2: Evolution of CET1 (Dec 2013-2014) compared with evolution of performing loans (Dec 2014-June 2015)**




While a univariate analysis cannot be conclusive, it still reinforces the notion that capital serves as a safety cushion for credit risk and backs banks' risk bearing ability. At the same time, higher equity levels may lower the cost of debt finance for banks, further boosting lending potential.

## *3. Legacy assets as a restraint to credit growth*

As I mentioned in my opening remarks, European banks have significantly improved their solvency ratios over the past years and are, on average, comfortably above regulatory minima. In many cases, they meet more demanding targets set by supervisors or investors. And, indeed, first timid signs of recovery in lending are visible, even though with significant dispersion across countries.

The question is, therefore, whether there are remaining constraints to credit growth. I have often mentioned that deleveraging, de-risking and disposal of legacy non-performing assets are very important components for restarting bank lending. A strong capital base is a precondition for this process and the asset quality reviews (AQRs) carried out last year also made clarity on the extent of problem loans in banks' balance sheet.

Many examples in financial history emphasise the importance of bank deleveraging to overcome banking crises and restore stability in a banking sector. In that respect, there are two possible strategies for addressing legacy assets: either a very rapid balance sheet adjustment – with possible significant credit contraction and output losses in the short run – or a more gradual adjustment – with more limited immediate repercussions but a risk of misallocation of resources, protracted economic stagnation and the possible 'zombification' of the financial sector.[6] Japan's experience in the 1990s is a good example of the costs for the economy of a delayed recognition of bank losses. The recovery in the US after the subprime crisis suggests that a faster cleaning-up of balance sheets is beneficial for banks and for the rest of the economy.

As in the case of bank recapitalisation, also in the management of non-performing loans there is a divide between the US and the EU. And indeed they are, in my view, two sides of the same coin.

In the US, the bail-out of banks has been accompanied by an asset purchase programme of USD 100 billion in agency debt and USD 500 billion in agency MBS, which also contributed to de-risking. Under that programme, the Treasury ultimately "acquired USD 225 billion […] [of MBS] which were subsequently sold in 2011 and 2012"[7].

I do not want to downplay the relevance of the restructuring process in Europe. I would rather argue that in the EU there has been a widespread preference for bank bail-outs and the restructuring has been driven mainly by the Commission's enforcement of the State aid rules. Compared with the US, where the process has been led by a federal resolution agency, the Federal Deposit Insurance Corporation (FDIC), the European institutional set up has led to a lower number of banks in the EU exiting the market – i.e. lower outright liquidations and reduction in the number of banks via mergers and acquisitions. The excess capacity created in the run up to the crisis has not been rapidly reduced and non-performing loans (NPLs) still represent an important burden and an impediment to more productive investments. Indeed, while asset quality improved slightly over the past few quarters, in June 2015, impaired and past due loans still

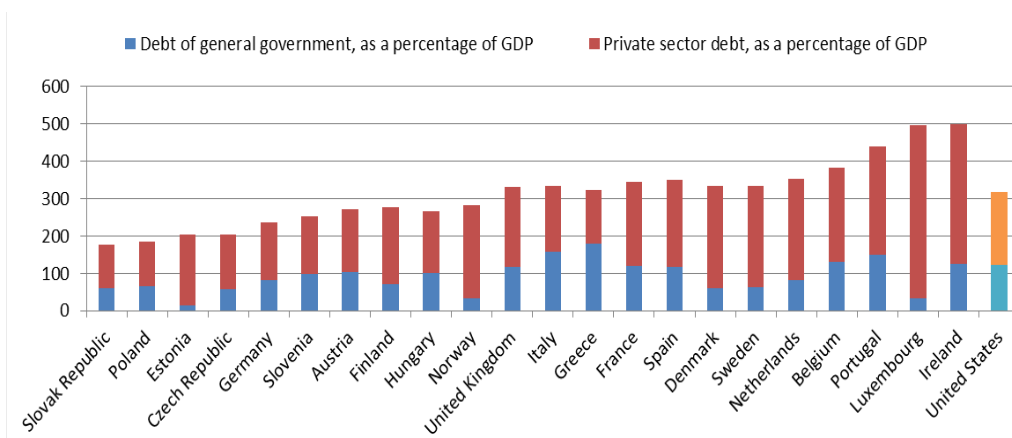
[6] Landau J. P., Deleveraging, long-term finance and the G20 agenda, Remarks at the BIS-Bank of Russia Seminar Moscow, July 2013.

[7] Federal Reserve Bank of New York, Staff Report No. 719, March 2015.

represented, on average, 6.4% of total loans for a large sample of EU banks. In countries where the recession was more acute and prolonged, the ratio was well above 20 percent.

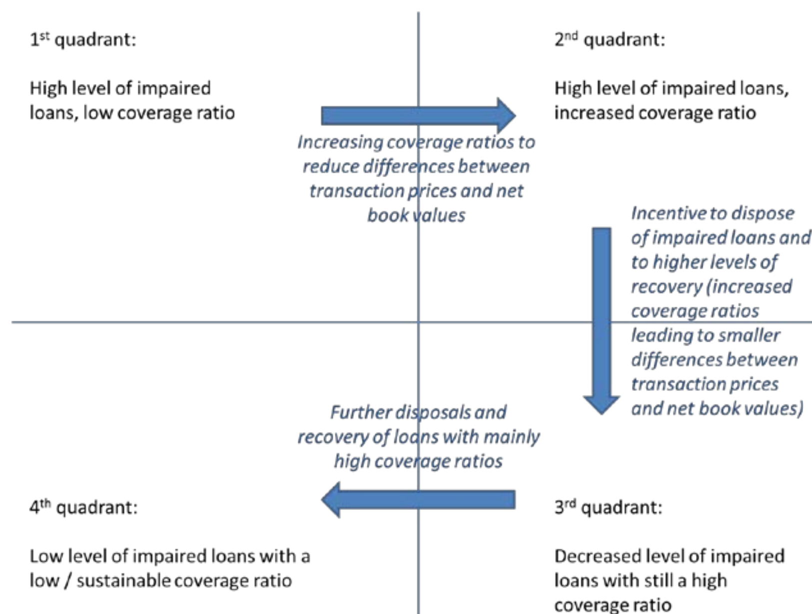
Dealing with their NPLs is, therefore, one of the key areas requiring action from banks as well as from their supervisors. The asset quality reviews (AQRs) carried out last year have been an important catalyst and pushed banks to adopt more conservative provisioning policies, contributing to the alignment of banks and investors expectations and, thus, prompting asset disposals. Several EU banks have already developed initiatives to transfer bad quality assets into ad hoc funds, which then engage into extensive restructuring actions. The scarce anecdotal evidence available shows that such actions encounter a number of obstacles, especially in terms of demanding legal requirements in local insolvency laws and creditors' protection regimes. This is an area where it would be extremely difficult to develop coordinated EU-wide initiatives, due to the limited harmonisation of the relevant legal frameworks. But it is probably the most promising field to support more restructuring, which could lead, at the same time, to mopping up excess capacity in the banking sector and rebalancing the liability structure of the private sector. Indeed, the slow pace of restructuring is reflected in the prolonged debt overhang, with persistently high levels of indebtedness in several European countries for both the public and the private sector (Fig. 3). In the absence of progress in reducing the debt burden, the exit from the crisis is likely to continue at a very subdued pace.

**Fig. 3 Debt of general government and private sector debt as a percentage of GDP (EU–OECD countries and the USA, end of 2014)**



Supervisors should continue monitoring that banks have in place sound provisioning policies. Our data shows that the coverage ratio has steadily increased since 2013 to 47.4% in June, after being at about 41% to 42% in the years 2009 to mid-2013. This might still not be sufficient to foster NPL transactions, though: only when the net book values and potential transaction prices are comparable, are banks willing to dispose their NPLs (Fig. 4). In addition, significant differences remain in the coverage ratios, which range from about 30 percent to more than 70 percent across the EU jurisdictions.

**Fig. 4 Relationship between NPL and coverage ratios**




Further support might come from the implementation of the new international financial reporting standard (IFRS) 9, which is expected to be applied starting in 2018. The implementation of the expected loss model for the impairment calculation – in contrast with the current incurred loss model – would indeed fuel and increase the level of provisions. Banks and market analysts expect, on average, an increase in provisions of about 30 percent. This expectation was confirmed by the responses to our latest Risk Assessment Questionnaire. The impact is assumed to be driven mainly by the so-called Stage 2, which will imply the possible reclassification of underperforming loans that are not yet considered as impaired.

### 4. *Market liquidity in the aftermath of the reforms*

The second topic I would like to discuss today is the impact of the regulatory reform on trading market activities, and particularly on market liquidity.

I would like to start with two fundamental points. First, it is not self-evident to me that a reduction in the role of market makers is bad *per se*. Second, it is not clear whether banks' retrenchment in market making can be ascribed to regulation.

Undeniably, there is some evidence that banks have reduced volumes of their trading books, particularly derivatives and securitisations. Such activities had increased substantially before the crisis, and have now returned to normal levels. For instance, between 2001 and 2008, EU banks' trading activities in derivatives increased by about 600 percent, against about 73 percent for total assets. Very recently, Jon Cunliffe vividly pointed out that this 'can create the illusion of liquidity rather than liquidity itself and expose the system to risk when the illusion disappears'. In fact, the question is whether, in case of severe distress or market disruption, market makers will be available to take-on risk and keep providing liquidity or they would rather withdraw abruptly.

However, concerns are now growing that regulation on market and liquidity risk is contributing to challenges for banks' ability to act as market makers. For example, in the US, market maker inventories of the corporate bonds are half the size they were immediately before the crisis and back to levels recorded in the early 2000s even though corporate bond markets have doubled in size since then.[8] Recent episodes of very high financial market volatility also highlighted that market liquidity is quite fragile.

In the EU, a number of market participants express concerns that liquidity on trading markets for certain assets would be reduced or even drying up, and that bank structural reforms risk further draining important liquidity from securities markets. They argue that the leverage ratio, liquidity rules such as the net stable funding ratio (NSFR) and increased capital requirements for trading book activities are hampering banks' ability to operate in these markets. There are also worries that reduced liquidity could clash with the objective of deeper and more liquid capital markets in the context of the Capital Markets Union: the EU's flagship project in the financial area in the coming years.

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[8] Cunliffe J., *Market liquidity and market-based financing*, Speech given by at the British Bankers' Association International Banking Conference, London, 22 October 2015.

I would, however, note that intended and unintended consequences of regulation should be better spelled-out. The fact that regulation did affect trading activities should not come as a surprise, as the crisis demonstrated that certain operations were very risky but neither backed by enough capital nor attended by adequate risk management practices. We tend to forget that excessive risk taking in such activities was at the very roots of the crisis and trading book business turned out to be very vulnerable once risks materialised. The new rules address this misalignment in incentives and contribute to better price risks that trading activities entail. In fact, the reduction of riskier activities – such as trading, investment banking and complex securitisation – and moving OTC operations into official trading venues were amongst the main objectives of the regulatory reforms supported by the G20 in the aftermath of the crisis.

On the other hand, I believe that structural changes more than regulation appear to have determined a strong impact on banks' preparedness to act as providers of liquidity. We are experiencing a prolonged period of reduced profitability, with banks adapting business models and focusing on core market segments and customers. This is all somewhat discouraging banks to act as market makers and as providers of liquidity. Indeed, market making activities have traditionally generated low income; this has been recently exacerbated by low yields, tightening bid-ask spreads and electronic trading. Lower profit margins and structural changes at banks may have substantially contributed to a reduced ability and willingness of banks to act as counterparties to immediate trading needs and as market makers.

Frankly, it is also hard for me to understand why additional capital requirements for trading book positions and increasing costs of holding inventories would mainly affect the availability and quantity of liquidity provisioning and inventories, rather than being factored into the pricing of, for instance, market making activities. Here, too, it is important to keep in mind that a better pricing of liquidity provisioning and liquidity risk was a key intention of the regulatory reform. To ascribe episodes of heightened trading volatility predominantly to regulatory factors reflects a rather narrow view and does not

recognise other important drivers of volatility. For example, research indicates that strong growth of Exchange Traded Funds has increased the volatility of underlying assets.[9]

While no convincing evidence has been provided that regulation is setting key disincentives for liquidity provisioning and market making, we cannot rule out that some regulatory reforms (e.g. the structural separation of retail business and capital market activities), or the calibration of some prudential requirements (e.g., the treatment of some transactions in the leverage ratio or in liquidity requirements) could turn out to have unwarranted negative effects on liquidity provisioning and market making. Serious analysis and impact studies should allow shedding light on these questions.

We have already demonstrated our willingness to act where overly severe calibrations could penalise certain activities. For example, after in-depth studies, we acknowledged that certain aspects of the post-crisis regulatory framework for securitisation - in particular, the one-size-fits-all approach that did not allow for any distinction between products with significantly different performances during the crisis - were having detrimental effects on the functioning of the market. The EBA published a report to the European Commission on a ‘framework for qualifying securitisation’. The framework proposes a more risk-sensitive approach to capital regulation for long-terms simple, standard and transparent securitisations qualifying, with low risk underlying assets. The report illustrates how the capital charges foreseen in the published revision of the Basel securitisation framework should be lowered so as to recognise the relative lower risk of qualifying securitisations. Work on the framework demonstrates our willingness to ensure that prudential requirements do not end up stifling the efficient functioning of capital markets.

In that respect, an open and constructive interaction with the industry ranks high in the EBA agenda, but would also require a commitment from banks to provide robust empirical evidence supporting their claims.

## *5. Concluding remarks*

[9] ESMA Report on Trends, Risks and Vulnerabilities, No. 2, 2014.

Soon after its establishment back in 2011, the EBA was confronted with a very high pressure from market participants, international institutions and European policy makers to strengthen the balance sheet of banks and to implement rigorous regulatory reforms. At the same time, European institutions and national governments strongly requested that we aimed at avoiding an abrupt deleveraging process, hampering the provision of credit to the economy. With the limited tools in its armoury, the EBA engaged in a difficult balancing act: we requested a significant increase in capital levels, constraining the possibility to achieve higher regulatory ratios by contracting risk weighted assets. As a result, the reduction in banks' balance sheets proceeded in a more gradual fashion and was concentrated in those riskier areas of business that had experienced an excessive expansion in the run-up to the crisis. With hindsight, this preference for a gradual adjustment, rather than a sharp correction in banks' balance sheet, has contributed to the sluggish recovery in bank lending, which only now is slowly picking up.

Now that we are closer to the finishing line, with the regulatory reforms almost completed, the EU banks' balance sheets in a much stronger position and some visible offspring of a recovery in lending growth, we face growing criticism that regulatory actions are having adverse effects on the economy and on financial markets.

I believe regulators should resist the natural reflex to turn defensive and reject any criticism. The reform process has been so wide ranging that it would be surprising if we did not realise with hindsight that some choices have turned out to be inappropriate and generated undesired adverse consequences. This is why we should stand ready to review and reconsider aspects of our policies and design of our rules. But this process should be based on sound analysis and clear evidence.

Today, I tried to review some of the most controversial aspects of post-crisis regulatory reforms and policies: the effect of more demanding capital and liquidity requirements on bank lending and on trading market liquidity. On the basis of the evidence, I am not convinced that a clear-cut case for changing the regulatory stance has been made. On the contrary, supervisors should increase their pressure on banks to

address asset quality problems and dispose of NPLs, as this legacy of the crisis is proving to be a serious burden to a more buoyant recovery in lending activity. If anything, we should put more urgency in addressing obstacles hindering a fast restructuring of impaired loans via harmonised interventions in bankruptcy legislations and tax provisions affecting the treatment of credit losses - all points highlighted in the Commission's proposals for the Capital Market Union.

I am sure that the review on the overall impact of the banking reforms launched by the European Commission will provide a good framework for an open minded, evidence-based debate on the effects of newly issued regulations. I stand ready to engage in this discussion.

Thank you very much for your attention.