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Supervisory policies and bank deleveraging: a European perspective

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Ladies and gentlemen,

This evening I would like to share with you some thoughts on the future landscape of the banking sector and discuss how policy makers could accompany the process of de-risking that banks are undertaking.

I will present my assessment of what is currently happening in the EU banking sector and what we expect may happen over the next years. In particular, I will try to address three questions.

1. The first question is whether we are heading towards a significant deleveraging in the EU banking sector.
2. The second one is whether adequate policy measures can ensure that this process occurs without major damage to the real economy.
3. The third question is whether macroprudential supervisory tools can be designed to prevent excessive leverage to be built up again in the future and operated in a smooth fashion when applied to cross-border business.

1. Do EU banks need to undertake a significant deleveraging process?

The financial crisis has its roots in multiple imbalances at the global level and has been triggered by the fall of asset prices. How a decline in asset value led to a major crisis at the global level has been vividly illustrated by Olivier Blanchard (2009)[1]. First, the underestimation of risks and disaster myopia, something not really new in prolonged periods of benign market conditions. Second, the difficulties to value some categories of assets and new financial products. Third, the interconnections among financial institutions due to the growth of securitisation and globalisation.

Finally, the increase of leverage, with financial institutions financing their portfolios "*with less and less capital, thus increasing the rate of return of capital*". It is clear that the higher the leverage, the more likely it is that decline in asset values determines the depletion of capital. In fact, extensive research in this respect demonstrates that the procyclicality of leverage acts as amplification mechanism propagating adverse shocks to the real economy.[2]

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[1] O. Blanchard (2009), "The crisis: Basic Mechanisms, and Appropriate Policies", IMF Working Paper, no 80.

[2] B. Bernanke and M. Gertler (1995), "Inside the Black Box: The Credit Channel of Monetary Policy Transmission", Journal of Economic Perspectives no. 9(27).

Encouraged by a low-interest rate environment and by regulations lagging behind financial innovation, banks could boost the size of their balance sheets and activities. This process entailed the growth of trading activities and investment banking, but also of retail lending, primarily of residential mortgages. The main drivers of leveraging have been real estate and structured finance and, more generally, trading book activities. For 70 of the largest EU banks, the exposures in the “held for trading” and “available for sale” portfolios increased by 68 per cent between 2005 and 2008, with a sharp 24 per cent decrease in 2009.

The different drivers were deeply interlinked and worked together, with optimism and the underestimation of risk contributing to banks’ excessive leverage. Leveraging up was considered as a legitimate strategy to maximise earnings and, thus, to satisfy the search for yield of market investors. Indeed, until 2007, the banking sector experienced profitability levels well above any other economic sector and banks reported returns on equity exceeding their normalised earnings capacity on a risk-discounted basis.

Since 2007, confronted with an unprecedented financial crisis, banks have shifted to liability-driven strategies: obtaining the necessary funding in the form of deposits or of market resources became the paramount strategic goal. Both in the US and the EU, deleveraging was seen as part of a necessary adjustment to remove excess capacity and restructure balance sheets, and to set the basis for a more stable and sound banking sector. Indeed, empirical research suggests that some deleveraging is unavoidable after a crisis: according to the BIS (2010), debt reduction followed 17 out of 20 banking crises that were preceded by a surge in credit.

However, the response to the crisis has been diverse on the two sides of the ocean. While US banks have reduced their leverage and reliance on wholesale funding, until recently, European banks remained, on average, more reliant on wholesale funding and leverage levels – while decreasing – remained comparatively high. This makes the EU banking sector more prone to structural and cyclical deleveraging pressures.

In the US, deleveraging has been significant. For the top 10 banks, the tangible common equity ratio (the ratio between tangible equity and tangible assets) increased from 5.7 to 7.8 per cent between 2005 and 2011. In the EU, the same ratio shifted from 3.4 to 4.5 percent for the 70 banks participating in the EBA recapitalisation exercise.

The figures on the level of leverage should be interpreted with great caution. There are in fact a few explanations for the difference between the US and the EU that are not linked to banks' behaviour but rather to the local regulations and the characteristics of the financial markets. Let me provide some examples.

First of all, off-balance sheet exposures – that are typically excluded from the computation of traditional leverage measures – are of different size across banks, with US investment banks being typically outliers[3]. Moreover, and most importantly, accounting rules may hamper the comparison, as measures of leverage differ to a significant extent under US GAAP and IFRS standards. Finally, after the freeze in the securitisation market, European banks have further developed the practice of funding mortgages through covered bonds. Therefore, European banks keep mortgage exposures in their balance sheets, as opposed to US banks, which can securitize and easily divest their mortgage portfolio, primarily via the Government Sponsored Entities (GSEs).

Furthermore, other factors may explain why the change in banks' leverage has been more pronounced in the US than in the EU. In the US, it is easier for banks to sell assets due to the dis-intermediated structure of the financial sector, where capital markets play a pivotal role. Bank deleveraging is therefore structurally easier, but indebtedness is in fact transferred from banks to other players, often not subject to equally stringent regulations or not regulated at all. Also, as the crisis kicked-in, we have been witnessing aggressive reduction in indebtedness levels by both households and businesses in the US, which, so far, has not been the case in the euro zone. This suggests that demand factors also matter and that they are intertwined with the debt level of the private sector at the onset of the crisis.

On the last point, the data provides a mixed picture. In the US, households confronted the crisis with higher debt levels than the euro-area ones. In 2007, the debt to disposable income ratio was about 140 per cent against 110 in the euro-area. The divide is even clearer looking at the mortgage to disposable income ratio (about 100 in the US per cent versus 60 in the euro-zone). In 2010, notwithstanding the debt reduction in the US, the ratio was still at 120 per cent. As for the corporate sector, in

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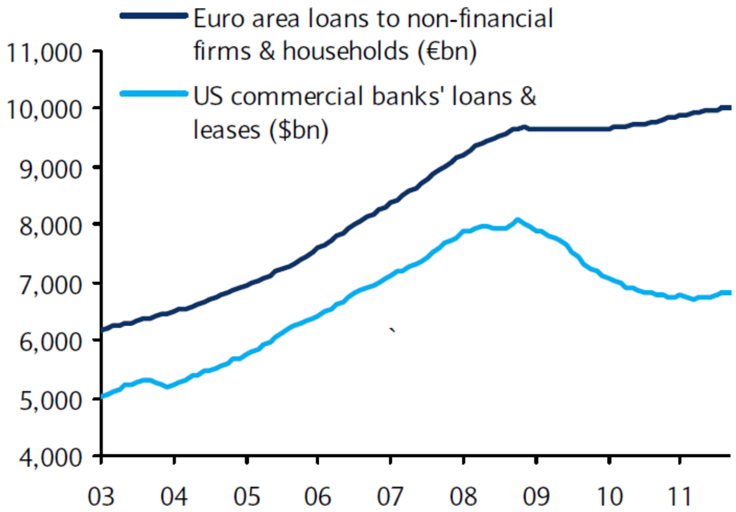
[3] S. Kalemli-Ozcan, B. Sorensen, and S. Yesiltas (2011), "*Leverage Across Firms, Banks, and Countries*", NBER Working Paper no. 17354.

2007, the leverage ratio (measured as the ratio of financial debt to financial debt plus capital) was about 30 per cent in the US compared to 37 in the euro-area (35 and 42 per cent respectively in 2010).

It is also fair to acknowledge that deleveraging has been prevalent at financial institutions – larger banks and brokers/dealers – that grew their balance sheets aggressively by increasing debt and assets in the upswing, a trend that has been more pronounced in the US.

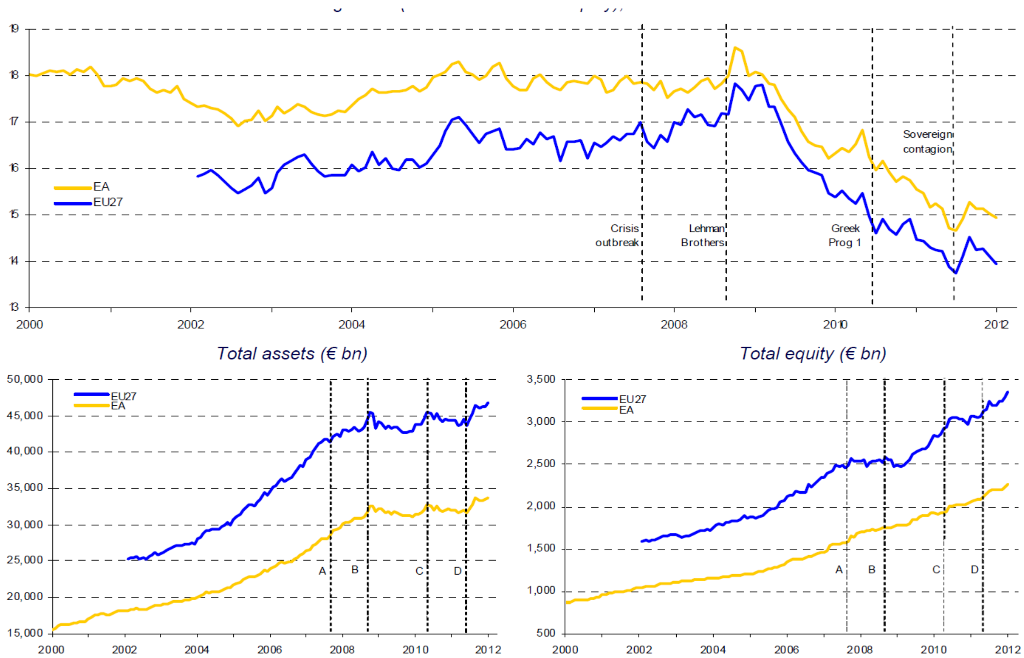
All these arguments point to a complex picture in deleveraging dynamics, but a simple fact still holds true: differently from their US peers, EU banks, until recently, had reduced their leverage almost exclusively through an increase in their capital levels, while the size of their balance sheets had remained almost unchanged – if anything, it had grown further (Charts 1 and 2).

Chart 1. Deleverage metrics



Source: Haver Analytics, Barclays Capital, McKinsey Global Institute

Chart 2. The drivers of deleveraging in Europe



Source: European Central Bank

All this has changed with the bursting of the sovereign debt crisis in the euro area. Strong pressure for deleveraging emerged in Europe during the final quarter of 2011, with the freeze of the markets for medium and long term bank funding. While this has been a source of concern, at this stage, there is no evidence that the deleveraging process has become excessive or disorderly, with disruptive consequences on the real economy. According to the BIS (2012)[4], European banks offered for sale a significant volume of assets, mostly those with higher risk-weights, including low-rated securitised assets, distressed bonds and commercial property. In the last quarter of 2011, credit to non-bank private-sector borrowers in the euro-zone fell by around 0.5 per cent, while exposures towards non-euro-area residents declined by almost 4 per cent. The home/regional bias in deleveraging is partly the result of banks' deleveraging pecking order and partly of difficulties in the US dollar funding, which remained more expensive and less readily available than home-currency funding for many European banks due to the reduction of prime money market funds' exposure to euro area banks.

[4] BIS (2012), Quarterly Review, March.

I would suggest some of the rationales for bank deleverage in the EU.

Funding shortages have been certainly a key driver. We have all witnessed the dramatic market funding freeze during the second half of last year for EU banks, alleviated some months ago by new regulatory and policy initiatives, primarily the ECB's 3-year Long Term Refinancing Operations (LTRO), but also state guarantees for new bank bonds.

EU banks are now facing longer-term challenges and deleveraging is the way for aligning the business model to markets' expectations and to the incentives posed by regulatory changes. Unquestionably, there is a need for de-risking, bringing leverage to more conservative levels. Indeed, a number of European banks have not yet completed the clean-up of their balance sheets and shedding of legacy assets. In addition, those banks that received public support are required under EU State aid regulation to dismiss part of their business to minimize competitive distortions. Banks may also need to rethink their involvement in investment banking and related activities as well as attempt to reduce their dependence on less stable sources of funding – such as short-term wholesale financing – as a response to the new rules introduced by Basel 2.5 and 3.

Hence, my answer to the first question is that the EU has avoided so far a disordered deleveraging process driven by a massive funding squeeze, thanks in particular to the actions taken by the European Central Bank. But a downsizing of banks' balance sheets has started and has to take place, in order to unravel some of the processes that have triggered the financial crisis. This is necessary to bring banks back to sounder and more stable business models. Several estimates have been put forward by analysts on the likely dimension of this deleveraging process. I don't think regulators should have a view on the overall size of the adjustment, but they should be aware that there is still some way to go and they should keep putting pressure on banks to complete the repair of their balance sheets.

2. What policy actions to avoid negative repercussions on the real economy?

A recurrent theme in the recent debate has been the claim of the banking industry that the regulatory reforms would have a major adverse impact on growth and employment. Deleveraging has often been characterised as "bad", as implying reduced flows of lending into the real economy. But deleveraging could be both "bad" and "good", simply because reducing the size of different components of a bank's balance sheet can have different impacts. The point is whether we can disentangle possible trajectories for deleveraging and deploy policies that favour an orderly deleveraging process, which does not hurt growth prospects.

For example, deleveraging is welcome when it entails dismissing or writing down troubled assets accumulated by banks before the crisis. In most post-crises periods, we have witnessed a massive deleveraging process, which often is simply reflecting the cleaning of the banks' balance sheets. The size of banks' balance sheets shrinks simply because losses are recognised and accounting values revised downwards. This process has no adverse real impact, as it does not change in any way the amount of loans.

On the contrary, there is a good amount of evidence that if residual credit risk is not recognised and dealt with, it is likely that the economy remains in a prolonged period of stagnation associated with a failure to address non-performing assets. Forbearance can be a force for good where a loan has a reasonable prospect of an imminent return to performance. However, it can be pernicious for both the borrower and the lender to maintain non-performing loans on balance sheets for prolonged periods.

When a universal bank with extensive activities in both investment and wholesale banking on the one hand, and retail and commercial banking on the other hand, decides to de-risk away from market activities, the investment banking/trading portion of the balance sheet will naturally shrink. This may in fact be a good thing insofar as de-risking is concerned, and indeed some regulators required banks to do that at the height of the crisis. On the other hand, indiscriminately cutting lending to the real economy may lead to an economic slowdown and possibly to a credit crunch. And I include here not only lending to the domestic economy by the parent bank but also real economy lending in other countries where the bank has subsidiaries.

This is a very sensitive issue in the EU where, for instance, subsidiaries of Western EU banks play a major role in Central and Eastern Europe.

Disentangling good and bad deleveraging is part of the usual dilemma for policy makers during a crisis. On the one hand, there is the willingness to prevent a sharp contraction in credit supply to firms and households and, in turn, negative repercussion on economic growth. On the other, some adjustments and repairs in banks' balance sheets are vital to restore the confidence in the financial sector and restart credit markets. And the Japanese experience warns us that forbearance – late recognition of losses, delayed restructuring of balance sheets, deferred capital raising – can produce harmful consequences.[5] Tang and Upper (2010) remind us of this lesson: "*fix the banking system first*".[6]

It has been noted that "*getting rid of the non-strategic assets that normally hang around after a long merger-wave […] is a responsibility of individual banks and their senior management, but moral persuasion from regulators and governments is also needed. Managers and directors can have a vested interest in preserving the present size, which can make it easier to extract private benefits and pursue rent-seeking behaviour*"[7]. In that respect, we should welcome the fact that the waterfall of deleveraging is also driven by regulation.

This leads me to the second question. What policy actions can be set up to ensure that only good deleverage takes place?

The first element of the policy toolkit should be an incentive-compatible regulation. If rules are properly designed, the cost in terms of capital and liquidity requirements of holding riskier assets is higher, providing the right incentives to what I called good deleveraging. And I assume there is still agreement on the fact that certain activities have contributed more than others to the build-up of vulnerabilities in banks' balance sheets. For example, deleveraging trading and investment assets is the consequence of a more demanding regulatory framework – Basel 2.5 and 3 and the Dodd-Frank Act – that affects primarily market risk and trading book exposures.

The second element is to put banks in the condition to keep granting credit to the economy. In Europe, the initiatives for restoring market confidence have been incisive. The operations to support liquidity approved by the European Central Bank have alleviated the pressure on bank funding, even though restoring the access to private markets for long term funds remains an important policy objective. While easing funding pressures on banks was essential to avoid a disordered deleveraging process, policies need to be put in place that encourage banks to repair their balance sheet and strengthen their capital position. The EBA required banks to form a capital buffer that will enable them to reach a Core Tier 1 ratio of 9 per cent, after a prudent valuation of the banks' sovereign exposures. This is a temporary and exceptional buffer to address

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[5] R. Caballero, T. Hoshi and A. Kashyap (2008), "Zombie lending and depressed restructuring in Japan", American Economic Review, no 98(5).

[6] G. Tang and C. Upper (2010), "*Debt reduction after crises*", BIS Quarterly Review, September.

[7] M. Onado (2011), "*Restructuring European banking systems*", VoxEU.

the systemic risk arising from the sovereign debt crisis. In order to discourage banks from complying with the recommendation by simply curtailing lending, we laid down precise guidelines and asked the banks to submit plans for recapitalisation, describing the steps they intend to take in order to reach the required level of capital.

Only a limited number of measures to reduce assets are allowed to meet our request: while it will be possible to transfer certain categories of activities to third parties – since this does not reduce the leverage of the system as a whole – reductions in lending will not determine any capital relief for banks, unless they occur within restructuring plans required by the EU and the IMF or per requested by supervisors.

The plans submitted by banks – and currently being carried out under the scrutiny of national supervisory authorities and the EBA – are encouraging. The actions that banks intend to put in place for reaching the target capital level focus predominately on direct capital measures – issuance of new capital, retained earnings, conversion of hybrid instruments into common equity. Overall, direct capital measures cover 96 per cent of the shortfall. In a small number of cases reductions in lending into the economy are included in the plans. The majority of these deleveraging activities correspond to conditions laid out in EU State Aid rules or other official programmes to ensure appropriate restructuring and return to long term viability. In practice, less than 1 per cent of the total measures will be represented by decrease in lending.

But let me turn to another important point. Over the last months, there has been some dispute on the role that supervisory pressure for strengthening capital levels played in the deleveraging process, particularly in the EU. In fact, asset deleverage has been primarily driven by a change in strategy and de-risking, reduced credit demand and funding constraints, much less by additional needs on the capital side. In Europe, the deleveraging process began long before the EBA started to consider banks' recapitalisation needs, and it was closely linked with the difficulties banks had in collecting funds on the market at a reasonable cost.

On this, I want to be blunt: I do not believe that high levels of capital are a deterrent to new lending. On the contrary, banks with low capital levels – or perceived by the market as being so – are those that have had problems in increasing lending. They either face major funding difficulties – which, in turn, do not allow them to grant loans – or focus primarily on preserving their meagre capital. Banks with large capital positions, by contrast, are less sensitive to cyclical shocks and more likely to pursue lending growth strategies.

Indeed, last September, the IMF warned that "*a number of [European] banks must raise capital to help ensure the confidence on their creditor and depositors. Without additional capital buffers, problems in accessing funding are likely to create deleveraging pressures at banks, which will force them to cut credit to the real economy*"[8] and the European Systemic Risk Board (ESRB) emphasised the need for coordinated efforts to strengthen EU banks' capital.[9]

The EBA's recommendation for temporary capital buffers is consistent with the lessons learnt from previous crises and responds to the IMF and ESRB warnings and meets market expectations for higher capital levels. It has pushed a rebalancing of the deleveraging through a major increase in capital (€115bn) and, at the same time, it only allowed for good deleveraging.

Going forward, supervisors need to maintain their focus on asset quality, making sure that residual credit risk is properly addressed and losses are fully recognised. This should also help driving market values and book values closer to each other, thus supporting the issuance of new equity.

At the same time, supervisors need to work with banks to identify pathways to new and diverse sources of funding, with less reliance on short term wholesale funding than in the past. This rebalancing in the funding models is a necessary component of a process that will lead banks to gradually exit from the extraordinary support measures provided by their central banks. An important component of this strategy could be supporting industry initiatives to re-establish a sound and well controlled market for securitisation. These actions on assets and funding should help banks refocusing their business models so that their activities are sustainable and reflect their areas of comparative advantage.

3. Which policy tools to prevent boom and bust cycles in integrated financial markets?

The final issue I want to tackle this evening is whether policy makers can reduce the probability of future boom and bust cycles devising effective preventive tools. The Basel 3 framework does envisage instruments that should contribute to smoothing the fluctuations in the financial sector. At the micro-prudential level, higher requirements in

[8] IMF (2011), Global Financial Stability Report, September.
[9] ESRB (2011), Press Release, 21 September.

terms of quantity and quality of capital should structurally reduce banks' risk-taking. In addition, the leverage ratio will set a ceiling to non-risk-weighted exposures in buoyant economic conditions. At the macro-prudential level, the countercyclical buffer regime will require banks to build-up capital cushions in good times – when risk is underestimated – to be deployed for covering losses when the cycle reverts and, thus, supporting the economy when this is most critical.

The effectiveness of this toolkit in preventing excessive leveraging and abrupt deleveraging is still debated at the global level and, particularly in the EU, with some jurisdictions claiming that the current steps towards strengthening prudential rules may not be sufficient.

In the EU, we are working for completing the implementation of Basel 3 in our legislation as soon as possible. Indeed, we realise that the breadth of the regulatory reform is such that it is producing some degree of uncertainty in the market place. Our priority is thus to reduce this uncertainty and provide an environment in which banks – and investors providing banks with the necessary funds – can again do their planning in a long term perspective.

What makes Europe – I believe – an interesting case study is the fact that we are committed to achieving a single rule-book for financial markets, that is a common set of fully harmonised rules that will be binding and directly enforceable in all EU Member States. While the single rule-book remains a shared goal, there is at the same time a call for greater flexibility at the national level, in order to favour the implementation of macroprudential policies.

Undoubtedly, there are strong arguments in favour of some flexibility in the use of macroprudential instruments. First, systemic risk may materialise in different ways and no predetermined rules could address it. Second, since credit and economic cycles are not fully synchronised across EU countries and financial markets are still heterogeneous, Member States may necessitate some room for manoeuvre in the activation of policy measures. Third, the development of macroprudential instruments is still at an early stage and some flexibility may contribute to the learning-by-doing process.

At the same time, the establishment of any flexible macroprudential framework in Europe should not jeopardise the Single Market. What happened during the crisis has warned us that the integration of financial and banking markets cannot be considered a permanent accomplishment if it is not underpinned by effective harmonization of the legal framework and its consistent application throughout the Union. We have all witnessed how the Single Market may well prosper when the economic cycle is upward, but it may well implode in downturn cycles if no coordinated responses are developed. We are currently witnessing a major retrenchment of banking business within national borders. Cross-border banking is significantly downsizing. The money market, which was the most integrated market since the introduction of the euro, has virtually disappeared and the limited signs of recovery in interbank transactions that materialised since the ECB's LTRO are remaining mostly within national borders.

The deleveraging process is being driven by the requests of authorities to hold significant capital and liquidity levels in domestic markets and to refinance the local economy. At the moment, we are facing a high likelihood that the deleveraging process will occur with a segmentation of the Single Market in banking. This might well endanger its ultimate goal: wider and deeper financial markets offering better and more financing opportunities for real economies.

This does not imply that no discretion should be left to the national authorities in shaping their macroprudential toolkit, but rather that this should happen under a coordinated approach based on strong *ex-ante* guidance and credible *ex-post* reviews of the measures adopted at the national level.

The level of flexibility to be left to the macroprudential supervisors is also linked to the objectives that macroprudential policies are expected to achieve. And it is fair to acknowledge that there is no clear agreement on this. According to a first viewpoint, macroprudential policy plays primarily a passive role, complementing traditional microprudential supervision, which neglects the time-dynamics of credit markets, and ensuring that capital resources are adequately allocated across time, building reserves in good times that can be run-down when economic conditions deteriorate. The second perspective regards macroprudential tools as an effective and wide-ranging mechanism for leaning against the wind, i.e. for reducing banks' incentives to expand credit and leverage in buoyant economic conditions, thus avoiding credit bubbles.

While the two perspectives are not necessarily mutually exclusive, they have different consequences in terms of design and use of the policy tools. In the first case, they aim at being neutral and rule-based. Some discretion may be left to the policy maker, but it is typically residual. In the second case, much more discretion is needed and the policy maker is endowed with a significant degree of freedom in adapting the policies to the specific juncture. In this case, however, it is crucial to preserve consistency in the activation of macroprudential tools and to avoid unintended consequences when they interact with microprudential tools. In a nutshell, greater discretion needs to be balanced with some pre-agreed principles on how discretion can (or cannot) be exercised.

The functioning of the countercyclical buffer – a key element of the Basel 3 macroprudential toolbox – is a good example. As currently foreseen, national authorities will be given the possibility to activate additional buffers reflecting the conditions of the credit cycle in their jurisdiction. In Europe, the *ex ante* guidance, to be issued by the European Systemic Risk Board (ESRB), coupled with an effective *ex post* peer review process should guarantee that these tools do not alter the level playing field and are compatible with the single rulebook. The approach followed for designing such a tool could be followed also for the introduction of other components of the macroprudential suite.

My answer to the initial question is therefore mixed. We have some tools – the leverage ratio and the countercyclical buffers – but we still do not have a well structured suite of macroprudential tools and specific rules of engagement for their employment. In addition, all measures have been focusing so far on the banking sector, while a sizeable share of the leveraging up of the system in the past was driven by other financial institutions.

Looking at the implementation, we are running the risk to open a wide area for discretion in national supervisory implementation, with national policy makers – not only in Europe – potentially able to hide everything under the macroprudential umbrella. In that respect, a constrained discretion regime for macroprudential policies – along with harmonised microprudential rules and homogenous supervisory practices – is the only avenue for ensuring that the same sources of systemic risk are addressed in a consistent way across countries, levelling the playing field and reducing spill-over from less to more conservative jurisdictions. Systemic risk cannot anymore be contained within national borders and requires coordinated policy responses.

4. Conclusions

Today I tried to argue that a deleveraging process is needed in the banking sector. It has already started, with a different pace in different areas of the global financial system. The first step has been the increase in capital levels, long overdue and one of the cornerstones of the regulatory reforms endorsed by the G20 Leaders. The second step implies a reduction in size of balance sheets, especially by addressing non-performing assets and de-risking in areas such as capital market activities and real estate lending, which grew too much in the run-up to the crisis. The third step entails a refocusing of business models, especially towards more stable funding structures and the gradual exit from the extraordinary support measures put in place by central banks.

I have seen no compelling evidence supporting the industry's argument that the regulatory reforms will bring about an unwarranted deleveraging process, badly hurting the real economy. On the contrary, I am convinced that without an ordered deleveraging process, through a significant strengthening of capital and a selective downsizing of asset levels, we would fail addressing the fragilities that are preventing banks from performing their fundamental functions.

A point I acknowledge in the industry's criticism is that in the path to the new equilibrium, authorities need to provide for regulatory certainty and close coordination of actions.

Supervisors and central banks have to carefully coordinate their actions to accompany this process and make sure that it occurs in an orderly fashion, without hampering the continued flow of lending into the real economy. In particular, in deploying their armoury of tools, including the new macroprudential instruments, national authorities should avoid policies too narrowly focused on domestic objectives: if the deleveraging process is shaped by policies aimed at maintaining domestic assets while de-risking in foreign jurisdictions, we risk triggering a segmentation of financial markets that may well hamper growth and employment. This is particularly true in the euro area and the EU, but has a more general relevance for global financial markets.

Thank you for your attention.