

## Europe 2020 and the Financial System: Smaller is beautiful

Karel Lannoo

Meeting Europe's 2020 objectives of *smart, sustainable and inclusive growth* is even more of a challenge for the financial sector than for the EU as a whole. Smart, sustainable and inclusive growth is just the opposite of what the financial sector stood for, and how it continues to be perceived by the public. The huge regulatory agenda that is on the table should tame the financial sector, but whether it will help it to meet the Europe 2020 objectives is an open question (see European Commission, 2010a).

The Financial Services Action Programme (FSAP) was one of the core pieces of the Lisbon Agenda. Drafted initially in 1999 to secure the full benefits of the single currency, it was merged into the Lisbon Agenda in June 2000 "to foster growth and employment by better allocation of capital and reducing its cost". The benefits of the single financial market were later quantified in several studies for the European Commission to amount to at least 1% of GDP annually (see European Commission, 2003). These studies should be reviewed carefully. The last ten years have seen such a large-scale waste of capital (excessive real estate investment in Spain, Ireland and the Baltics, and unsustainable consumption booms in Greece and Portugal) that one might doubt the benefits of financial market integration – at least in the absence of a better regulatory framework.

As a result of the financial crisis, we are now moving in the opposite direction of the last ten years. Not only is financial integration receding on several indicators, but a vast regulatory plan is being put together where safety and stability take precedence, ultimately over credit growth and profitability. In addition, the combined effect of these measures, developed at

global, European and national level, may create new barriers to market integration.

The objective of this policy brief is to provide a brief analysis of the impact of the financial crisis on the banking sector from the perspective of Europe 2020. The article starts with an overview of the effect of the financial crisis on large banks. It then reviews the key regulatory reform proposals and discusses their impact on the structure and profitability of the banking sector.

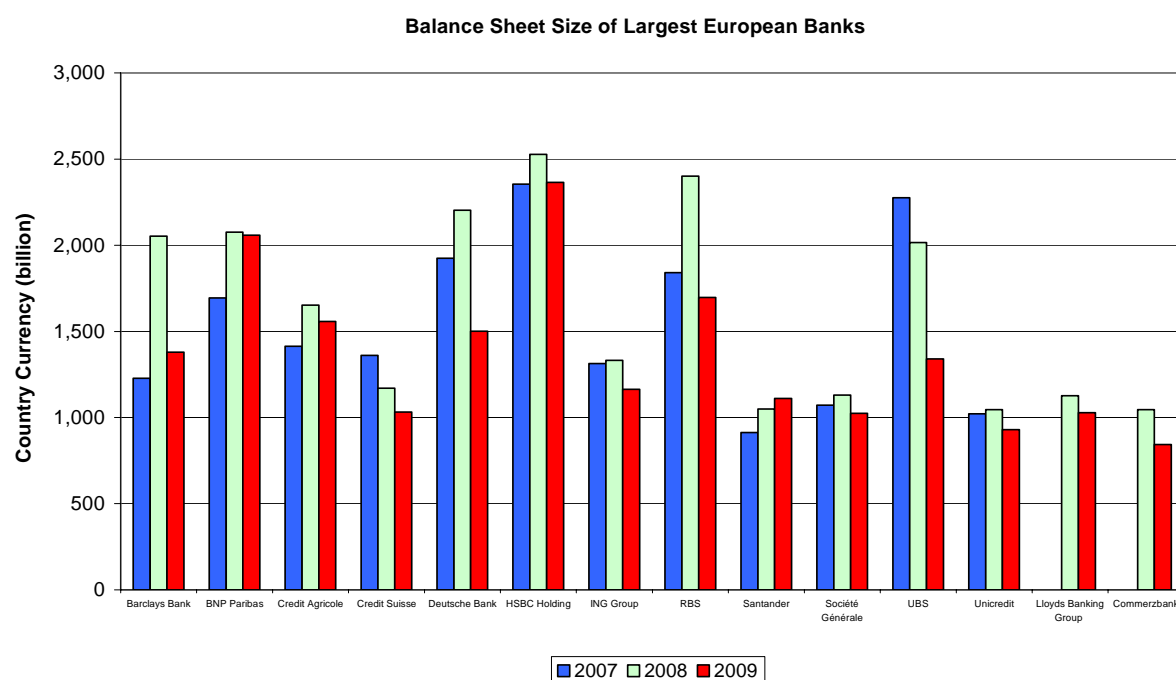
### A financial system under pressure

Compared to the period of unrestrained credit growth before the crisis, the post-crisis period is marked by cracks and pain throughout the EU. The key word now is *deleveraging*, i.e. a reduction in the degree of indebtedness in the financial system. Already in early 2008, after the first cracks appeared with the collapse of the securitisation market, it was expected that the financial system would have to reduce leverage. Back then, however, analysts did not foresee that the process would be so painful and affect the 'real' economy to such a degree. By November 2008, it started to become apparent that the financial crisis would have profound and far-reaching implications, leading to an average drop in GDP in the EU of 4% in 2009, the sharpest fall in post-World War II history. To limit the downside and allow the credit channel to continue to function, EU member state governments reacted with a massive support programme for the financial sector in a panoply of debt guarantee schemes, equity support and bad bank schemes, amounting in total to some 12.5% of GDP (European Commission, 2010b). For the non-financial sector, fiscal stimuli were provided to differing degrees across EU member states.

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Figure 1. Deleveraging in Europe's '€1 trillion banks'



Note: We kept the balance sheet data in local currency (euro, sterling and Swiss franc) to arrive at a correct comparison of the magnitude of the decline, as the exchange rate movements were substantial. End-of-year exchange rates £ to the € are 0.733 (2007), 0.952 (2008) and 0.888 (2009); CHF 1.655, 1.485 and 1.484. For Lloyds and Commerzbank, comparable 2007 data were unavailable, as in both cases the banks went through a merger in 2008, in the Commerzbank case with Dresdner, and in the Lloyds case with HBOS.

Has deleveraging started? The evidence is mixed. Large banks seem to have engaged in this process. Among Europe's 14 banks with assets of €1 trillion or more, it can be noted that the total balance sheet reduction amounts to about €3.5 trillion or 16% from 2008 to 2009 (see Figure 1). In some cases, namely Commerzbank, ING, Lloyds, RBS and UBS,<sup>1</sup> this deleveraging was forced upon the bank in return for state aid, under the EU Treaty's state aid rules. Others did so voluntarily, such as Barclays and Deutsche Bank. At the same time, the core capital ratios (equity and reserves) increased from an average of 2.8% in 2008 to 4.1% in 2009, with core capital increasing from €638 billion to €781 billion for the total of the banks in our sample.

On an aggregate basis, deleveraging is less pronounced. ECB data indicate a slight drop in the total liabilities of the euro area banking system since mid-2009, but certainly a halt to the sustained balance sheet growth observed since 2002. Core capital ratios, on the other hand, have strengthened from 5.9% at the end of 2007 to 6.3% for the first quarter of 2010.<sup>2</sup>

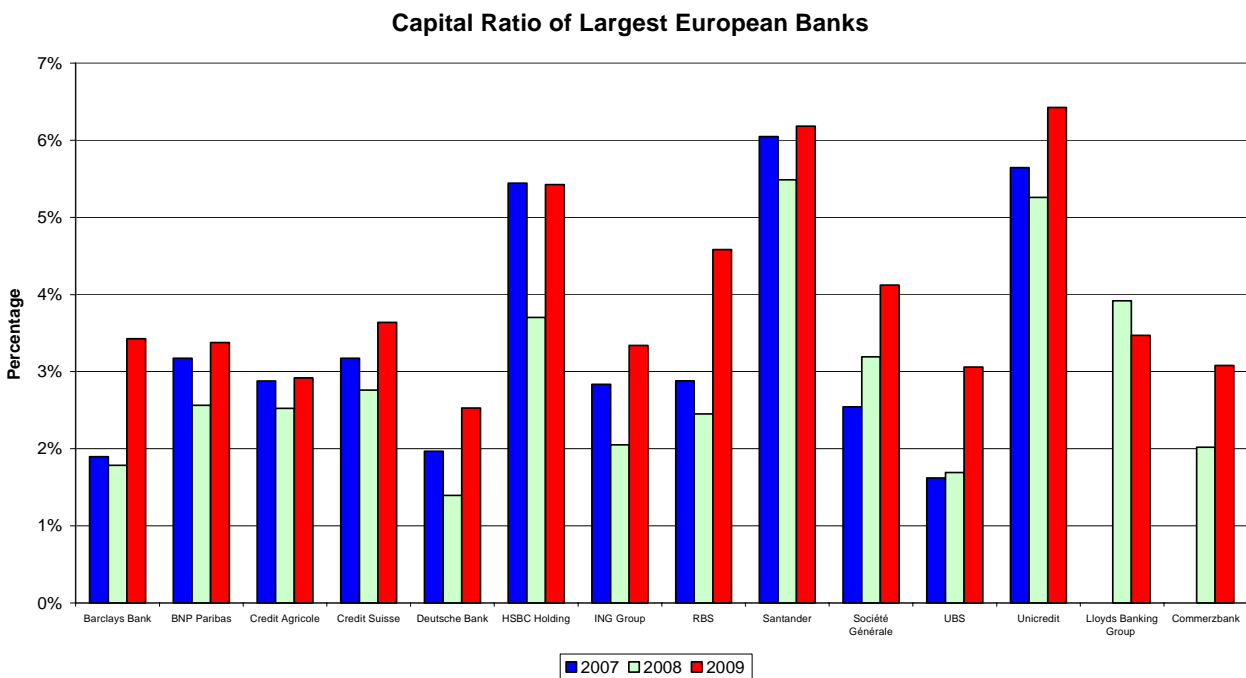
<sup>1</sup> For Commerzbank and ING, the deleveraging as agreed with the EU Commission under the EU Treaty's state aid rules amounts to over 45%, for RBS over 25% and for Lloyds under 20% (see Lannoo & Sutton, 2010).

<sup>2</sup> ECB, Statistical Data Warehouse, Credit institutions balance sheet.

Seen over a longer period, the deleveraging of these large banks is possibly only the beginning. Growth in size and consolidation are processes that have been going on at global level since the early 1990s. Total assets of the global top 25 banks are now 6 times higher than in 1990. In 1990, none of the largest banks had a balance sheet larger than its home country's GDP. In 2008, seven of these top 25 banks had assets exceeding the home GDP – all European by no coincidence. In the US case, the largest bank reached 15% of GDP (JP Morgan, 2010, pp. 5-7).

At the EU level, authorities had stimulated the process of scale enlargement with the single market programme, which aimed at strengthening the global competitiveness of the EU's financial firms. The EU intervened actively to promote cross-border mergers and acquisitions of financial groups (see, for example, ABN-Amro, Santander, Unicredit), but without having a solid framework in place for the integrated supervision of such groups or for burden-sharing in case of failure. The weaknesses in the supervisory framework are being addressed at the regional and global level, but the issues of burden-sharing and resolution remain highly controversial.

Figure 2. Capital strengthening in Europe's '€1 trillion banks'



Source: Banks' balance sheets.

## What's cooking?

A vast regulatory programme is in the making at global, European and national levels to draw the lessons from the financial crisis. At the global level, the G-20 is in the lead, in cooperation with the Financial Stability Board (FSB) and the International Monetary Fund (IMF). Its conclusions set general *de minimis* rules, although so far, the G-20 has gone into considerable detail, and the implementation of its recommendations is advancing smoothly. The overall ambition of the G-20 is to achieve comprehensive regulation of all financial markets, products and institutions.

The EU is following the G-20 process closely, and, at the same time, strengthening the framework for cross-border supervision of EU groups and introducing new rules. By early 2011, the new supervisory authorities should be in place. They will participate in the supervisory colleges of pan-European groups, constitute pan-European supervisory data bases and have the facility to delegate supervision and mediate amongst national authorities. On the regulatory side, efforts at harmonisation can be subdivided into three sets of initiatives:

- **Prudential:** Basel III, or capital requirements Directives (CRDs) III and IV; the resolution fund; common rules for central counterparties (CCPs) and central securities depositories (CSDs).

- **Product:** Hedge and other alternative non-regulated funds; rules for standardisation of OTC derivatives and their clearing through CCPs.
- **Conduct:** Credit rating agencies; bank remuneration; stricter rules against market abuse and short selling.

The core measures of the package are the new prudential rules for banks. One part, covering higher capital requirements for trading books, remuneration at banks and rules on securitisation have almost been adopted,<sup>3</sup> but the most substantial part is still being debated, especially the rules on minimum capital ratios and buffers, dynamic provisioning and liquidity ratios. So far, only one new post-crisis measure has been effectively adopted in the EU, the credit rating agencies regulation – although the debate about their role seems to be far from over – while most others are awaiting adoption by the European Parliament and EU Council (see the annex for an overview of financial crisis-related regulation at the EU level).

Also at the national level, initiatives are being taken to adapt the institutional and regulatory frameworks. In

<sup>3</sup> Some changes to the CRD were adopted as technical amendments by the European Commission in April and July 2009. It concerns modifications to the rules on large exposures (to include off-balance sheet items) and securitizations (including the 5% retention on the balance sheets of the originating institution).

several EU member states, the institutional framework for supervision is changing, with more powers veering towards the central bank in general, and a curtailment of the financial supervisory authorities (see, for example, the experience of Belgium and the UK). Some member states have also unilaterally adopted new laws that may impact the free provision of financial services (such as rules on liquidity regulation and living wills in the UK).

Other measures are still in the pipeline. Over the last few months, the momentum behind a bank balance sheet and/or transaction tax has grown. Initially proposed by Gordon Brown in November 2009, it gained significant weight in January 2010 when President Obama proposed a Financial Crisis Responsibility Fee. It is now commonly expected that there will be a form of a bank activity and/or transaction tax in most EU countries to reduce leverage and reinforce financial stability, as proposed by the European Council in June 2010. The proceeds of such a tax could go into national resolution funds.<sup>4</sup> A second measure concerns the structure of banking. The ‘Volcker rule’, which forbids banks from engaging in proprietary trading while maintaining interests in hedge and private equity funds, was adopted in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 25 June 2010.<sup>5</sup> Although the EU has so far indicated that it will not adopt anything similar, the new UK coalition government agreement states that it will examine a possible separation of investment from commercial banking. Restricting certain financial activities raises many issues that touch upon the core of banking, namely maturity transformation between short-term liabilities and long-term assets (see Micossi et al., 2010, pp. 20-21).

### **The brave new world for banking: Smaller is beautiful**

The combined effect of global, EU and national rules means that regulation will drive banks’ business models even more than has been the case so far. It will lead to lower profitability for global universal banks and provides a strong incentive to reconsider the universal model in favour of a segmentation of the financial system into niches, to realise the benefits of lower capital charges for specialist players and to reduce complexity in general. This will be accelerated

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<sup>4</sup> See the European Commission consultation (May 2010) which however stops short of proposing a European resolution fund

<sup>5</sup> The ‘Volcker rule’ is similar in several respects to the 1933 US Glass-Steagall Act, but it does not propose a formal separation of investment and commercial banking. The US House and Senate are currently reconciling the financial reform bills.

by the possible introduction of a bank tax, whose scope is not yet known.

Not surprisingly, the banking industry is up in arms. JP Morgan (2010) calculated that the capital needs of global banks would be an additional 19% of tangible equity as a result of the new measures. It estimates that profitability (measured as return on equity) of global banks would decline from 13.3% in 2007 to 5.4% in 2011, due to the different proposals now on the table. The bank argues that it would be difficult to attract private capital at these levels, and hence the pricing of financial products would have to increase substantially, by about 33%. However, this argument overlooks the fact that with higher capital requirements, banking would become a much safer business, thus requiring a lower return on capital. Rating agencies see a huge need for additional capital in the banking sector. As governments progressively retrieve the guarantees and support schemes, downgrades will follow, leading to additional capital and refinancing needs peaking in 2012 (Fitch, 2010). This is aggravated by the shortening of the maturity profile of banks’ bond financing during the crisis (BIS, 2010, p. 79). Also the Institute for International Finance, the global bank’s lobby, sees a huge need for additional capital to comply with the new rules. This will have a bigger impact in Europe, because of its more bank-driven system.

From a shareholder perspective, imposing higher capital requirements is like diluting the capital of the bank. Since banks were operating on an extremely thin capital base, shareholders were happily taking the upside of this situation in the form of capital gains and dividend payments, but the downside was covered by the state, through the support measures in crisis periods, and because of the preferential treatment of debt, less tax income to the state. Hence, imposing higher capital requirements should be beneficial for states and taxpayers. Furthermore, faced with the spectre of Basel III, banks have successfully argued for long transition periods, arguing that a rapid introduction would lead to further deleveraging and decline in credit availability. However, the opposite may be argued: lengthening the transition prolongs uncertainty and allows banks to restrict lending. It has therefore been proposed to make the transition period as short as possible: the faster banks are recapitalised, the sooner they will be able to borrow and lend again. If it were to be done overnight, banks would not have the time to restrict credit nor to argue the need for further delays again at a later stage. Strong banks would cut dividend and bonus payments (the payout levels for 2009 are proof that a huge opportunity was

already missed); weaker banks may resort to debt to equity swaps.<sup>6</sup>

Banks should also explore other business models. The question can be raised whether it remains interesting to be a global universal bank in the new regulatory environment. According to the JP Morgan report cited above, scale continues to have an advantage, to serve a larger and more complex client base. Economies of scale emerge from spreading fixed costs over a larger revenue base and lower funding costs, but what is an optimal size and where do scale effects really stop have not been quantified – a well-known gap in the academic literature. In addition, Basel III changes the paradigm. Whereas under the Basel II framework, capital needs were declining with the size, or barely existed if at all, for SPVs and OTC derivatives trading, for example. Now the opposite will be true. The new Basel framework adopts tougher standards for ‘Systemically Important Financial Institutions’, requiring them to internalise the risks they create for the public at large. It sets higher capital requirements for trading book activities, counterparty credit risk, complex securitisations and re-securitisations, and OTC derivative activities. Normal capital requirements will be allowed for centrally cleared derivatives, but this will require banks to participate in the capital of these CCPs. Before, these banks could propose their own risk models for these activities. As authorities will be extremely wary not to have too-big-to-fail banks under their supervision, certainly within the EU as long as fiscal policy remains local, enforcement will be guaranteed.

In addition, the new bank tax that is being devised in several EU member states will target a certain part of a bank’s liabilities, minus the capital, or tax the sum of profits and remuneration in the financial sector.<sup>7</sup> Such tax would tend to reduce the size of the financial sector, as it would tax above-level profits and remuneration (IMF, 2010). This will again hit the larger banks the hardest. Moreover, in the EU this tax will be raised at the local level to fund a national resolution fund, which will disadvantage cross-border banks that have expanded through acquisitions (as most have in the EU).

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<sup>6</sup> See “Shock therapy is best cure for banks”, *Financial Times*, Editorial, 29 June 2010 and Daniel Gros, “Cost of Basel III”, mimeo, June 2010. The Swiss supervisory authority introduced a minimum leverage ratio at the end of 2008 – without creating a strong competitive handicap for their banks.

<sup>7</sup> See Joint Statement by the French, UK and German Governments on bank levies, 22 June 2010 (download at: [http://www.hm-treasury.gov.uk/d/junebudget\\_joint\\_statement.pdf](http://www.hm-treasury.gov.uk/d/junebudget_joint_statement.pdf)).

#### *Box 1. New capital rules and charges for banks*

- Capital (Basel III)
  - o Tighter definition of core capital (confined mainly to common equity and retained earnings)
  - o A maximum leverage ratio (or a minimum ratio of capital to total assets)
  - o Counter-cyclical capital buffers, requiring banks to accumulate extra capital during upswings
  - o Forward-looking or dynamic provisioning
- Minimum level of very liquid assets (liquidity coverage ratio and net stable funding ratio)
- Rules on securitisation (including e.g. the 5% retention for securitisation)
- Tighter trading book rules (tighter calculation of value-at-risk)
- Rules on remuneration
- Extra capital charges for OTC derivatives, other derivatives mandatorily cleared through central counterparty (CCP)
- Bank tax (liability, financial activity and/or transaction tax)

Segmenting a financial group according to its business lines may, from a regulatory capital and supervisory perspective, become a more advantageous model. At its core, a financial group can focus on commercial and consumer lending, but split all of its specialised activities into separate entities. Asset management can come under the UCITS Directive, and be subject to a much lower capital charge;<sup>8</sup> money transmission (and short-term credit) can fall under the payment services Directive, investment services under MiFID, and be subject to the trading book capital requirements. OTC derivative positions could be executed through a hedge fund, and non-banking entities will not be subject to the bank tax. Distribution would happen through intermediaries and advisors. A segmented structure would also make it much easier to deal with restructuring and liquidation in case of problems, and conform to the supervisory demands for a ‘contingency plan’.

In fact, the segmentation process has already begun. Bank insurance is regarded as passé. The ING Group, as an example of bank insurance in the EU, will divest its insurance activities and revert to basic banking (see ING 2009 Annual Report). As large banks discover the burden of the new Basel III package, they will start to consider other options. At the same time, competition

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<sup>8</sup> See Lannoo (2010) for a comparison of capital requirements in the asset management industry.

is increasing from non-financial operators, who are looking to enter the financial system as niche players. Telecom and retail companies which manage large user-datasets are looking to enter the consumer loan or money transmission market. Also, the continuing uncertainty about the financial system has led corporates to create new banks. A consortium of 17 large corporations has started a new cooperative bank, the Corporate Funding Association, and Siemens has also stated that it would start a bank.<sup>9</sup>

## Conclusions

The Europe 2020 proposals regarding the financial system deserve closer elaboration as regards the modalities of their introduction and impact on the 'real' economy. Compared to the Lisbon agenda era, regulatory reform of the financial sector is even more crucial now, whereas it only receives scant attention in the Europe 2020 programme. The financial sector is currently in serious disrepair and the proposals on the table to better regulate financial activity will have a profound impact on the future structure of the financial system. The sector is resisting change and has argued with insistence that the new measures, essentially the Basel III proposals, should be toned down and phased-in progressively, because of the huge capital needs and its impact on lending. However, given the ongoing uncertainty regarding the soundness of the European banking sector, it could be argued from a public policy perspective that these measures should be introduced without delay. This would also force banks to consider other business models, which would at the same time reduce complexity and ease bank resolution and restructuring.

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<sup>9</sup> See [www.corp-funding.com](http://www.corp-funding.com) and Siemens announcement, 28 June 2010.

## Annex. Financial crisis-related regulation at EU level: An overview

Measure	Purpose	Status	EU Council Presidency-2 <sup>nd</sup> half 2010
Depositor protection schemes	Increase minimum level of protection to €0,000	Adopted October 2008, new consultation 2 <sup>nd</sup> half 2010	
Credit rating agencies	Introduce single licence	Adopted April 2009 Amended June 2010	Start discussions in Council
Bank capital (CRD), amendments: <ul style="list-style-type: none"> <li>• Securitisation, large exposures</li> <li>• Executive remuneration, trading book and complex products</li> <li>• Leverage ratio, capital buffers, liquidity regulation</li> </ul>	<ul style="list-style-type: none"> <li>• Min. 5% on a bank's books</li> <li>• Extra charge for high pay packages</li> <li>• Higher capital charge for trading book, more and better capital, minimum liquidity</li> </ul>	<ul style="list-style-type: none"> <li>• Commission directives (adopted April and June 2009)</li> <li>• Draft directive (July 2009)</li> <li>• Consultation (April 2010), draft directive July 2010?</li> </ul>	<ul style="list-style-type: none"> <li>• Conciliation with EP 2<sup>nd</sup> half 2010</li> <li>• Discussions start in EU Council</li> </ul>
Hedge funds	Regulate non-regulated segment of fund industry	Draft directive (April 2009)	Decision in EU Council (May 2010), conciliation with EP 2 <sup>nd</sup> half 2010
Prospectus Directive	Simplification	Consultation (January 2009), draft amendments September 2009	Discussions in EU Council
Market abuse	Improve and simplify directive	Consultation (April 2009)	Draft directive 2 <sup>nd</sup> half 2010?
Depositaries of funds	Segregate funds from depositaries	Consultation (May 2009)	Draft directive 2 <sup>nd</sup> half 2010?
OTC derivative markets and infrastructures	Transparency, mandate central clearing for standardised OTC derivatives	Consultation (June 2010)	Draft regulation September 2010
European Systemic Risk Board	Identify macro-financial risks	Consultation (June 2009), draft and Council decision (Dec 2009)	Conciliation with EP 2 <sup>nd</sup> half 2010
European Banking Authority	Coordinate banking regulation and supervision	Consultation (June 2009), draft and Council Decision (Dec 2009)	Conciliation with EP 2 <sup>nd</sup> half 2010
European Insurance Authority	Coordinate insurance regulation and supervision	Consultation (June 2009), draft and Council Decision (Dec 2009)	Conciliation with EP 2 <sup>nd</sup> half 2010
European Securities Markets Authority	Coordinate securities markets regulation and supervision	Consultation (June 2009), draft and Council Decision (Dec 2009)	Conciliation with EP 2 <sup>nd</sup> half 2010
Omnibus directive	Adapt existing rules to ESFS	Draft directive (October 2009)	Conciliation with EP 2 <sup>nd</sup> half 2010
Crisis resolution procedures and funds	Coordinate national rules	Consultation (Oct.2009, May 2010)	Draft directive 2 <sup>nd</sup> half 2010?

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