

***Regulation and the real economy***  
***- Sixth lesson -***

In my last lesson of the year, I will try to show you how the regulatory measures described in the course can impact - and have impacted - the real economy. Of course, such measures are destined to strengthen the resilience of the financial system. By the same token, they are also intended to benefit the real economy. We know too well, indeed, that financial crises can cause havoc to the economy. What happened in the wake of the 2007-2008 financial crisis,- i.e. the severe recession of 2008-2009, the dramatic and lasting surge in unemployment, the fall of investment - is, unfortunately, well documented.

But it can also happen that, in spite of the best intentions, regulations may impact negatively the economy and growth. The law of unexpected consequences should always be present in the minds of regulators.

I will divide my remarks in three sections:

1. On a general plane, how can one characterize the relationship between regulation and growth?
2. What do we observe, today, regarding the economic consequences of the new regulatory framework?
3. What could be done to mitigate such consequences?

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## I. Financial Regulation and Growth

These two concepts might seem, at first glance, somewhat unrelated. But history shows that they are closely associated.

The usual process goes as follows: periods of economic overheating tend to please politicians who don't want to "spoil the party" by restricting lending. This leads to excessive debt accumulation and risk-taking, which eventually end up in a financial crisis. At this point, two things happen simultaneously with pro-cyclical consequences:

- Financial institutions and other borrowers start reducing their debt;
- Public authorities, criticized for their previous leniency, engage in "re-regulating" the financial system.

Before touching on the present issue of economic growth and financial regulation, I will try to illustrate how the traditional, and highly stylized, process I have just referred to unfolded in the run up to the 2007 crisis.

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### **1. *The run-up to the crisis : deregulation, which was far from being the major culprit, has played a significant role.***

**Light regulation-leading to bank irresponsibility- was not the main cause of the problems.** And those who pretend - or believe - it was maybe paving the way for further mistakes. **The crisis was, in fact, triggered by the extraordinary ease that characterized financial conditions and the expansion of credit.**

States acted as if they could indefinitely borrow their way out of the constraints of economic cycles: fiscal deficits and public debt went up massively for decades. And in a number of countries,

private debt exploded. The case of Spain illustrates this point: the Central Bank had developed a rather remarkable set of prudential rules (counter-cyclical buffers and rigorous supervision). But these instruments proved insufficient given the magnitude of the private sector credit bubble in the housing sector. No regulatory system can resist inordinately loose monetary and credit policies.

[ I explained in a previous lesson how central banks - taking advantage of the “Great Moderation” - ended up reducing interest rates to extremely low levels. Why should they have taken the risk of jeopardizing growth since inflation was no more an issue? The explosion of credit and the related rise of asset prices with its wealth effects did not seem to bother monetary policy-makers. It was as if inflation targeting (ex-post C.P.I. based) had become the only compass ].

**Loose monetary conditions in an expansionary environment are usually associated with more credit but also with more risks** because there is a limited supply of relatively low risk assets. In an environment of easy liquidity and low interest rates (or even negative in real terms as was the case in the U.S. from 2002 to 2005), the search for higher yields and riskier assets became irrepressible. An economy artificially boosted by loose monetary conditions creates indeed the illusion of financial stability and results in very low risk premia.

Of course, **loose rules - result of two decades of deregulation - compounded this fundamental problem and facilitated high leverage.** The Basel capital ratios of the time were low and supervision relied excessively on internal bank models. Off balance sheet operations were loosely or even in some cases not taken into account. And to make things worse, in 2004, US investment banks got practically exempted from leverage ratios.

The common belief was that market forces would, by themselves, correct excessive imbalances. This belief proved eventually to be unfounded. I could also mention the pro-cyclical effects of the “fair value” accounting rules that pushed up paper profits in good years thus entertaining the illusion that high asset prices were “real” and there to last.

**The combination of cheap and abundant liquidity with weak supervision and misguided regulation and risk models triggered an enormous credit bubble and deterred many banks - who “followed the herd” - from exercising their indispensable role in terms of due diligence and risk assessment.** This was all the more so that the surge in securitization encouraged banks to sell on the markets instruments based on credits of dubious quality -albeit well rated by rating agencies that were embroiled in conflicts of interest -thus allowing them to “re use” their capital endlessly.

Furthermore, the US political authorities tried to prolong the housing boom by pushing banks into doing business with a new category of mortgage borrowers, i.e. the poorest segment of the population regardless of their capacity to repay.

The “extraction of capital”, as it was called and flourished in the years leading to the sub-prime crisis, was a dangerous and artificial way of refinancing loans through more and more indebtedness on the assumption that housing prices would continue to go up...

All this ended in the catastrophe we know, the consequences of which are still plaguing our societies in terms of recession and unemployment. 28 Million jobs were lost worldwide.

Did those years of exuberance, deregulation and financial innovation produce at least at the time significantly higher growth than might have been expected under more stable credit conditions? The matter is debated. But it is clear that the expansion was fragile, artificial, (in the sense that much of the capital flows were “in bred” and stayed within the sphere of financial institutions) as well as short lived, not to mention the huge size and pain of subsequent inevitable - and differentiated from country to country - adjustments. [Graphs 1 to 5](#) show how deep have been the recessions in the Eurozone after the financial crisis. Germany is the only country of the zone that has offset its GDP losses as soon as in 2010 (actual GDP level related to potential). [Chart 6](#) shows how much the Eurozone growth is lagging behind the US.

## **2. The present “growth and regulation dilemma”**

**Deleveraging is taking place everywhere ([Graphs 7 and 8](#)).** The intensity of this process is proportionate to the excess leverage built over the past years: the higher the leverage, the deeper the deleveraging.

This is a normal development. Weak and over extended balance sheets have to be repaired in the financial as well as in the non-financial sectors. The process is lengthy and difficult, especially as the post-crisis recession further weakens the situation of borrowers and forces banks into additional provisioning and further deleveraging. But this time, it is compounded also by the extreme tensions that appeared, when the crisis erupted, on the wholesale markets which had been the main suppliers of bank refinancing and suddenly dried up.

As shown on [Graph 7](#), cross-border lending has shrunk since the global financial crisis.

Changes in bank business models, balance sheet adjustments, limited dollar liquidity available to non US bankers, have driven their slowdown.

A recent IMF study<sup>1</sup> shows that regulatory tightening can explain about half of the decline in the foreign lending to GDP ratios between 2007 and 2013.

The quasi disappearance in several parts of the world of an active interbank market (the expansion of which had been favored by close to zero interest rates as we have shown last time) illustrates the magnitude of the confidence problems that a large number of banks are experiencing. This is reflected in historically low banking stock market prices which make the raising of new capital particularly problematic ([Chart 9](#)).

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<sup>1</sup> *Post-crisis International Banking : An analysis with New Regulatory Survey Data WP/16/88 April 2016 by Hibiki Ichiue and Frederic Lambert.*

**Normally, according to past experience, the deleveraging process takes, on average, 5 to 6 years to get worked out. This time**, given the extreme nature of the crisis as well as the perverse link that has appeared in some European countries between the sovereign and the banks, **things are taking more time**. This is made worse by the need to deleverage simultaneously in the private as well as in the public sector : indeed, States, burdened with excessive debt, have no more the ability to act counter-cyclically as they thought they could afford to do so when they took massive deficit spending decisions in 2008-2009. Therefore, the recovery remains timid and fragile ([Chart 6](#)).

## **II. The economic consequences of the new regulatory framework**

### **1 – More demanding capital requirements have affected the banking sectors.**

I come now to the regulatory response after the crisis. It took the usual pattern: strengthen capital requirements in order to rebuild loss absorbency cushions so that such disasters could “never more” happen again (meaning those produced by those banks that failed and had been bailed out by massive amounts of tax payer money). These additional capital requirements, coupled with strict rules on liquidity, were intended to strengthen the resiliency of the financial system at large and, therefore, to promote the conditions for sustainable growth.

**On the whole, capital requirements have been considerably strengthened** as well as the definition of capital, while risk weighted assets have been tightened. All these measures go in the right direction and their magnitude should not be underestimated. For instance, bank capital has been multiplied on average by a factor of 2 (depending on the banks’ balance sheets) since the crisis ([Chart 10](#)).

Faced with these demands, combined with pressure from the EBA's stress test in the context of the EU sovereign debt crisis, large European banks have been led to reinforce their financial structures<sup>2</sup>.

In practice, the tightening up of regulations has led to major changes in the business portfolios of financial institutions and has considerably reduced their risks. Examples of this include the move away from financing requiring liquidity in foreign currencies<sup>3</sup>, the shortening of the maturities of loans, which mitigates the transformation risk taken by institutions<sup>4</sup>, as well as the closure of many trading desks, particularly on fixed-income products.

Ultimately, since 2008, the combined impact of the increases in capital and the scaling down of various activities has resulted in an important drop in the pace of balance sheet growth for many financial institutions, while at the same time significantly strengthening their capital levels : At the same time, for the majority of financial participants, the proportion of market activities considered to be the most risky is now at a limited level: in most cases, the RWAs on these activities represent between 10 and 20% of all risks<sup>5</sup> - instead of 50% or more at the peak of the crises.

In this way, although the stock values and the price to book ratios ([graph 9](#)) of European banks remain below that of their counterparts in other regions around the world (around 0,5 price to book in Europe against 1 in the US) and the European banking area is still fragmented, confidence seems to be gradually returning : CDS premiums ([Graph 11](#)) on Eurozone senior debt have fallen during the past years, and many institutions have repaid their LTROs (3 year borrowing from the ECB) early (banks have repaid all the 1 trillion Euros borrowed under LFRO 1 and 2). But bank credit rates remain still differentiated across the Eurozone, thus hurting disproportionately the peripheral economies ([see Chart 19](#)).

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<sup>2</sup> Assessment of the European Banking Authority (30 June 2013).

<sup>3</sup> Changes in new lending by type of lender and loan – BIS Quarterly Review, March 2012 page 11, Table 1.

<sup>4</sup> Regulatory consistency assessment program – Analysis of risk-weighted assets for market risk – BCBS February 2012.

<sup>5</sup> Ibid.

It is important to understand that **this effort to strengthen the banks' balance sheets has impacted Europe on an altogether different scale from what has been elsewhere in the world.** In the US, it is common for businesses and public authorities to access markets directly, for GSEs (Government sponsored entities) to buy back many loans from the banks,<sup>6</sup> particularly mortgages and securitization is far more developed there, etc.

By contrast, the European economy is three-quarters financed through banking intermediation, while the market finances three quarters of the American economy. As a result, the European banking system is three to four times larger than the US system in terms of assets. Europe is therefore impacted by regulation at least 3 times more than the US. It is worthwhile noting that new regulations have been inspired by “anglo-saxon” countries.

## **2 – The deleveraging of European banks and its impact on the Economy.**

**The stabilization and retrenchment of banks' balance sheets in Europe highlights the extent to which banks have scaled back their lending,** even if the actual scope of this observation is often blurred by the classic contrast between, on the one hand, deleveraging due to the decline in demand for loans (because of the stagnation of the economy) and, on the other hand, deleveraging due to the weakness of supply of loans by banks faced with the increase in prudential constraints and the deterioration of risk related to their customers. Graphs 13, 14, 15 and 16 give a vivid illustration of the magnitude of bank deleveraging in the EU (as compared to the US).

Another manifestation of this bank retrenchment is related to the fall of the loan/deposit ratios (from 140% to 110% since the crises in the Eurozone) (see Graph 17).

QE has not significantly changed the credit picture (Chart 18).

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<sup>6</sup> GSEs buy, on average, 70% of all US bank mortgages.

The evolution of Central Banks balance sheets and of M3 ([Graphs 19 and 20](#)) shows how little monetary creation by the ECB has percolated in the real economy.

While it may not be possible to clearly separate the two factors (declining demand for credit and restrained supply), research shows that, in our European economies that are facing a very slow recovery, there is demand for loans among good-quality businesses that is not being met (see [Graph 21](#)). The most recent ECB survey shows that demand for credit is growing in the Eurozone by 30%. But it also shows that almost 30% of credit applications have been turned down (34% in Italy).

Banks' replies to ECB surveys indicate that in connection with the new regulatory and supervisory action, they had reduced their risk-weighted assets since the second half of 2013, especially for riskier loans.

**On the whole, the Eurozone has experienced a reduction of close to 10% of its banks' balance sheets since the beginning of the crisis.**

According to the IMF, this trend could reduce the euro area's output by almost 1,5% whereas deleveraging in the US would hit their output by only 0,5%.

In its "Global Financial Stability Report (G.F.S.R.)" (October 2012), **the IMF underlines the magnitude of bank deleveraging in the EU.**

Here I would like to make two observations:

- a) While the Basel 3 capital requirements had been carefully planned to be implemented gradually until 2019 in order to avoid precipitous credit reductions, in fact the process has been accelerated and banks, at least in Europe, are abiding by the full-fledged ratio of 9% as of January 2013. This has intensified the move towards "regulatory based deleveraging".

b) Markets, and to some extent regulators, have contributed to this acceleration and amplified the fears in the sense that global assessments have tended to prevail over bank by bank analysis. Since we all know that there is nothing like a category of “European banks” or of “too big to fail institutions”, it is high time that markets and notably international official institutions carefully look at individual balance sheets and avoid regional generalizations as well as simplistic and aggregate judgments on what are very different firms.

### **3 – An assessment.**

In sum, we can assert, on the basis of evidence :

- That **bank deleveraging has been very significant in the Eurozone (about 10% over the past years)** affecting especially credit to non financial enterprises) ;
- That, compared to the US and the UK, the Eurozone lending dynamics remain weak ([see Graph 22](#)) ;
- That regulation, (in principle, the same for all banks) **has particularly affected the Eurozone banking** system and therefore Europe because of the mere importance of banks in financing the economy (3/4 against 1/4 in the US)<sup>7</sup> ;
- That, on the debate : “ is it weak demand that explains deleveraging or is it constrained credit supply by banks ? ”, what is now well documented is that **SMEs** - because they are unable to access financial markets - **exhibit greater sensitivity to credit supply constraints** and that European banks have tightened their credit standards relative to the pre-crisis period.
- That **banks should also be able to rely on markets in order to ensure proper and adequate securitization.**

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<sup>7</sup> See « Restarting Europe Long Term Investment Finance » : CEPR January 2015 by Giovannini and al.

But European regulations that are pushing banks to deleverage are also, in fact, (see, in particular, Solvency II) impeding securitization mainly for “ stigma “reasons (subprime crisis). Is this consistent with the idea of facilitating the transition from banks to market financing ?

- **The “ new wave “ of regulation** (tightening of RWAs, implementation of the NSFR, of the leverage ratio and the TLAC) **is inevitably going to compound deleveraging and its impact on the economy.**

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All in all, the econometric assessment of the macro-economic impact of the post-crisis regulatory effort is strongly debated.

A complete set of macro-economic impacts of the post crisis regulation has been computed five years ago by a number of economic think tanks and financial institutions ([see Graph 23](#)).

The idea was to measure the net long term economic benefits of a “safer” financial system (taking into account the economic costs of regulation as well as the effects of a reduction on the probability of a crisis because of a stricter regulation). You can see on the slide how different are the results (from a cost of 4 to 12 b.p. on annual GDP growth rates – over 4 to 10 years – for a one percentage point increase of capital ratios).

Under the LEI (Basel Long Term economic Impact Group) model, the increase of the capital ratio (CETI) from 7% to 10% combined with the new liquidity requirements, could have reduced the **level** of GDP by 1% (assuming no change in the rate of growth).

And by integrating the lesser probability of a crisis in the future, the LEI concluded that, in the long term, the net positive impact on GDP would be around 2,50% of GDP.

But a study by Laurent Quignon<sup>8</sup> has just revisited the whole subject in the light of the most recent regulatory developments.

It can be summarized in the following way ([see slide 24](#)) :

On the basis of a 12% Basel capital requirements (actual), the level of GDP would be reduced permanently after the coming years of regulatory implementation, by -1,70% in the Eurozone (-1,10% globally) because of regulation. This cost could be offset in the future by the economic benefits stemming from a lesser probability of financial crisis (+2,7%).

Thus, in net terms, there might be a positive benefit over the very long run of + 1% for the Eurozone.

**But the immediate – and more certain - impact would be clearly negative (-1,70% permanent impact on the level of Eurozone GDP).**

Besides, while the immediate costs are relatively straightforward to calculate (given the empirical evidence on the regulatory impacts of higher capital requirements on lending spreads and lending volumes and consequently, on GDP), the computation of the benefits stemming from a lesser probability of a crisis is much more uncertain. Indeed, the quantification of the cost of a banking crisis is still very fragile. Furthermore, the European Single Resolution Mechanism (basically to be financed by banks) will increase the costs for banks and for the economy. Therefore, the “benefits” derived from the Basel capital requirements will be further reduced.

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<sup>8</sup> «Economic impact of prudential regulation : a reevaluation» (BNP Paribas Conjoncture February 2016 N°2).

### III. What can be done?

1. Set against the backdrop of a very weak economy, any additional capital or liquidity constraints on top of those already defined will particularly impact those businesses that :

are entirely dependent on the banks' goodwill and have limited negotiating power.

Naturally, SMEs are the first affected.

Under such circumstances, it is vital to understand the economic impact of these phenomena. Considering that the States are not in a position to contribute toward kick-starting the economies, there is no doubt whatsoever that growth will only be able to resume if lending is stepped up. **While it may be desirable to reduce the role of banking intermediation in European countries, this change can only be accomplished very gradually.**

In one of Global Financial Stability Reviews (G.F.S.R. of the IMF, there is a revealing indication to the effect that the relationship between the tightening of regulation, on the one hand, and the strengthening of economic growth on the other hand, is very difficult to establish. Beyond certain, relatively high, thresholds, the IMF tells us that “ **very safe systems may produce less economic growth** “.

In view of the many dangers on the horizon (fragmentation of the European market, slow growth, link between the sovereign crisis and the banks' situation, etc), **I believe that the time has come to overhaul projects intended to further tighten the banking regulation and to sit back and analyse the economic impact of these proposals.**

Financial regulations have made European banks more resilient. Indeed, banks have considerably strengthened their capital, and have increased their levels of liquid assets, while reducing their risky assets, notably by scaling back market activities, an area in which they had been too frequently involved beforehand.

A deleveraging trend, with a reduction in banks' balance sheets, is normal after a debt crisis.

However, the European banks' reduced levels of profitability – as a result of regulation - are making it difficult for them to find fresh capital to fulfill tightened capital requirements.

The more this profitability is limited, in a highly competitive environment and in an environment of low interest rates, the less it is possible for them to build up reserves and the more difficult it is to raise capital. This problem is being compounded by the increase in capital constraints. The banking sector's profitability for investors has become far lower than that of industrial companies. In this situation, compliance with the liquidity and capital adequacy ratios can only be fully achieved through a reduction in assets, including loans. In comparison, the impacts of these prudential requirements on the profitability of American banks are lower since they are in a position to off-load a major part of their mortgage loans to entities like Fannie Mae and Freddy Mac.

**So, we have to stop increasing – as is intended – capital requirements through additional measures. That can only lead to more deleveraging, and eventually, to a credit crunch.**

What is important in the current situation is not to reduce European banks' leverage. Indeed, because of their low profitability (due to high capital ratio) capital increases are proving difficult to carry out; more deleveraging would therefore translate into a further reduction in credit for the economy and even weaker growth. **What is important is to concentrate on de-risking the assets of balance sheets and to focus very carefully and closely on the quality of**

**the risks taken by financial institutions.** It is not time for deleveraging, but rather “derisking”.

A number of initiatives are working towards this: harmonisation of RWAs and monitoring of risk quality at European level with a single supervisor (Banking Union), improvement in asset valuations and provisioning quality.

**2 There are a few specific issues that should, in my view, be dealt with urgently to mitigate some of the most worrisome consequences of regulation on the real economy.**

**a) Regulation should encourage and favour equity, not debt.** The world has suffered from excessive debt and a lack of capital.

But what do we see?

- Generally, taxation systems favouring debt (by allowing taxpayers to deduct interest payments from their taxable income) against equity (which has no comparable advantage). In some countries, the distribution of dividends is even specifically the object of additional taxation.
- Basel 3 is deterring banks from holding equity (not considered as a “stable” asset) and encouraging them to hold (in principle 0 taxed) sovereign bonds.
- The short term liquidity ratio (LCR) has the same effect.
- The European insurance regulation - Solvency 2 - penalises (through higher capital requirements) the holding of equity by insurance companies. This has already contributed to the shrinking of equity instruments in insurance companies portfolios.

We know, however, that insurance firms have always played a crucial role in financing - and holding for long periods - equity stocks issued by non financial enterprises.

**Thus a major source of financing of the European economy is being hampered by Solvency 2. I don't think that the recently**

published “Green book” by the Commission has brought a satisfactory answer to this question.

b) Regulation should not be discouraging long term lending by banks. But it does. See NSFR ([graphs 25 and 26](#)) (NSFR : Net Stable Financing Ratios).

In fact, the long term rules on liquidity, if not deeply amended, would inevitably reduce long term financing by banks.

Indeed, the obligations for banks to match their (non-deposits) funding and their assets, would lead them - if they intended to maintain their present average lending maturity - to issue long term bonds in such amounts that those would not be compatible with market availability. **Banks would therefore be forced to dramatically shorten the maturity of their lending.** Furthermore, the interbank market would be hurt. The recent statement by Lord Hill (the Commissioner in charge of capital markets) stressing the need to keep NSFR regulations consistent with European requirements is positive.

Of course, there is a natural tendency to move, in Europe, from heavy banking intermediation to a more market driven pattern. But this will take time, and require well thought-through measures. We should be very careful not to curtail bank lending too hastily.

**Capital markets must be given time to develop with a view to financing the economy.** In this respect, public policymakers must be made aware that the markets are not in a position to “take over” from the banks, which are being asked to rapidly reduce their transformation role.

NSFR regulations would inevitably result in a marked reduction in the duration of loans by banks, which will not easily be relayed through direct access to the financial markets for borrowers. In the Eurozone today, financial institutions supply around 20 trillion Euros

of long-term financing based on only 8,5 trillion Euros of long-term resources on the markets. In Europe, the additional long term financial resources imposed by the projected NSFR have been estimated at 1.500 billion euros<sup>9</sup> (i.e. some 300 to 400 billion a year until 2017).

Therefore, I believe there is a need for a reexamination by the Commission of the most questionable aspects of this new regulation.

**c) The projected reform of RWAs (Risk Weighted Assets) should be phased and adjusted in order not to create a significant increase in bank capital charges :**

Several proposals are being examined by the regulators and are to be decided before the end of 2016 :

- Reduction of the scope of internal models.

Would be subject to “standardized” rules :

- Sovereign risks,
- Including local entities,
- Loans to financial institutions.

- Operational risks (accounting for 10% of RWAs).

Would also be computed through a standard method :

Such a change could entail a significant increase (40% of the capital charges on operational risks). That could increase the overall Basel requirements by up to 1 percentage point for the largest banks (G-SIBs).

- Trading risks (representing 7% of total RWAs) would be increased by 40% ie +2,8% (Basel capital charges).
- And credit risks - which account for 85% of total RWAs – would see their capital requirements increase by 20% (+1).

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<sup>9</sup> Basel 3 Monitoring exercise, EBA, March 2013.

**All in all, the above additional capital requirements would increase by 21%. Thus total capital charges on RWAs would jump from 12% to more than 15% percentage points.**

**Such an increase (by 25%) would entail a further reduction in the profitability (already low) of banks and put European banks at a disadvantage vis-à-vis the American banks.**

Indeed, American banks benefit from two important advantages :

- Less competition on interest margins (the “mutualist” phenomenon, significant in Europe, does not exist in the US). Those are the banks that can afford reducing charges to their client because they are not listed and do not have the market process on their results,
- GSEs (Fannie Mae Freddie Mac) lift out of US banks balance sheets 70% of their mortgage lending assets (which would not be possible in the UE).

**d) Regulation should not impede insurance companies from financing long term infrastructure investments :**

Risk charges for insurers’ unlisted equity such as energy pipelines, transport links ... were prohibiting such financing by insurance companies. The capital charges were 49 % !

A recent decision has reduced this charge to 30% (starting on April 2<sup>nd</sup> 2016). The decision is intended to encourage insurance companies to finance such infrastructure projects.

This decision results in an equalization of unlisted infrastructure investments on the level of charges on equities traded on regulated markets.

We see here how regulation can introduce disincentives and distortions ... and can be eventually changed.

**e) Regulation should take account of SME's (which are the main creators of jobs).** There are several ideas to foster the financing of corporations and specially SMEs :

- Developing equity/bonds growth market for SMEs and midcaps (MIFID 2).
- Adjusting the calibration of SME lending capital requirements (see : Lord Hill 26 March 2015).
- Favouring securitisation of corporate loans.

Many central banks are making proposals in the field of Securitization.

The fact of the matter is that securitization is lethargic in Europe. We should therefore take simple and rapid actions to revitalise it. I believe that the most important condition to be met in order to achieve this relates to regulation. Presently, the capital requirements on mezzanine tranches of securitized products are excessive and will deter investors from buying. This regulation (Solvency II) should be revised “.

**f) TLAC and leverage ratio are still to be finalized :**

As I showed in my recent lesson on the banking union the move towards TLAC could lead to dramatic consequences on bank deleveraging.

The Commission should see to it that the TLAC agreement (reached at the end of 2015) is adequately transposed in European law. It is important, in his respect, that the MREL Directive on bank resolution is consistent with TLAC rules and does not hurt the European level playing field. There have been statements to this effect (Lord Hill). I hope European negotiators will live up to those expectations.

As for the leverage ratio, any increase above the present level of 3% would inevitably result in less lending for a number of European banks.

## g) Regulators and policy-makers should be encouraging savings

The equation of savings and investment in Europe is the following ([Graph 27](#)):

Households financial savings amount to 12.000 billion euros (outstanding) and “ the rest of the world ” to 2000, i.e. a total of 14.000 billion.

This amount of saving finances:

6.000 public deficits

9.000 non financial private enterprises

1.000 financial institutions

You see that more than 80% of total financial needs are ensured by household savings.

It should also be noted that financial institutions play a major role in channeling gross savings to the investment needs of the economy (they intermediate more than 57 trillion savings).

**Domestic savings - especially in external deficit countries - should be encouraged, not repressed.**

In this respect, we cannot but raise the question of the long term consequences on household financial savings stemming from systematic low interest rate policy (This issue was touched upon in our last lesson).

The matter is of fundamental importance for future growth and investment. All the more so that world savings are being negatively affected by demographic trends.

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Present very low interest rates associated with Q.E. could create systemic problems.

Indeed, the main question today is : “ are long term savings compatible with 0 interest rates ?. “

The existence of a fundamental mismatch between assets (with no returns) and liabilities (with contractual obligations) of life insurance companies and pension systems is a major systemic danger emanating from 0 interest rates.

Who is watching ?

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### Concluding remarks

In fact, we are facing, on the Continent, a rather sobering situation :

On the one hand, banks are reducing their traditional expansion of credit because of the slow growth.

On the other hand, there is an additional constraint: out of the 10% deleveraging process estimated, half could stem from the tightening of banking regulation.

Lastly, as we have seen, the NSFR will force a large number of European banks to finance their medium-long term loans by issuing bonds of the same duration. This will lead European banks, especially in the periphery, to compete with States and corporations on what is a limited financial market. This calling into question of the fundamental and traditional role of transformation played by the banking system, will also incite banks to shorten the maturity of their loans whatever the justified needs of their clients. Such a shortening of maturities will inevitably reduce the ability of the system to finance growth. **The calibration of their proposed piece of regulation (NSFR) has to be profoundly changed by the Commission.**

**So it is clear that the addition of different pieces of regulation, including American pressure on tightening the leverage ratio (each one having perhaps its own logical justification) can, in a cumulative way, lead to significant inconsistencies and, in a downward environment, to excessive negative economic side effects.**

I hope some understanding of this issue will develop not too late.

In this respect, I have already noted several interesting signs :

- The new Chairman of the Commission has asked EIOPA to propose a more appealing regulation for Infrastructure bonds ;
- He has also made proposals to enhance high quality securitization as one of the elements of a “ Capital Market Union “.

To conclude, let me stress a few simple considerations :

1. The advanced economies will be experiencing years of sluggish growth, in part because of the magnitude of the deleveraging problems affecting the private as well as the public sectors ;
2. Banks will have to continue to increase the resiliency of their balance sheets and improve on their risk assessment methods ;
3. Regulators will have to be modest and not believe that regulatory effectiveness is a function of complex, detailed and too numerous rules ;
4. Supervisors - who in my view, should carry out the essential part of the job - will have to improve their methods, learn from the private sector and be permanently on the watch ;
5. Policy-makers will have to rely on fiscal adjustment but also more and more on real structural measures to make their economies competitive so they can take advantage of emerging countries growth and preserve financial stability ;

6. The positive point of the European continental situation is the existence of healthy savings pools. The challenge is to encourage those resources to be channeled into long term investment which is the ultimate condition for growth. This requires a stable tax and regulatory environment which does not favor debt against equity ;
7. Enable insurance companies to play their role of financial stabilisers leveraging their long term liabilities ;
8. Central Banks will need to look more actively into the macro dimension of financial vulnerabilities in order to avoid the mistakes of the past; detecting asset bubbles early on and overseeing the financial system in its most comprehensive definition will be of the essence. Pouring money in a period of deep deleveraging cannot be seen as the solution. The situation is paradoxical :

On the one hand, Central Banks are creating huge amounts of money in order to support economic activity and employment.

But that has not seemed to work in the Eurozone. Indeed that money doesn't percolate into the economy.

Why is that? Because economic agents (State, households, companies) are repairing their over-extended balance sheets and deleveraging and because banks are facing increasing capital constraints. When a Central Bank throws money at a deleveraging economy, not much can happen in terms of demand and credit growth.

But, this being said, the same Central Bankers (in their capacity of members of the Basel Committee) have been objectively contributing to hampering the ability of banks to make loans (we know that **the deleveraging that is taking place is not entirely explained by shrinking demand for credit; it co-exists with a significant amount of unsatisfied demand for loans**).

The high capital ratios imposed on banks reduce (and increase the cost of) the ability of banks to lend and, therefore, to create "bank money" which is the major vector of money.

The higher the capital ratios, the lesser the lending by banks (be it financed by leveraging deposits or funds borrowed on the markets).

To sum up, the same people who are creating Central Bank money are the ones who, at the same time, are inhibiting, through regulatory measures, the creation of bank money (90% of total money), which would be the only way to spur economic activity.

We have an economic system in the process of deleveraging after a major credit boom. Now, we are adding to this, inevitable, phenomenon, a man-made banking deleveraging. Indeed, under present market conditions, it is almost impossible for Euroarea banks to raise fresh capital; therefore, they are reducing the denominator of their capital ratios, i.e. their lending. (The figures contained in the Financial Stability Reports of the IMF are particularly worrisome).

**I don't see how all this** can allow the resumption of satisfactory economic growth in Europe, where bank intermediation still plays an overwhelming role in financing the economy.

*Jacques de Larosière*