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FINANCE FOR GROWTH. A NEW VISION FOR EUROPE

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Maurizio Sella – President, Assonime

- Since the financial crisis rules governing world financial markets have undergone a major overhaul, in the main following the regulatory agenda set by the G-20 and Financial Stability Board (FSB). The impact of regulatory reform on the economy has been seen as benign since reform would "promote a safer, sounder and more resilient financial system […], rebuilding confidence and reducing pro-cyclicality […], which will enhance the system's ability to intermediate financial flows through the cycle and for different investment horizons" (FSB 2014). However, over time some aspects of regulatory reform have come to the fore for their possibly adverse direct impact on incentives to lend and borrow long-term.

- In Europe, given the paramount weight of banks in the financing of the economy, these concerns relate first and foremost to the strengthened capital requirements under Basel III Accords. Two issues requiring separate examination are the impact on banks and bank business models of higher capital requirements, on the one hand, and the continuing reliance on banks' risk management models for the determination of regulatory capital, on the other. On this, it has been argued that higher capital requirements will inevitably constrain the supply of credit. Others have argued that it is unclear whether forcing banks to hold more equity would raise the cost of credit to the economy, as the reduction of the risk premia paid by banks for their (non-deposit) funding could well compensate for forgone interest-rate tax deductions on their debts.

- In any case, more stringent regulatory requirements should be designed so to lead to a reduction in 'financialization' rather than lending to the real economy. This is, indeed, the core of the ongoing debate about the revision of global banking regulation, that the industry is calling "Basel IV". The main (technical) issue under discussion by regulators is how banks can use their internal models (IRB) to determine the riskiness of their loans. In particular, the Basel Committee is about to introduce two floors (*input* and *output floors*) that will strongly limit the use of internal ratings. In the view of regulators, the proposed measures aim at reducing excessive variability in risk-weighted assets (RWA) and, by doing so, avoiding the possibility by banks of 'gaming' the rules. However, the goal of the regulators of achieving higher harmonisation of existing risk-weighted systems, and reducing differences between different banking systems should not result in a disruption of the financing of the real economy.

- From the banks perspective, who have already invested considerable resources in the last decade to develop and implement complex internal ratings systems to revise their capital and credit portfolios, there is the fear that the new rules would result in an additional burden that will strongly limit their lending ability. In particular, European banks are especially sensible to the topic since many of them rely on internal ratings, while American banks are actually less worried. In the United States only few banks, and just the large international groups, have adopted internal models, while all the others continue to follow the standard models. Additional capital requirements by the Basel committee should not have a significant impact in any region, including Europe, in order not to alter the global playing field in banking.

- The recent EU Banking Reform package proposed by the Commission (to review the CRR/CRD IV, the BRRD and the SRM) aims at building a regulatory framework more conducive to growth in the EU, but there are elements that must be carefully reviewed in order to create an efficiently regulated single market for finance in which European banks are not put in a competitive disadvantage. The introduction of additional capital requirements (i.e., the implementation of the international standards on total loss-absorbing capacity –TLAC – for global systemically important institutions; the minimum requirements for own funds and eligible liabilities – MREL – for all EU banks; the binding leverage ratio and stable funding ratio) will result in heavier constraints on banks' lending ability, especially for large banking groups, and further limit their profitability in a still too fragile recovery environment. Those measures are only partially compensated by the prevision of lower requirements for bank lending to SMEs (the so called SME supporting factor) and for funding infrastructure projects (capital requirements for project finance) that instead go into the direction of increasing funding for the real economy.

- The outcome of the regulatory debate is even more crucial for the Eurozone since it is still plagued by severe imbalances in its banking and financial system. According to a recent IMF's Global Financial Stability Report, one in three banks in the Eurozone must confront severe challenges due to legacy issues (900 billion of non-performing loans and an unspecified amount of toxic assets), and the need to revise business models to respond to a sharply modified economic environment, and adapt to taxing regulatory changes. Moreover, there is also an issue of low profitability of many European banks that has become a constant feature since the financial crisis: they are constrained by the effects of the expansionary monetary policy (the quantitative easing) on one side, and increasing capital requirements on the other side.

- The EU banking system is, therefore, still plagued by widespread fragilities that are a major source of uncertainty, raising the spectre of a broad-based liquidity crisis in large segments of the banking sector. In Europe, the topic is relevant also with respect to bail-in and resolution framework: under the current interpretation of burden-sharing rules by competent authorities, this situation may be perceived by investors as foreshadowing the risk of write-down or conversion of banks' debt instruments. In particular, once it is acknowledged that the banking industry has to confront head-on its substantial requirements for fresh capital, and that private sources of capital may be insufficient, then the competent authorities should be ready to open the way to well-designed precautionary recapitalisations, supported by public back-stops. Many member states in the Eurozone and the European Union are still enmeshed in stagnating economic conditions, which are due in no small part to the inability to tackle decisively the structural weaknesses of banks and restore their ability to support the real economy with adequate lending. Resolving this issue cannot and should not be delayed by an unduly restrictive interpretation of EU rules, which already contain all the required margins of flexibility.