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Is the European banking system safer ten years after the crisis?

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The Great Financial Crisis (GFC) of 2008 – triggered by the bankruptcy of the US investment bank Lehman – has had severe effects on the European financial and economic system: several large European banks collapsed, or faltered, at the same time leading to an immense confidence crisis on the interbank lending market. Devaluation of assets put a marked strain on banks' balance sheets and a review of banks' credit portfolios revealed non performing loans (NPLs) of 800 bln euros in the euro area alone. Huge rescue packages by EU governments, adding up to about 1.2 trn euros, burden public households since then.

Is the European banking system, ten years after the crisis, more stable than 2008? Or can a systemic and structural financial crisis happen again?

In the immediate aftermath of the crisis it was politically possible to introduce new banking laws or to accelerate already existing draft legal requirements. Resistance by the banking industry was for a moment rather low as stricter regulation was accepted in exchange for large rescue packages and bail-outs of banks. The most prominent legal initiative was the so-called Capital Requirements Regulation (CRR)/Capital Requirements Directive (CRD) IV. This legal act is a further advancement of the accords set out by the Basel Committee for Banking Supervision (BCBS). This accord was initially shaped by a rather liberal regulatory stance but developed into a detailed regulatory framework with strong re-regulation of the banking sector (see Redak 2006). The main content of the new acts are stricter capital regulation on the one hand, leading to higher capital requirements as well as better capital quality, and liquidity regulation on the other hand. Liquidity risk was long time ignored by regulators. But in the crisis, when interbank lending came to a halt, it appeared as the second-most import risk after under-capitalisation. In particular, the risk that banks lose their short-term funding due to bank runs or a lack of confidence in the interbank market led to severe problems for several banks (e.g. Dexia, Hypo Real Estate, …) during the turmoil of 2008 (see Redak 2009). By introducing the so-called Liquidity Coverage Ratio (LCR) banks were required by the new law to hold enough liquid assets to counter an outflow of liquidity over a certain period of time.

In addition to the capital and liquidity requirements a new law was passed with the aim to combat not only bank-specific, "idiosyncratic" risks but also systemic risks. Under the headline "macroprudential supervision," new instruments were introduced in order to cope with (large) banks whose size or business model might jeopardize the whole banking system, financial stability or the economy. In order to avoid that "too-big-to-fail" banks need taxpayers' money or set fire to other banks (contagion) they have to have even more capital in the form of a so-called GSIB buffer (GSIB --- globally systemically important banks) or a so-called systemic risk buffer. So-called counter-cyclical capital buffers can forestall pro-cyclical moments in banks' behaviour. Last but not least new instruments for mitigating systemic risks from mortgage lending were introduced as well.

Even more supervisory intervention was made possible from the beginning of 2016 by the introduction of resolution regime via the Banking Recovery and Resolution Directive (BRRD), whose aim it is to avoid that a bank exiting the market harms financial stability or the economy. In the future, a bank should be able to leave the market without using public/taxpayers' money. Thus, for the first time, an "insolvency act" for banks was introduced. This regulatory framework provides also for early intervention measures long before a bank is on the verge of insolvency. If certain thresholds are passed the regulatory authority can set – theoretically – a wide range of measures of very interventionist character: It can impose that business areas are abandoned, that risky business lines are stopped, that participations in other companies are sold and branches are closed, or that the credit volume is restricted. These measures allow regulators a deep interference with the business and management of a bank. In comparison to decades of prior liberal regulation this looks like a paradigm shift in regulatory history. Since the end of World War II, when a strict regulatory corset including credit rationing requirements and interest rate regulations limited the leeway of banks, no such intervention was possible during the decades of liberalisation and deregulation.

A central part of the BRRD is the so-called bail-in that was introduced in order to end public bail-outs. A bail-in distributes losses of a failing bank along the hierarchy of its creditors/investors -- thus shifting the burden-sharing from public households to private investors. In rare cases where private investors' funds cannot cover all the losses, additional funds can be tapped via the new Single Resolution Funds (SRF). Banks are paying money ex-ante into this funds, which can then be used to rescue banks.

The last pillar of the regulatory reform is the reregulation of the deposit guarantee systems. In a first step, a harmonisation of diverging national deposit guarantee schemes was introduced. Its most important aspect is the ex-ante filling of a deposit guarantee fund (as opposed to the promise to honour deposit guarantees ex-post if needed, as it was common in some countries). However, the final step of completing the banking union is still under construction: an EU-wide common deposit guarantee system, called EDIS (European Deposit Insurance Scheme). This system would cover private deposits of up to 100,000 euros regardless of the geographical origin within the euro area.

Also, a new institutional setting accompanies all these measures and instruments: BRRD, SRF and EDIS are part of the so-called banking union in the euro area. Since November 2014, the European Central Bank (ECB), resp. the Single Supervisory Mechanism (SSM), directly supervises large systemic institutions. This should lead to uniform supervision, help to push back national lobbying by banks and to reduce the "softening" of EU laws on the national level ("national discretion") in order to preserve privileges of national banks. Transferring supervisory competences from a national to a supranational level is also meant to deepen European integration.

This new supervisory architecture was in principle intended to make the European banking system more resilient: higher capital requirements and better quality of capital would decrease the probability of banks' default, macroprudential regulation would address in advance systemic risks and systemic banks. If a bank would still fail, the new resolution regime would clear the way for a smooth exit of the institution from the market. With the bail-in instrument, which put the burden of banking losses on investors and creditors, a redistribution of losses from small savers to wealthy investors would be possible.

The banking sector is more stable than in 2008

Has the new regulatory and supervisory regime in practice been as effective as described above or do we have to fear that a new financial crisis will have the same detrimental effect to the population and the economy as in 2008?

As mentioned above, two indicators in particular are relevant when assessing this question. Looking back on the concrete problems of banks in 2008, the level of capital and liquidity was central to a bank's failure. The average capitalisation of European banks has increased clearly, from 12 % in 2008 to 18 % end-of 2017 (Source: EBA). Although 18% is below ideas of a 25%-30% capital ratio (e.g. Admati/Hellwig 2013), banks have made efforts to bolster their capital level. In terms of capital quality, it is noteworthy that the most reliable form of capital in terms of loss absorption, so-called "common equity Tier 1 (CET 1)" has increased substantially. The improvement of capital ratios is also partly due to a rearrangement and a reorientation of balance sheets: high risk activities of banks (high risk loans, speculative securities, etc.) diminished[1], banks got rid of risky participations, etc. As this reduces the denominator, the capital ratio improved.

Concerning liquidity, the situation is better than in 2008, too. Thanks to the introduction of liquidity regulations, banks on average are less riskily funded than ten years ago. The rather risky funding on the wholesale and interbank market declined whereas retail funding increased. By imposing the so-called Liquidity Coverage Ratio (LCR) on banks they are now required to hold more liquid assets in order to counterbalance an outflow of deposits. Until end-2019 European banks must meet the LCR requirements but current data shows that the majority of banks fulfils already the LCR (see EBA 2017).

The general resilience of banks is therefore higher in 2018 than in 2008. Some further developments show a more benign situation of the banking sector, too: Total assets of banks in the 28 EU countries shrank by 7 % in general, in relation to GDP the size of the sector diminished as well (Source: EBA). A reduction of banks as well as their branches is also a sign of a restructuring of the sector (see ECB 2017). Albeit, this development is very heterogeneous. In countries where the banking sector was hit especially hard by the crisis, like Ireland, Greece, Cyprus, and Spain, the balance sheet reduction was more dramatic, leading up to a 75% reduction of total assets since the crisis. In these countries so many assets were depreciated that – as in the case of Ireland – only a quarter of the former balance sheet remained. But even in Germany the total assets of banks shrank by 30 %. Some countries, in contrast, have a growing banking sector, in particular countries in Eastern Europe like the Czech Republic whose banking size increased by 80 % since 2008. Since this growth is deemed excessive in the eyes of the Czech regulators, macroprudential measures were introduced in the last months in order to slow down credit growth.

An assessment of the development of balance sheets since the crisis from a financial stability point of view has several aspects: whereas some economists were afraid of a credit crunch, others welcome the development as an overdue restructuring of an overbanked and oversized European banking sector. Due to the high level of competition in the sector and in order to make short-term profit, credit growth before the crisis was excessive and not sustainable.

The reduction in total assets was not only due to a reduction in loans. Balance sheets shrank very often in the course of restructuring efforts which also included cutbacks of securities trading portfolios and participations.

If the crisis is interpreted not only as a financial crisis but also as a structural crisis of modern capitalism, along with lower growth and productivity perspectives of capitalist production, then the second interpretation – that there were overcapacities in the European banking sector before the

[1] German banks like HSH Nordbank, NordLB or Commerzbank, e.g., reduced clearly their shipping portfolios.

crisis – is more convincing (see Kader/Schwarzer 2015). For years, low productivity firms, unrealistic real estate projects and sometimes low-income households were alimented with credit by banks. The 800 bln. euro stock of non-performing loans reflect this unsustainable development. A shrinking banking sector in Europe is therefore not a bad sign for financial stability. It is not a sign for a credit crunch because the reduction bank lending was compensated by growth of the European corporate bond market, showing that European firms increasingly fund themselves via capital markets, not only via banks. From a risk perspective this is a positive development, because corporate funding gets more diversified and dependence on banks abates.

Still, in addition to the growth of bond financing another trend has emerged which gives more rise for concern. In the last years activities on the so-called shadow banking system increased, too (more details see below). This raises suspicion that some banking activities shifted to sectors which are less regulated than the banking sector itself and may pose new threats to financial stability.

Too-big-to-fail is far from being solved

Whereas a lot of changes in the European banking sector and its regulation improved the resilience of the sector, some countertendencies demand attention. With more and more distance to the crises, the so-called disaster myopia phenomenon[2] appears. Banks are more and more successful in pushing back or weaken regulation. This was visible when the ECB and the European Commission undermined the efforts to improve banks' capitalization by deciding in 2016 that part of the regulatory capital requirements can be shifted into so-called Pillar II guidance. That "guidance" is not mandatory and hence this change led to a shrinking capital requirement[3]. The rules for restricting the pay-out of dividends and profits were softened for banks which do not meet capital requirements[4]. Capital and dividends are inversely related: A bank can either allocate its profit to capital and thus increase its loss-absorption capacity or pay it out as a dividend to investors, thereby reducing capital. It is clear that from time to time dividend pay-outs are necessary in order to find investors, but timing and volume of the pay-outs are crucial. In 2017/18 European banks paid out high dividends on the back of high profits. Whether this was cautious is controversial. First, supervisory theory suggests that capital should be saved especially in good times so that it can be spent in bad times. Second, the profits are in many countries not based on the operating business but derived from a reduction in provisioning. Provisions have to be built against impending losses and represent a cost factor for banks. As the economic development in the Euro area improved in the last years, banks and their auditors reduced provisions as potential losses seemed to diminish. Costs are thus reduced and profits boosted without an improvement of the operating business (saving/lending) of banks. A similar picture emerges in the US: "Large banks are poised to hand over more capital to investors than they are generating from their businesses for the first time since the 2008 crisis, lowering their defences against another catastrophic shock to the financial system"[5] (Financial Times). Summing up,

[2] „Disaster Myopia" points to a tendency that regulatory action is strong in the immediate aftermath of a crisis but diminishes over time irrespective to the level of risk (see Guttentag 1986).

[3] See: bloomberg.com/news/articles/2016-08-26/bank-supervisors-bark-may-exceed-bite-after-eu-capital-revamp, (26.8.2016)

[4] See: bloomberg.com/news/articles/2016-02-19/ecb-seeks-to-allow-dividend-coco-payouts-when-banks-lose-money (19.2.2016)

[5] See: ft.com/content/bcf77ea2-6ff3-11e8-92d3-6c13e5c92914?emailId=5b27378898e8400004405ffb&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 (15.6.2018)

previous improvements in the capitalisation of banks in Europe move gradually backwards, making the banks probably undercapitalised again when the next crisis looms.

The reorganisation of banking supervision, namely the concentration of supervising large banks at the ECB, is of little help. According to media coverage national lobbying by banks was only geographically scaled up and banks' interventions now take place at the ECB. In addition, national supervisors on the board of the Single Supervisory Mechanism (SSM) strongly support their national banking systems for competitive reasons and try to achieve advantages for their national champions. In contrast to globalization trends the banking sector in the EU is still very national (see ECB 2018) and particularly Western European countries attach importance to preserve and maintain their local banking groups. Eastern European countries have started recently to push back against the dominance of foreign-owned banks. Cross-border activities of European banks – a sign of financial integration – have diminished since the outbreak of the crisis (see ECB 2018) and bank mergers took place rather on a national than international level (e.g. Banco Santander/Banco Popular). The European Commission not at ease with these developments reacted with plans for the so-called "Capital market union" in order to foster the deepening of European financial markets.

The second pillar of banking regulation – the above mentioned resolution regime (BRRD) – lacks efficient and forceful implementation, too. An obvious example for cautious approaches regarding banking resolution is the Italian bank Monte dei Paschi di Siena. Monte was one of the first stumbling banks after the introduction of the BRRD. Instead of resolving the bank according to the new directive via a bail-in, the Italian government rescued the bank with public funds. This is still possible under the new law when the criteria for a so-called "precautionary recapitalisation" by the state are met. The criteria were not fulfilled; nevertheless, the European Commission approved the public rescue[6] after dogged negotiations. The Italian state had already before injected money into this bank, which is sitting on a huge pile of non-performing loans and was no longer capable of attracting private investors. Public money was therefore wasted on an apparently broken bank. Apart from Monte dei Paschi some other smaller Italian banks (Banco Popular di Vicenza and Veneto) were rescued with the 20 billion-euro rescue package. These are small banks with modest interlinkages with other banks, and they should have been able to leave the banking market without distortion. The case of Monte ignited fears that this could be a negative test case for the implementation of the BRRD, esp. for future bail-ins. Some months later, however, another example showed that regulators and politicians are still searching for a consistent handling of the resolution laws.

In the case of Spanish bank Banco Popular, resolution and supervisory authorities were challenged again last year. Banco Popular showed a month-long downward trend in its capital and liquidity levels. This happened after the Spanish banking supervisor had already in 2015 vetoed the bank's plans to expand to Portugal and Central America, and asked for measures to improve its liquidity situation. In the course of the real estate crisis in Spain the bank piled up a large amount of non-performing real estate loans. Finally, the ECB declared the bank as "failing" on June 6, 2017. The next question was whether to rescue the bank with public funds (bail-out) or to look for a private solution (bail-in). In the end the bank was rescued without state aid, which was made possible by the take-over by Banco Santander and a partial bail-in. A substantial amount of equity capital was written off, and capital investors had to bear the losses. For some smaller investors a compensation scheme was established, but the costs for compensation have to be borne by Banco Santander. The resolution of Banco Popular demonstrates that resolving a bank in Europe without taxpayers' money is possible without disturbing financial stability or even the economy. Contagion to other banks – always

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[6] See: bloomberg.com/news/articles/2017-01-09/italy-clears-hurdle-in-monte-paschi-rescue-without-even-trying (2.9.2017)

worrisome for supervisors – was almost inexistent, market indicators (like CDS spreads for other Spanish banks) reacted only mild and briefly.

Whether future resolution cases will be resolved without tapping public funds is doubtful, because resolution authorities act with a high degree of inconsistency. Therefore, the probability that state aid will be needed for failing banks in the future is still high. This is aggravated by the fact that the so-called "Single Resolution Fund" (SRF) is only scantily endowed ex-ante with merely 55 bln euros that will be paid in by banks until 2023 – a piffling sum compared to the 480 bln euros of direct state aid banks received after 2008. The total assets of the largest bank in the euro area, BNP Paribas, are 40 times more than those of the SRF. Even mid-range banks like Italian UniCredit have total assets that are 20 times higher than the SRF. In case of a crisis of a larger bank the SRF will have to tap the rescue funds of the European Stability Mechanism (ESM) rather sooner than later, thus take hold of another fiscal backstop fed by taxpayer's money.

The last pillar of the banking union, a common European Deposit Insurance Scheme (EDIS), is a large construction site at the moment. The aim is to insure all covered deposits in the Euro area (i.e. private deposits of up to 100,000 Euro) via a common fund which is filled up by banks. Germany is vehemently acting against a quick introduction of EDIS fearing that German banks will have to pay for Southern European banks. But the mutualisation of risks is the cornerstone of EDIS – and in my view the cornerstone of the European Union. Moreover, not only Southern European countries will profit from EDIS. All countries with a high share of covered deposits, e.g. Austria and Germany, might profit from EDIS as national deposit insurance schemes are not large enough to cover bigger bank runs. Current regulation of national deposit insurance provides that only 0,8 % of covered deposits have to be paid into the fund by banks until 2024 – a very meagre sum which means that in the end again public guarantees from which the insurance schemes profit might be necessary.

Public guarantees have recently been favoured by the ECB also for the case of emergency liquidity assistance for banks in resolution. Since the outbreak of the crisis the number of potential fiscal backstops has considerably increased. Ten years after the crisis we can observe that the "too-big-to-fail" issue in Europe is far from being resolved and the probability that state aid is needed for failing banks is still high.

Growth of shadow banking

Besides banks, other financial institutions can pose problems to financial stability in Europe, too. Many analyses suspect the shadow banking sector. There is no clear cut definition of "shadow banking", the ESRB defines it as "activities (of non-banks) that may pose systemic risk with regard to their engagement in credit intermediation, liquidity and maturity transformation, leverage and interconnectedness with the banking system."[7] Although severe data problems exist, the ESRB estimates the size of the sector in the EU at 40 trn. euro (corresponding to 272 % of EU GDP and 40 % of total assets of the European financial market). The sector's growth was particularly significant from 2012 onwards; it grew by 30 % since then. The size seems large at first sight but not all activities covered bear risks. Several activities and institutions in this sector are well regulated and conducive to financial markets, e.g. investment and pension funds. Countries with large capital markets and a funds industries like the US and the UK are seeking a new definition of "shadow banking" or a change of the name.

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[7] See: https://www.esrb.europa.eu/pub/pdf/reports/20170529_shadow_banking_report.en.pdf (21.9.2018)

Risky segments of the sector are institutions like special purpose vehicles (SPVs), security and derivative dealers (SDDs), or financial corporations engaged in lending (FCLs) whose activities are bank-like (lending, deposit taking, etc.) but not regulated like banks.

The ESRB concludes that "non-bank financial institutions may engage in credit intermediation while employing leverage which may lead to the amplification of risks across the financial system. Risks can also arise from liquidity and maturity transformation in the non-bank financial sector, even if there is limited use of leverage" (ESRB 2017, 6). Furthermore, the ESRB sees a close relationship between the shrinking banking sector and the increase in shadow banking in the EU.

Structural weakness of European economy is blind spot

Summing up, the banking sector increased its resilience in terms of capital in liquidity since 2008 due to new laws and regulation. Nevertheless, new systemic crises cannot be excluded and they might be even bigger than in 2008. First, this is because new regulatory instruments are not used forceful enough. Second, banking weakness is only a mirror of underlying economic weakness. 800 bln euro of non-performing loans means that a large part of investment and consumption decisions were not sustainable. Structural economic weaknesses of the European economy, high indebtedness in many countries and sectors in the EU and low productivity (see Ollivaud et al. 2016) will make lending to those weak areas worrisome. Nevertheless, instead of addressing structural weaknesses in the European economy many politicians rather favour an increase in bank lending or see a credit crunch as the reason for low output. In their eyes, regulation puts a drag on bank lending and therefore economic activity. This is wagging the dog. Several econometric studies (see Giambacorta/Shin 2016, National Bank of Belgium 2016) show that better capitalised banks increased their bank lending after the crisis and do not impair credit to the economy. On the contrary, less capitalised and weak regulated banks will build up new risks by lending to a flagging European corporate sector or over-indebted households. Low interest rates should stimulate banks to lend even more, but the banking sector still has to cope with a large amount of bad debt stemming from the last crisis. If the economy shows only cyclical downswings, more money from banks can help as they have financially alimented corporates in the past. But, if the economic weakness is considered being structural, pouring money into it is detrimental (see Guttmann 1996, Kader/Schwarzer 2015. Andrews/Petroulakis 2017).

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