Balance sheet leveraging rules, credit risk assumption and profit levels[1]

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The recent crises have undermined public confidence in the banks and more broadly in financial institutions, raising concerns about structural flaws in corporate practices and in regulation. Recent scandals have brought to the fore the importance of a greater degree of social responsibility in the financial sector. Regulation cannot lose sight of the critical role that banks play in the communities in which they operate. Banks cannot be viewed as ordinary businesses; instead, they have particular responsibilities towards the well-being of practically all segments of the community.

Access to credit is crucial for every economy. Ample and reasonably priced credit is critical for business growth. It also enables households to finance home purchases or education. On the other side of the banks' balance sheet, deposits are essential stores of value, for example for purpose of financing retirement. In fact, banks play the important role as intermediaries between the sources and users of funds. Unethical management of banks has a pervasive and negative effect on most sections of society, as recent experience in many advanced economies has shown.

The pursuit of profits and management bonuses led banks and other intermediaries to adopt excessive leverage. With a very large amount of debt supporting shareholders' capital, the leveraged institution maximizes the short term return to shareholders during the upswing of the business cycle. However during the downswing, losses are similarly amplified with the degree of leverage.

Banks and other intermediaries tend to take on high levels of risky assets. For example in various countries, banks provided credit to households – including mortgage borrowers – on very risky terms. Loan-to-value ratios have, in many instances exceeded 100 per cent and loan-to-income ratios were very high. These borrowers included many that were known to the lenders as being incapable of meeting their debt-servicing obligation whenever growth in income levels and house prices was interrupted. This is what happened with the bursting of residential property prices.

Innovative financial instruments provided even more occasions for speculation. Loans booked on the banks' balance sheets are routinely bundled and packaged into securities that are then sold and subsequently re-traded in the financial markets. The practise of securitization is not

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necessarily harmful, since it enables the originators of loans to reduce credit and duration risks. But risks are not eliminated but only shifted to other financial institutions, generally without the originators retaining a share in the securitized investment. Moreover, as I mentioned earlier, the underlying loans were highly risky, and to further complicate matters, information about the underlying loans was not correctly communicated. This loss of transparency further fuelled the speculative bubble, amplifying the ramifications of the financial crisis.

Banks were not alone in their risky practices. In the financial markets, traders pursue speculative profits, as trading in many securities including derivative instruments is conducted between traders that have no interest in any underlying assets. A prime example is trading in the securitized loans that I have just mentioned, but the same is true with transactions in foreign exchange and other financial instruments.

Households went along, signing loan agreements that became unsustainable, unless the housing-price bubble kept increasing. So did regulators, who were described as being engaged in regulatory forbearance; they relied on the self-regulation of markets.

Governments paid dearly for the inattentive regulation. Public sector subventions to banking institutions were an added burden on government finance and widened the risk premium in government debt yields. Since debt issued by the government in a particular country features in the balance sheet of banks in other countries, a problem in the banking sector in the first country would easily prompt a problem in the other country’s banking sector that would in turn call on the government for subvention. In these circumstances, sovereign debt crisis and banking problems feed on each other in a negative feedback loop that spread across national jurisdictions.

One lesson from the crisis is that besides ensuring financial stability and investors’ protection, regulation should take into account banks’ particular responsibilities and ensure that they are effectively committed to the public good. On one view, policy makers have legislated tight regulations that fill the gap that was left open by the absence of ethical standards.

The EU Commission committed itself to a fundamental overhaul of the regulatory and supervisory framework of the financial sector. Accordingly, in the post-crisis period, ambitious new standards to limit excessive risk-taking and augment the banking sector’s resilience were introduced.

Building on the recommendations of a group of high-level experts, the European Commission, in its communication "Driving European recovery" in March 2009, set out a roadmap for improving the regulation and supervision of EU financial markets and institutions. The subsequent communication "Regulating financial services for sustainable growth" of June 2010 presented a package of legislative measures for the financial services sector to be brought forward by the Commission and adopted by the Council and Parliament. The measures were

intended to create a safe and responsible financial sector – one that delivers greater transparency, effective supervision, greater resilience, and enhanced consumer and investor protection.

Recognising the global nature of the financial system, the reforms were coordinated globally at the level of the G20. A significant part of the EU reform agenda has therefore been about implementing the G20 commitments. Accordingly, over 40 laws were approved at a European level, including measures to restrain bankers' bonuses and boost the amount of funds that banks hold in reserve. Further objectives were to increase the transparency of hedge funds, ratings agencies, central counterparties and complex trading and to improve consumer protection.

Restraints in remuneration policy are designed to reduce risk taking behaviour, boosting confidence in the overall system. The suggested levy on the financial institutions' turnover is rather confiscatory and punitive in nature. It can possibly be adapted to a more positively oriented charge on financial turnover that would finance a fund set up for the purpose of supporting meritorious causes. Ideally it can be targeted for educational or other projects focussed on persons or families who were disadvantaged or negatively impacted by the crisis or by unacceptable behaviour of financial market participants.

The Basel Committee on Banking Supervision, through international regulation, seeks to enhance financial stability by setting common standards of financial supervision worldwide. Accordingly, the Committee issued several recommendations regarding the overall design of the capital and liquidity framework in the banking sector. Proposed regulations were set out in *Basel III: International framework for liquidity risk measurement, standards and monitoring*, issued by the Committee in mid-December 2010.

The Basel Committee's reforms (Basel III, complemented by CRD IV) intend to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. Within the EU, the European Commission implements Basel III through the use of a Regulation and a Directive. The Commission published its original formal proposals for the Capital Requirements Regulation (CRR) and amended Capital Requirements Directive (CRD) in July 2011. This collective package of legislation is commonly referred to simply as 'CRD IV'.

The establishment of the Single Supervisory Mechanism (SSM) in late 2014 is an important step to-wards a banking union in Europe. Aside from the SSM, the banking union is aimed at the establishment of a common deposit guarantee system and a common resolution fund for the euro area and other countries that want to join in. By virtue of the SSM, the European Central Bank is given the power to monitor the health of, and the risks taken, by all the major banks within the euro area, avoiding the weak regulatory stance that was evident in certain national jurisdictions.

Institutions such as development banks or on a different dimension, the European Investment Bank, can provide at least partial remedies for the failure of the transmission of changes in monetary policy onto faster credit growth, as well as for the lack of a centralised fiscal authority in the euro area. These institutions are able to channel cheap and accessible funds to investments or business growth where they are needed the most. Indeed, development banks represent public sector institutions that utilize state assets or sovereign guarantees of loans to focus on SMEs funding, social housing, education, research and environmental investment. They complement the lending activities of commercial banks by providing long term loans and access to funds for small businesses that traditionally face higher premia as they are judged to carry a higher level of risk than bigger businesses.

On the other hand, development banks need to be carefully managed, so as not to end up becoming a burden on the state and on tax payers, or a financial threat to the country rather than an equaliser of financial opportunities.

There is room for further development on the regional level of the development banking institution – perhaps with the participation of the European Investment Bank (EIB), the European Bank for Regional Development (EBRD) and the Council Europe Development Bank. With the necessary funding, such institutions can be more effective in promoting infrastructure projects, thus compensating for the very low investment levels in the euro area as compared to the United States (see Chart 1).

Chart 1: Euro area to US private investment shares to GDP