"NSFR bitter pill to swallow, needs recalibration"

CHECK AGAINST DELIVERY

Keynote speech by Gonzalo Gasos, Head of Banking Supervision of the European Banking Federation, at the fifth annual Liquidity & Funding Risk 2017 conference, Tuesday 19 September 2017, London.

Good morning,

Ten years ago, on a day like this, not very far from here, we witnessed crowds queuing in front of a bank office to withdraw their deposits. The illiquidity incident was a big surprise. We thought these things only occurred in remote places but it was actually happening in the financial centre of Europe.

Welcome everyone to the tenth anniversary of the financial crisis that started with severe liquidity problems in some banks, followed by insolvency and widespread systemic risk. In the aftermath of the crisis, the major regulatory reform in the financial sector was conceived and the most prolific regulations are being implemented in national jurisdictions across the world.

Since the beginning of the regulatory reform and also during the run-up to the financial crisis, much has been written about capital adequacy and the loss absorbency capacity of every category of capital. At the European Banking Federation, the representation of more than 5,000 banks from all European countries, we have been assessing the impact of Basel III, notably how much capital would be needed to comply with the new requirements resulting in figures above 500 billion euro. Analysts, consultants and policy makers have also dedicated time and attention to assessing the capital demands for the finalisation of Basel III. All in all, we have scrutinised the use of capital for prudential purposes.

However, looking backwards, there is not so much research available on the impact of liquidity regulation and even less about the interaction between liquidity and other prudential instruments. In turn, the implications of future restrictions to the funding of banks is still unchartered territory, which may explain the cautious approach of international standard setters who are still examining the potential unintended consequences of the Net Stable Funding Ratio in the financial markets.

Against this background, I would like to shed light in my keynote speech on three aspects of the liquidity and funding rules that, no matter the details of their final definition, will be present in the banking business for the years to come. I am sure the in-depth review of the liquidity and funding regulations that will follow in this seminar, organised by Risk.Net, will make references to these points that I would invite you to reflect on:

First, liquidity and funding are not standalone rules. They are inherently connected to the rest of the prudential standards and their interplay needs to be understood.

Second, liquidity is said to be the most common cause of bank failure, or, at least that is what follows from the interpretation of the bankruptcies post-crisis.

Third, liquidity and, in particular, funding, are costs in nature. Unlike capital requirements. In a world of ever increasing costs and declining margins, every cost needs to be examined and the cost of liquidity and funding should be no exception.

My first point is about the interaction between liquidity and other rules in the prudential landscape. As I mentioned before, the available research on the impact of liquidity and funding ratios is limited. In Europe, we have the Quantitative Impact Studies conducted by the European Banking Authority in the context of Basel III, and several studies at national level especially in countries where liquidity requirements were implemented earlier, like the UK and the Netherlands. These exercises concluded that liquidity and funding ratios would have no significant negative effect on lending to the real economy and GDP growth.

But these studies pointed out a common finding: an important substitution of short-term intra-financial loans with other high quality liquid assets. The EBA monitoring report published last week indicates that European banks have doubled their stock of high quality liquid assets since 2011, mainly by investing in government bonds. Due to the preferential treatment of government bonds, banks have replaced a large part of other financial bonds, covered bonds and asset-backed securities. In short, the liquidity and funding ratios may have put behind the model of interbank liquidity and implemented a new model of minimum requirements for State finance.

I would like to draw your attention to the combined effect of funding, leverage and capital requirements. The shift towards government bonds pulls down the Net Interest Income of banks therefore reducing profits. With less profit, banks capacity to meet capital requirements by retained earnings is lower. This impact may be significant. According to a study on the effects of the NSFR, with data of banks from 15 countries, the interest margin would decrease 80 basis points, or by 40%.

If we put these rough numbers together, it is not rocket science, the big numbers speak for themselves:

- the volume of business of European banks remain roughly the same as 10 years ago;
- the net interest income has been reduced by more than 15%;
- and the capital has doubled.

So the old 12% Return on Equity has been reduced due to lower income and divided by 2 due to double capital. The result: 5%, the new Return on Equity of European banks.

What does that mean? with fierce competition from new players and with a cost of equity that remains around 8%, the competitive profile of European banks, on average, is undermined. At the EBF we have been raising this concern that should be addressed by policy makers. Some years ago, in a conference, I raised the question whether international policy makers should include profitability as a key factor of financial stability. The answer of a top representative was that he was not concerned because, according to his long experience, banks always find a way to make money. That used to be a big truth, I thought, but with so many requirements plus the upcoming NSFR, they might have cut all remaining ways to make some decent money.

Let me now move to my second point: is the lack of liquidity the cause of bank failure?

If one reviews the press communications about the banks that have gone bust in the last decade, the upshot is that most of them failed due to lack of liquidity. But we need to go deeper than that. We need to distinguish between cause and effect. In a way, it is as if we concluded that all humans die because their heart stops beating. Similarly, all banks go bust at the point at which they have no more liquidity to meet their obligations. But more often than not illiquidity is the consequence of a multifaceted problem. Tackling the symptoms does not cure the original disease.

Let me put a recent example. The first bank resolved by the Single Resolution Board three months ago confirms this pattern. It was a solvent bank but with a long-lasting problem of a high non-performing-loan ratio that had gradually lost market credibility. However, it went on until one day the President had to call the supervisor to declare "We don´t have enough liquidity to open the bank tomorrow". It was again the risk of a run of depositors that killed a bank. The result came to the media the following day as a bank strangled by lack of liquidity.

This fact leads to the following questions:

- Did the liquidity coverage ratio work as expected?
- Was there a problem of funding?
- What was the core factor that pushed the bank to the brink?

There is no single answer to these questions, but we have some indications. First, the bank met its short-term liquidity requirements regularly. Second, it had been raising capital from legacy shareholders and issuing long-term debt for quite a long time, therefore its long-term funding was adequately stable. Finally, there was a problem of business mainly due to the significant portfolio of non-performing loans that slowly deteriorated the bank's capacity to generate new resources. This was the bank's most serious problem. However, there is a widespread belief that it was a case of illiquidity.

This is in part because the regulatory system does not sufficiently discriminate between different diseases. In the field of medicine there is the *Vade mecum*, a comprehensive compilation of diseases and treatments. In the banking sector, there is no *Vade mecum*. We just have a liquidity coverage ratio that is the equivalent of an aspirin; and a net stable funding ratio, the equivalent of a pacemaker. The recently resolved bank obediently took an aspirin every morning to ensure short-term liquidity and had a pacemaker installed to ensure adequate long-term funding. However, none of these measures were effective with the acute illness of a high non-performing loan ratio, the cancer, in a way, of the banking system.

This case makes one wonder why the regulatory environment monitors the liquidity and funding of a strong bank with the same intensity as the liquidity and funding of a weak bank. In medicine, we do not apply the same medical treatment to the person with remote heart complications as to the person with impending heart disease. Likewise, I think, banks' regulation and supervision should require liquidity and funding requirements with the intensity, granularity and frequency, commensurate to the risk of the bank.

However, the liquidity requirements are exactly the same for the entire population of banks. The NSFR, in its current definition, is like prescribing a pacemaker for each and every bank. And it is not for free. It is the bank who pays for it via reduced profitability, huge compliance costs and supervisory fees.

This question brings me to the last point I would like to make. High liquidity and long-term funding do not come for free. They represent costs to the banking business. Therefore it is imperative to ask oneself the question: is liquidity and funding worth the cost?

We need to recall a fundamental difference. Conceptually, capital is a cost-neutral choice for the bank, whereas liquidity is just a cost. In a banking sector overwhelmed by regulatory restrictions and with lower levels of return than other industries, this becomes a critical competitive factor.

In principle, if a bank raises its level of capital, the value of the bank should, in theory, remain unchanged. This is one of the pillars in the theory of capital formulated by professors Modigliani and Miller, the capital-structure irrelevance proposition. According to the Modigliani and Miller theorem, in a perfect market a marginal increase of capital, replacing other forms of funding, does not affect the value of the company. The capital structure is a choice but it does not represent a cost.

This theorem was widely cited by policy makers to support the rationale of the Basel III proposals for capital requirements back in 2010. The argument was that by increasing the capital of the banking system, the greater security would compensate the cost of new capital and make the investment equally attractive from a financial viewpoint. This has not come totally true yet, because the market still perceives the banking sector to be riskier than its current strong capital position would deserve. Recent data show, however, a more optimistic prospect so perhaps the benefits of a stronger capital position are finally becoming apparent.

Liquidity and long term funding are not cost-neutral choices. The obligation to increase the holding of high quality liquid assets represents a cost. Let's put an extreme example to illustrate the point. If a bank replaced all its assets with government bonds, it would become the best bank according to the LCR and NSFR criteria. Bravo. But the value of the bank would go down to that of a basket of government bonds, the value of which is not high these days.

The difference in value would represent the *alpha* of the bank. A well performing bank is able to deliver value above and beyond a passive investment in government bonds. The *alpha* or additional value of the bank is enshrined in its expertise, the knowledge of the credit market and the diligent daily management of its risks. Too restrictive liquidity and funding ratios strip a big chunk off the *alpha* that the bank can deliver.

It can be argued that a minimum level of mandatory investment in high-quality liquid assets brings safety to the banking system. And it does. But with a cost. And the cost is allocated asymmetrically between businesses. Certain portfolios that are critical for the economy like trade finance, SME lending and long-term project finance, are hit by every regulation: capital, leverage, and especially, funding.

In particular, the NSFR in its original calibration could bring about unintended consequences, four of which I would like to highlight:

- it can restrict, paradoxically, the liquidity of the repo market;

- number two, it forces good banks to become more passive investors in government bonds; rendering their resources and structure too complex and costly for such plain-vanilla business;
- number three, it reduces the net interest income of banks, compounding the problems associated with the transition to a less leveraged system and rendering the banking sector less attractive in front of alternative investments;
- finally, it hits disproportionately business activities which have nothing to do with the financial crisis but which are crucial for economic development, in particular trade finance, SME lending and infrastructure finance.

In conclusion, if the Liquidity Coverage Ratio has been implemented at a reasonable cost, the same cannot be said for the Net Stable Funding Ratio. The NSFR will be a bitter pill to swallow in its current form. It needs to be recalibrated. I look forward to hearing the more palatable proposals from the experts in this seminar.

About the EBF:

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.5 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth. www.ebf.eu.

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