

What impact is regulation having on the European financial services sector?

Rafael Doménech and Santiago Fernández de Lis

**Wilton Park Conference: Financial Regulation in the European Union:
The Impact on The Economy and The Financial Services Sector**

Frankfurt, March 19-21, 2012

Main messages

Drivers

Supply side:
effects of higher capital
requirements

Demand side:
effects of lower credit/GDP

Procyclical banking
regulation

European financial
integration

Effects

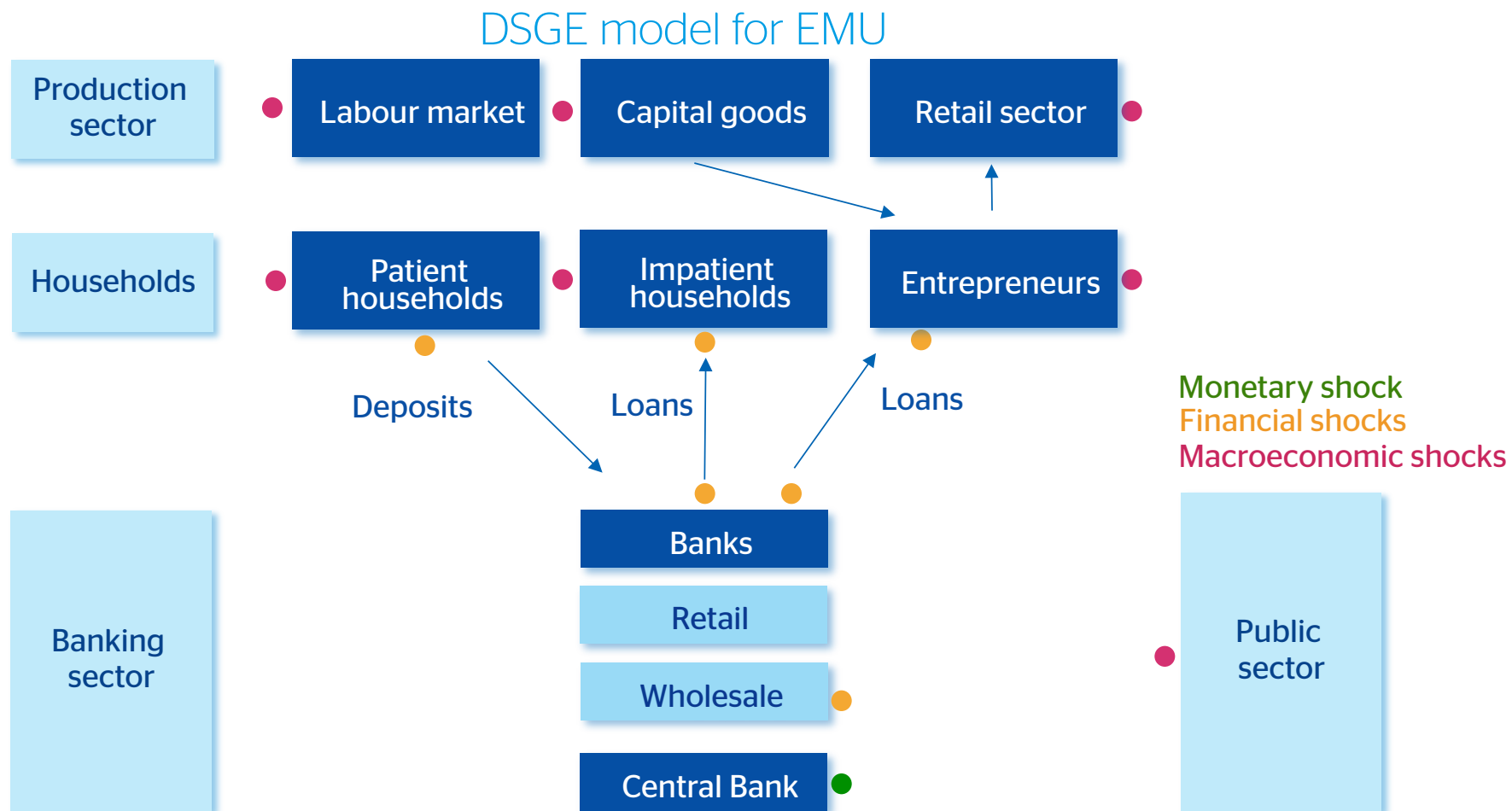
Frontloading of Basel III: greater negative effect in credit than in
GDP → acceleration of deleveraging

Negative short-run effects on ROE and ROA, with very high
heterogeneity across countries (efficiency, competition, ...)

Regulatory overreaction to the financial crisis:
race to the top, too soon

More European integration needed, but fragmented financial
markets point in the opposite direction

1. Impact of European banks recapitalization



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The GDP fall to meet the EBA requirements would be -0.2pp in the first year

Impact of Basel III + EBA + 1% Banks' decision
(EC < BBVA < IIF)

Variable	Year 1	Year 4	Long-run
GDP	-0.40	-0.59	-1.22
Consumption	-0.12	-0.15	-0.50
Investment	-2.34	-3.86	-6.86
Credit	-1.78	-2.39	-5.03

Some indirect effects and recapitalization strategies may reduce these negative effects

2. Effects of lower credit demand on the banking sector

Dimensions

Banking output over GDP

Employment

ROE and ROA

Short-term effects
on profitability

Effects

In general credit expansion implied an increase of VA/GDP
Deleveraging → lower GDP share but with great heterogeneity

Employment share shows higher relative productivity of banks
Deleveraging and technical progress will accelerate this process

No relationship between leverage and ROA & ROE in the long run
Large heterogeneity across countries: efficiency and competition

Deleveraging will have negative transitory effects
on ROA and ROE

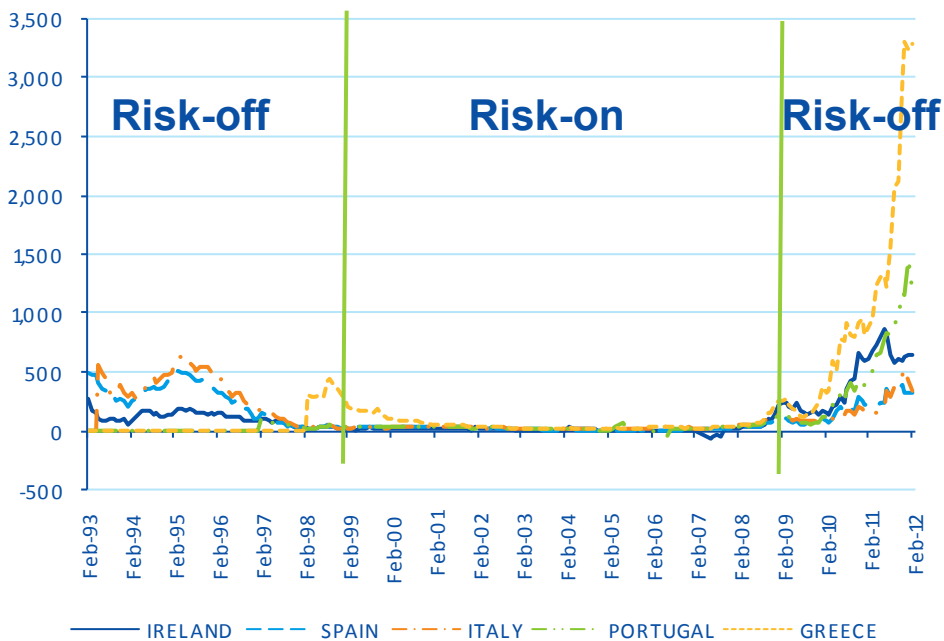
3. Pro-cyclicality of the financial system

Partly a result of asymmetric market discipline ...

... partly a result of regulation

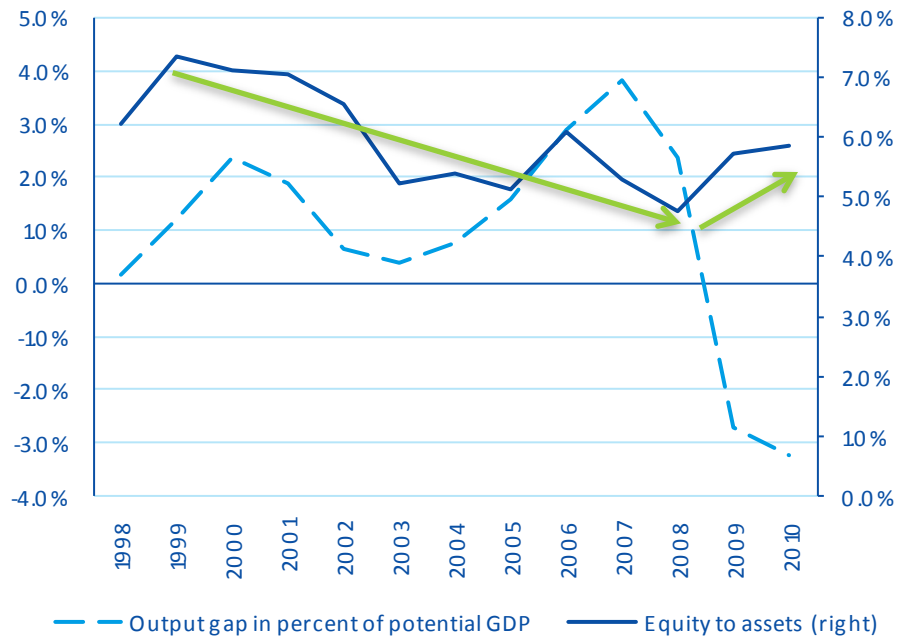
Sovereign 10Y spread

Source: BBVA Research based on Bloomberg data



Spain: Equity to assets and output gap

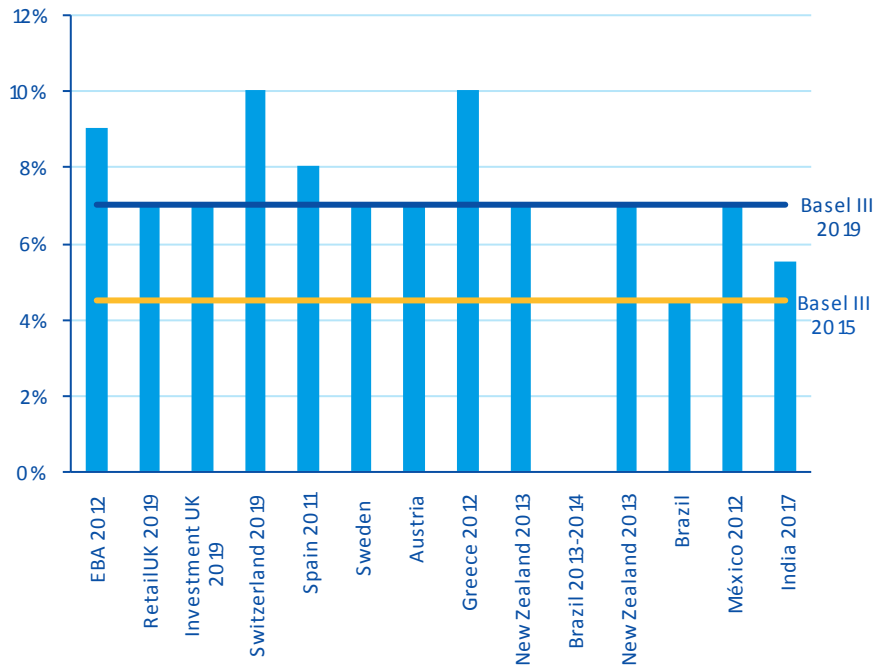
Source: BBVA Research based on Bloomberg data



3. Regulatory responses to the global crisis

Core Capital Ratio* (%)

*Core capital + Conservation Buffer
Source: BBVA Research based BIS data



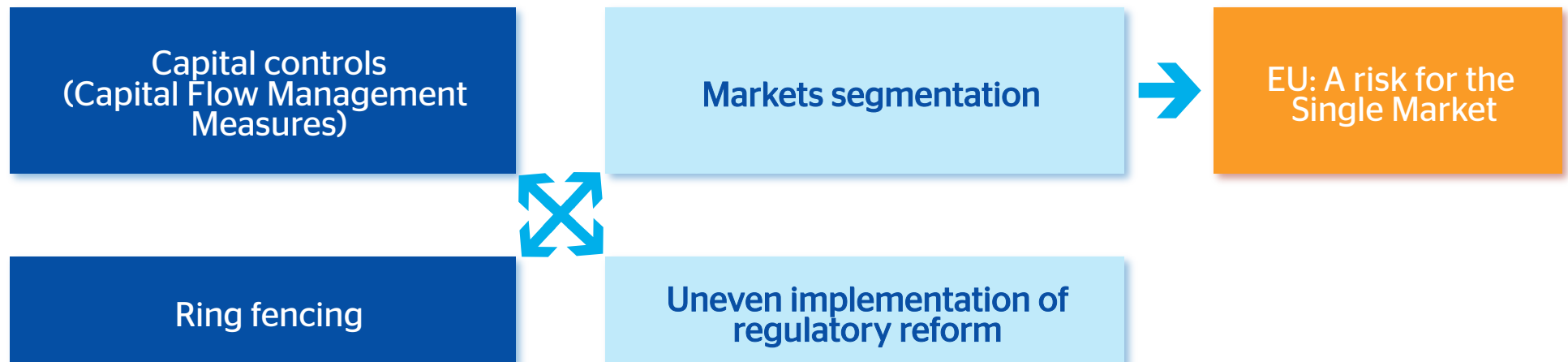
In the good times: regulatory arbitrage led to a “race to the bottom” in regulation

In the bad times, “race to the top” (partly as a result of market pressure), overriding Basel III gradualism

EBA exercise exacerbates pro-cyclicality and opens the Pandora’s box of credit risk in own sovereign exposure

4. The segmentation of financial markets

Is this crisis the start of a reversal in financial globalization?

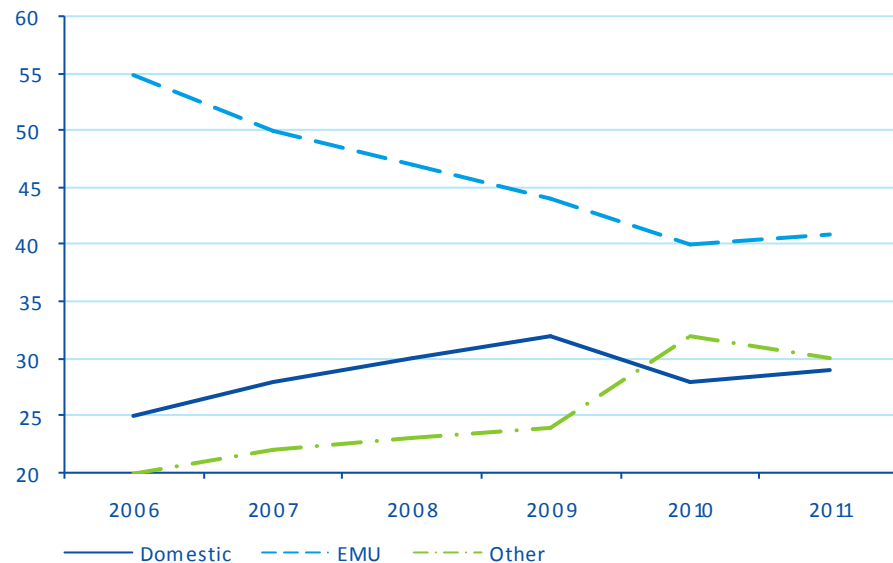


4. The crisis endangers financial integration in Europe

- Reversal of financial integration in the Eurozone
 - Lack of transparency in banks BS, despite stress tests
 - ... and exacerbated perception of country risk
 - Circularity sovereign and banking risk

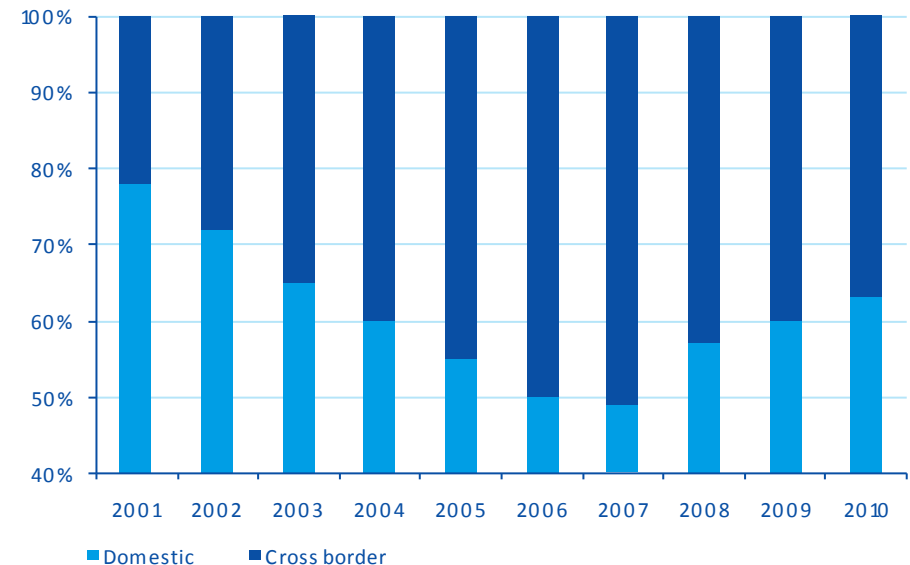
Geographical counterparty breakdown in EMU unsecured money markets (%)

Source: European Commission



Collateral used for Eurosystem credit operations (%)

Source: ECB



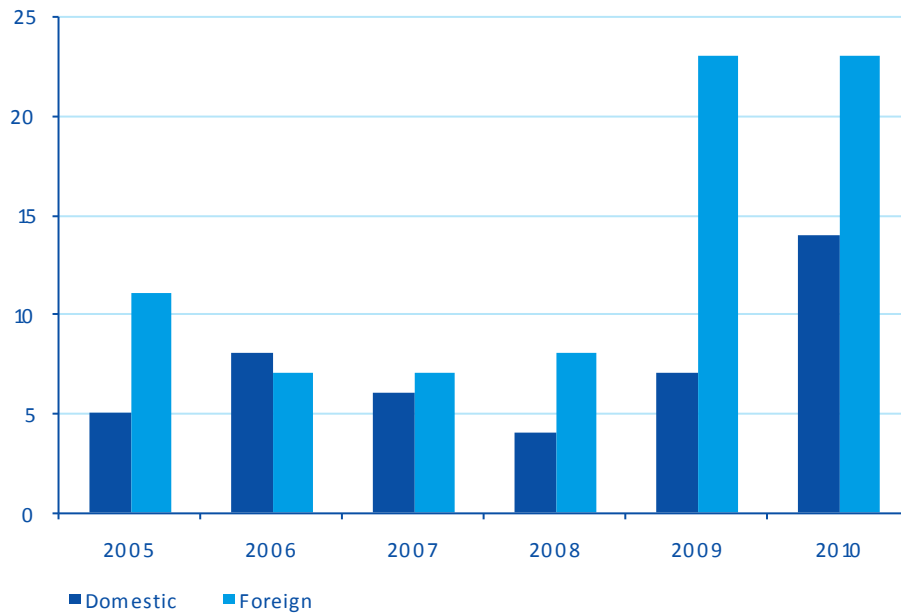
* European Commission (2011), "European Financial Stability and Integration Report 2010" and ECB (2011), "Financial Integration in Europe"

4. The crisis endangers financial integration in Europe

Financial activity in general is becoming more national

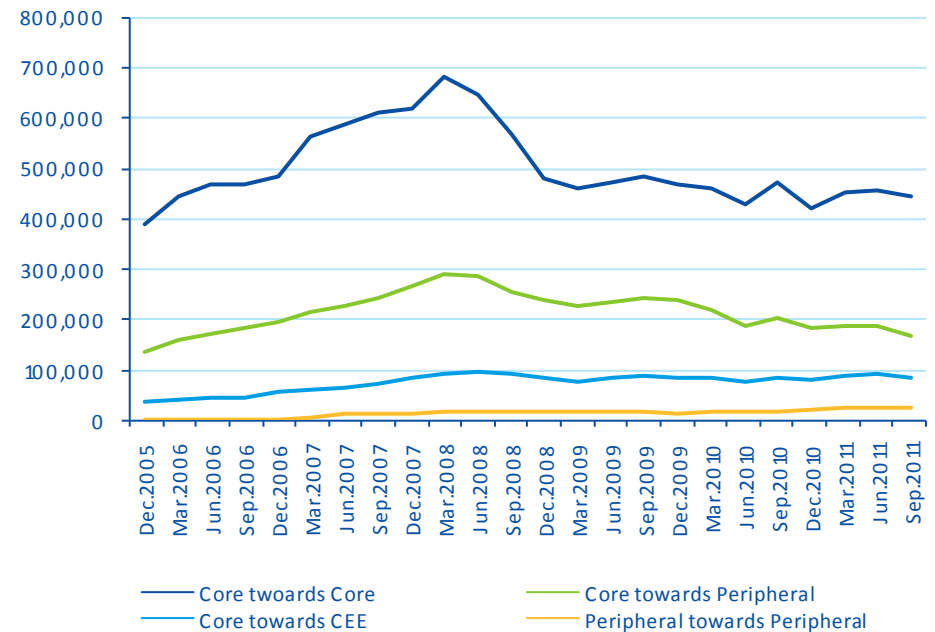
European banks: number of sales of foreign an domestic units

Source: ECB and Bankscope Zephyr



European banks' average exposure to EU members (USD)

Source: BIS

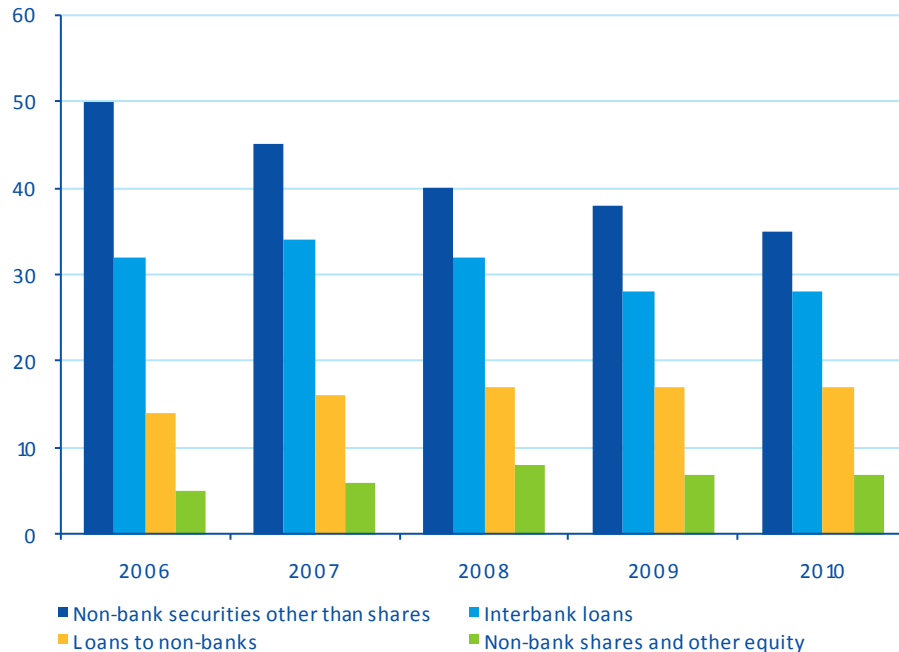


4. The crisis endangers financial integration in Europe

- Reversal is more pronounced in short-term, more integrated segments ...
- ... whereas less integrated, longer term segments (equity) are less affected

Cross-border provision of financial services in the euro area-assets (%)

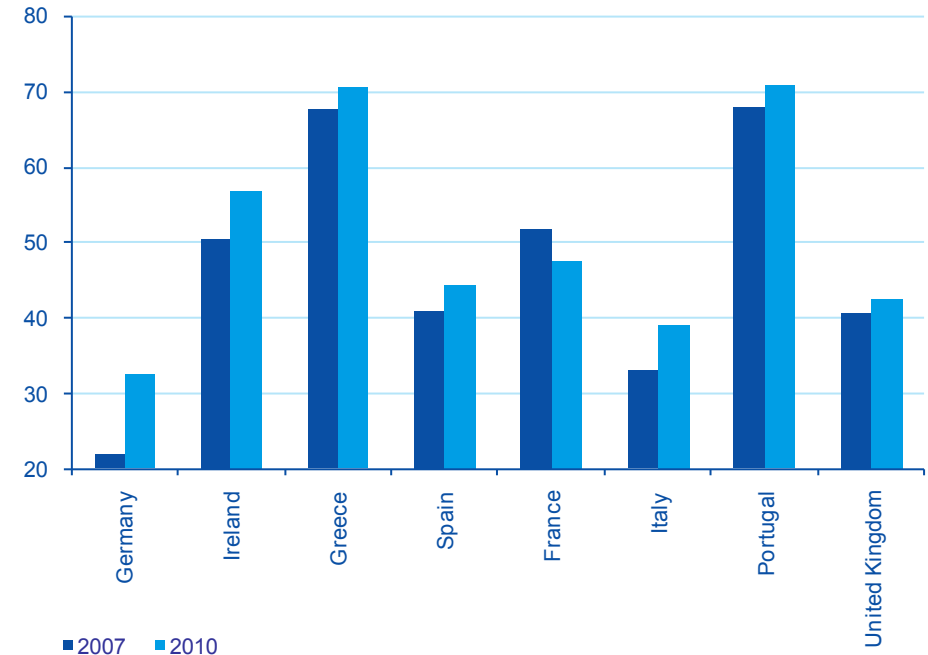
Source: ECB



- At the same time, banking concentration is increasing in Europe

Share of total assets by five largest credit institutions

Source: BBVA Research based on ECB data



4. Restoring European financial markets

Regulatory pressure + segmentation + concentration = risk of efficiency losses, widening of intermediation costs



Important to resume the trend towards financial integration in Europe



The ECB liquidity injection provides a valuable breathing space ...



... but the euro zone banking system cannot rely indefinitely on the ECB intermediation function
It is imperative to restore the normal functioning of interbank and wholesale markets

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Thank you

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Annex:

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Leverage and banking performance

Although econometric results are statistically significant, they hide too much heterogeneity and patterns across countries

Regressions of output, employment and returns on credit over GDP

	Dependent variables					
	<i>VAB</i>	<i>L</i>	<i>ROA</i>	<i>ROE</i>	<i>ROA</i>	<i>ROE</i>
<i>Credit/GDP</i>	0.03 (4.59)	-0.01 (2.40)	-0.004 (2.44)	-0.089 (2.62)		
<i>Credit/GDP</i> (First difference)					0.048 (8.75)	0.987 (7.91)
N. Obs.	94	94	101	102	93	94
R sq.	0.19	0.06	0.06	0.06	0.46	0.40

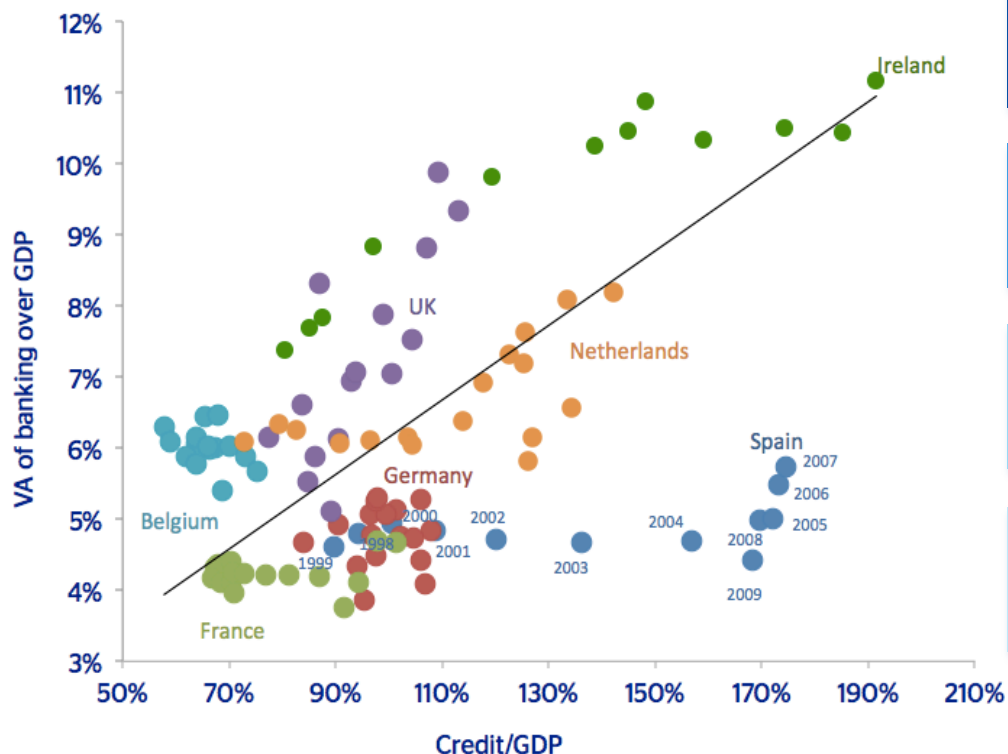
Period: 1998-2011. Countries: Spain, Germany, France, UK, Belgium, Netherlands, Ireland and Italy

Annex

Deleveraging and baking output in National Accounts

Credit/GDP and VA of banking sector over GDP

Source:



In general, credit expansion has implied an increase of banking output over GDP

Nevertheless there is a clear heterogeneity across countries

Spain has been clearly an exception to this pattern

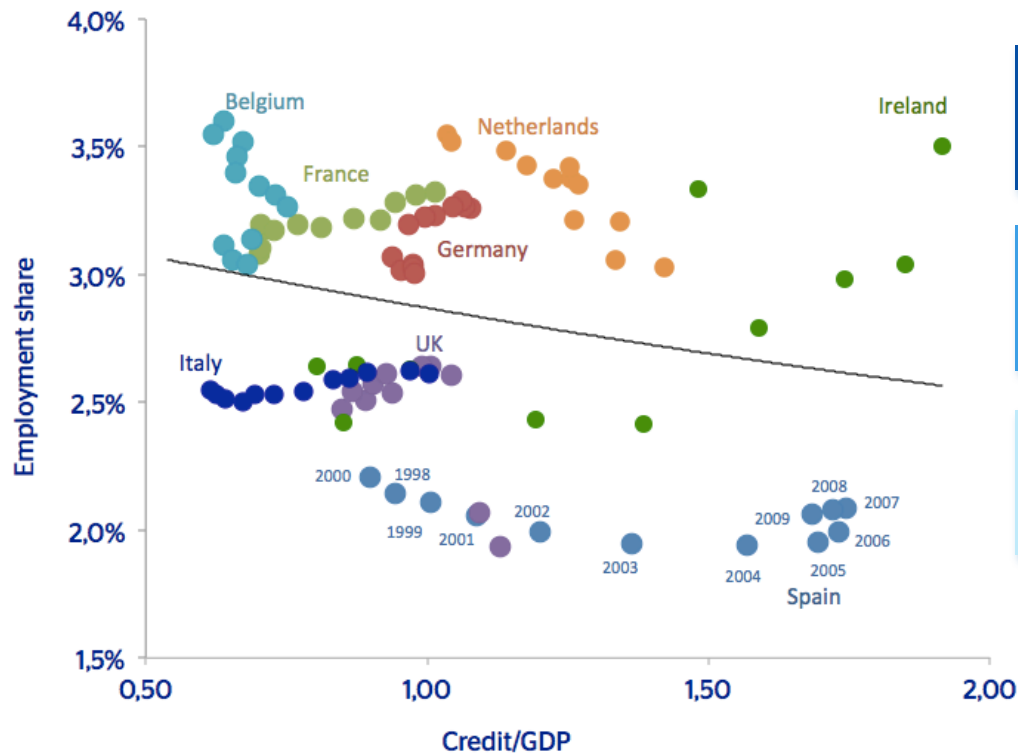
Deleveraging will imply a lower GDP contribution of the banking sector

Annex

Deleveraging and banking employment

Credit/GDP and banking employment share

Source:



Despite the increase in GDP share, employment share has fallen or remained constant ...

... due to the increase in the relative productivity of the banking sector

Deleveraging and technical progress will accelerate this process

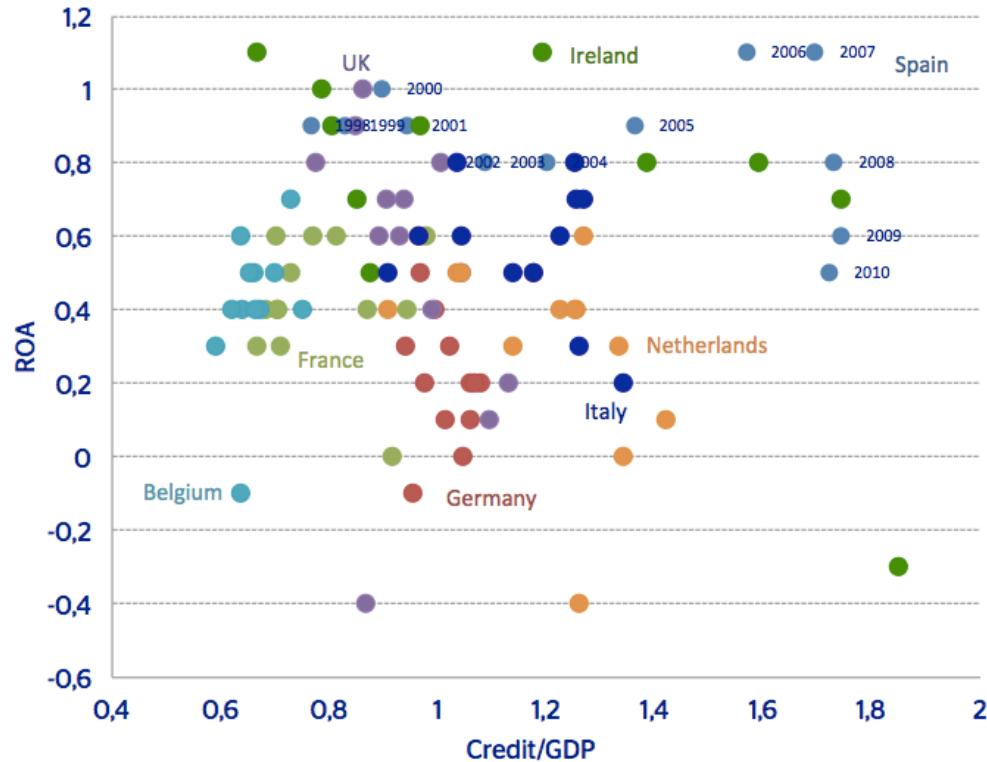
Annex

Deleveraging and banking profitability

ROA and Credit/GDP

Cross-section and time series evidence

Source:



No clear relationship between credit/GDP and ROA

Long-run levels of ROA determined by other factors as efficiency or competition

Similar results are obtained in terms of ROE

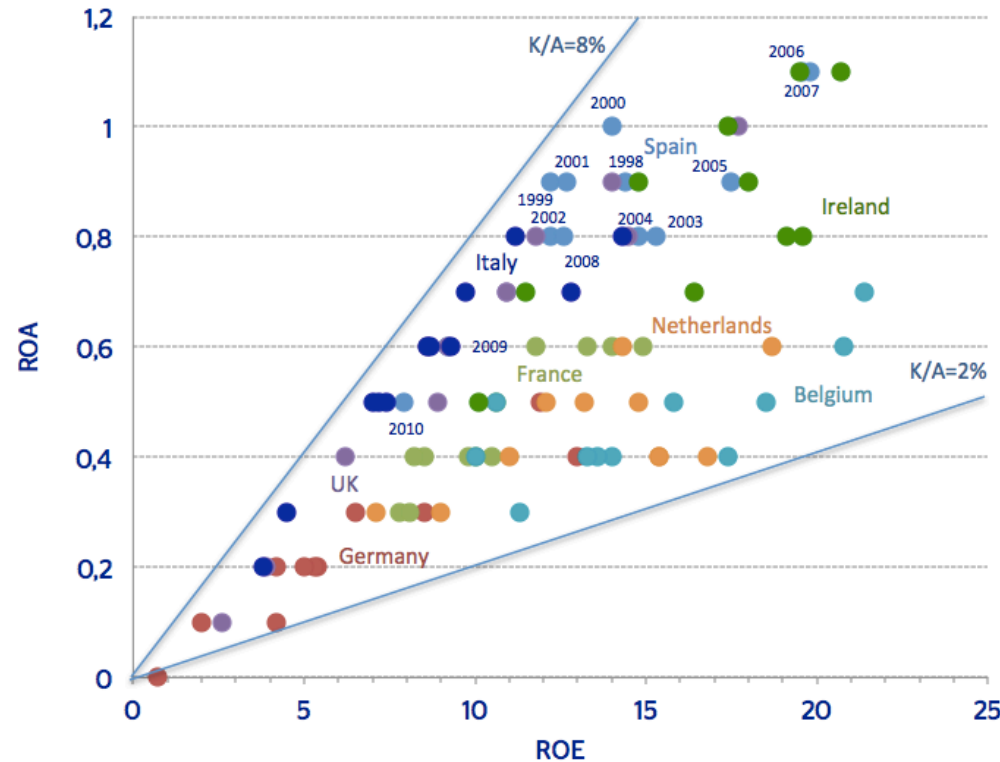
Annex

Deleveraging and banking profitability

ROE and ROA

Cross-section and time series evidence

Source:



Countries with similar ROE show very different ROA and, therefore, different K/A

Countries with similar K/A show very different combinations of ROA and ROE

Higher K/A does not imply lower ROE in the long run

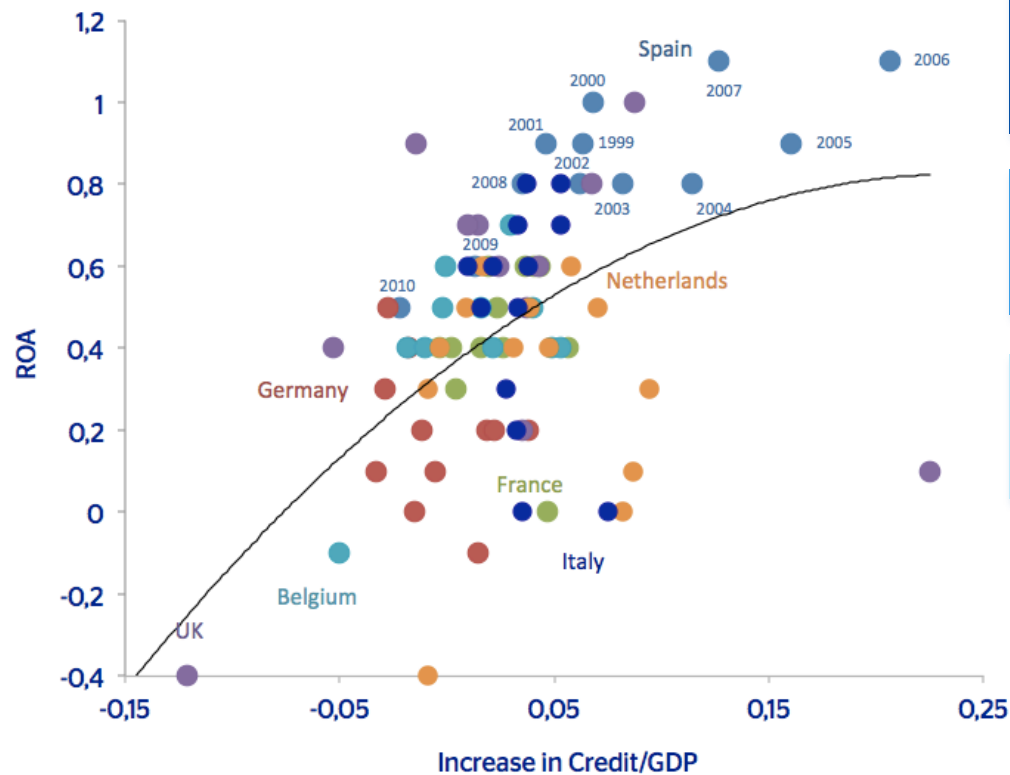
Annex

Deleveraging and banking profitability

ROA and Credit/GDP

Cross-section and time series evidence

Source:



Transitory positive correlation between the changes in credit/GDP and ROA

Deleveraging will have negative transitory effects on ROA

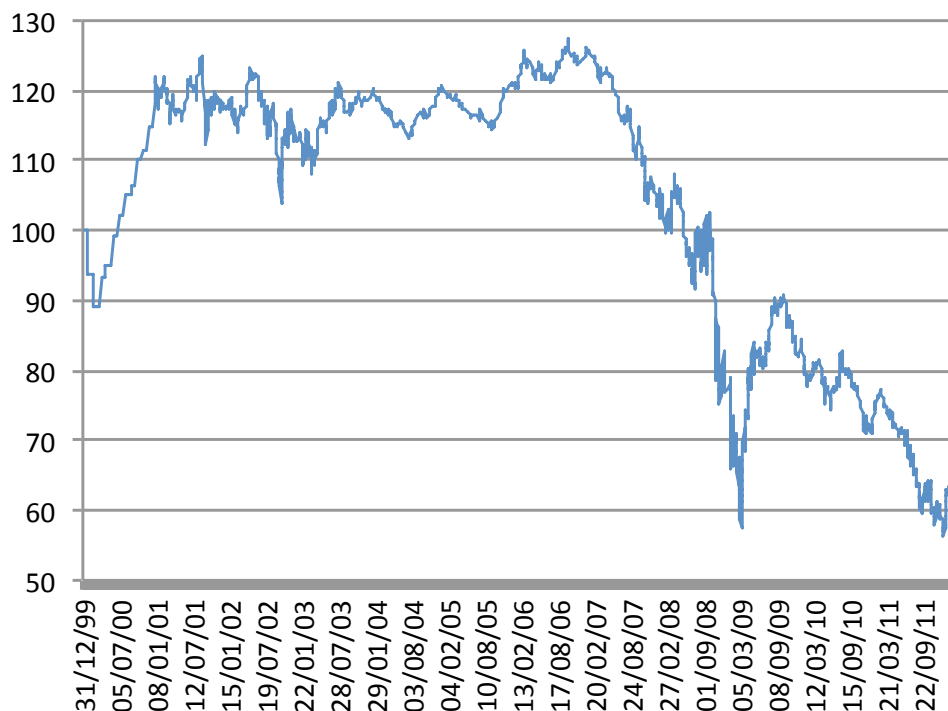
Similar results are obtained in terms of ROE

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Deleveraging and banking profitability

Equity markets and Credit/GDP Banks index relative to total

(Dec 31, 1999=100). Source: Euro Stoxx



- Periods of high growth in credit and profits
→ Better relative performance of banks
- Expectations of losses and credit deleveraging
→ Worse relative performance of banks
- Long-term performance determined by other factors, leverage not the most relevant