

EDITORIAL

Basel III – focus on capital ratios is misleading

Elina Pyykkö, ECRI/CEPS Researcher



The proposed Capital Requirements Directive IV incorporating Basel III revisions and the complementary regulation are designed to strengthen the resilience of the banking sector and to ensure banks' ability to finance economic growth. While Basel III introduces useful amendments, its treatment of all banks equally, regardless of their riskiness, has faced strong criticism. Ring-fencing is one proposed measure that would take the nature of bank

operations better into account, but as discussed later, it does not solve the problem of reflecting the right level of risk in the capital requirements.

The main criticism levied against the framework has concerned its simplistic concept of ratios, as they are set once and for all banks. In an interview given to **VOX** on September 23rd, Professor Viral Acharya of the Stern School of Business at New York University warned that simply requiring banks to double their capital ratios will likely cause them to raise capital by shrinking their assets – not by raising new equity. This would lead to lower lending to the private sector, which would slow down the economy. Since the requirements are the same for all banks regardless of the particular risks they actually take, these requirements may place a disproportionate and counter-intuitive burden on lower-risk retail banks. This latter category plays an especially important role in the financial sector via its lending to the private sector and households. Rather than the amount of capital, Acharya argues that the focus should be placed on the riskiness of the banks' operations. He stresses that capital needs to be raised against those asset holdings that contain the highest risk. He argues that often it is not the amount of capital a bank holds today that is important, but rather how much capital a bank holds in a serious crisis scenario.

These issues are also highlighted in the recent **CEPS study** "Business Models in European Banking: A Pre- and Post-Crisis Screening" launched at the European Parliament on September 20th, which demonstrates the underlying differences between banks with different business models. The panellists of the event further discussed the problems with the focus that Basel III has on capital ratios. Professor Nassim Taleb of New York University pointed out that the fundamental problem with the Basel recommendations is that their preoccupation with capital gives banks an incentive to play with liquidity, cash and funding schemes. The speakers emphasised the need for managing systemic liquidity risks, especially given that it is unlikely that the Liquidity Coverage Ratio and the Net Stable Funding Ratio will be enforced in the near future in the EU. Professor Enrico Perotti of University of Amsterdam reminded the audience that academics have continuously called for adding risk charges, thereby targeting unstable funding. In practice, this would mean basic charges on short-term funding, which would be adjusted as needed. The higher costs would support those financial institutions that rely on stable sources of funding, such as savings banks, securing traditional sources of credit for the private sector and households.

These arguments consistently suggest that capital ratios alone will not reinforce the resilience of European banks. The riskiness of bank operations should be considered in setting capital requirements and there should be some mechanism for revising those risk levels, when justified. As a response to this criticism, several experts – for example, the UK government-appointed Independent Commission on Banking – have promoted the idea of ring-fencing retail banking from investment banking. Ring-fencing would likely prevent the risks taken in investment banking from spilling over to the commercial, retail side. It should be acknowledged, however, that ring-fencing alone does not account for the risk-taking incentives that are present in the commercial sector. Therefore, even ring-fenced, banks should be exposed to proper risk weights in assigning required levels of capital, which raises the issue of proper risk measures.

ECRI EVENT

The shadow economy in Europe

Lunchtime meeting in cooperation with CEPS and VISA Europe
Date: 18 October 2011, CEPS, 1 Place du Congrès, 1000 Brussels

The shadow economy is estimated to be about €2.1 trillion in Europe and is widely acknowledged to represent a major revenue threat for the global economy. The economic crisis increased the attention given to but also the participation in the shadow economy. Since the shadow economy is difficult to observe and thus to control, and because many countries have already implemented comprehensive improvement strategies, more innovative mitigation strategies to combat the shadow economy are called for. One of the suggested innovations is to aim at reducing the incidence of cash transactions in the marketplace. Electronic payment systems provide one means of making participation in the shadow economy more difficult, as these systems provide a trace of transactions. This event will discuss the challenges of combating the European shadow economy, and how electronic payments could be used in this endeavour.

AGENDA:

- 12.30 Registration and lunch
- 13.15 Words of welcome by **Karel Lannoo**, CEO, CEPS
- 13.20 Introductory remarks by **Dr. Friedrich Schneider**, University of Linz
- 13.40 Reactions from: **Wolf Klinz**, MEP and Member of the Committee on Economic and Monetary Affairs
- 13.55 Comments by: **Luigi Davide Steffanini**, General Manager, VISA Europe & **Andreas Pratz**, AT Kearney
- 14.00 Question and answer session
- 14.30 End of meeting

Registration at: <http://www.ceps.eu/event/shadow-economy-europe>

EC adopts Recommendation on access to a basic payment account

The European Commission is aiming to ensure that any consumer who is legally resident in the European Union can access payment services through a basic payment account at a reasonable cost. Today, there are estimated to be around 30 million consumers (7% of EU consumers) who do not have a payment account, with a large percentage of these 'unbanked' consumers coming from new EU member states that joined the EU after 2004 (EU12).

Not being able to access mainstream financial services exacerbates financial exclusion and limits the benefits of participating in a modern society that is becoming less cash-dependent. Internal Market and Services Commissioner Michel Barnier said: "Access to a basic bank account is one of the priorities of the Single Market Act. It has the potential to improve the lives of millions of Europeans. It is important to put an end to practices that exclude people from access to such a basic and essential service, and thus enable them to participate fully in the society they live in and to enjoy the benefits of the Single Market."

The Recommendation stems from the fact that many applications are systematically turned down due to the ineligibility criteria of consumers, often set by legal requirements or industry practices. Characteristics such as residency requirements, proof of income, profitability tests, risk assessment and credit history checks should not prevent EU citizens from opening bank accounts that enable them to carry out basic financial transactions, e.g. deposit and withdraw cash, receive and carry out payments, and transfer money. Putting in place the Recommendation at national level will ease the condition for consumers seeking access to essential payment services.

More information: http://ec.europa.eu/internal_market/finservices-retail/inclusion_en.htm

Real growth rates in retail credit market have risen for the first time since the financial crisis

The European Credit Research Institute (ECRI) has recently published its 2011 Statistical Package, a comprehensive collection of data on lending to households, covering all European countries and other major global economies for the period 1995-2010. The main findings of this year's Statistical Package are:

Early signs of recovery in credit growth

In 2010, the EU27 retail credit market saw an increase in real growth for the first time since the financial crisis. Since this century's peak of 8.21% growth in 2005, the weighted average growth of EU27 countries had been slowing, down to 0.86% in 2009. However, with a growth rate of 0.90% in 2010, this increase is still modest and well below the average compound annual growth rate of 4.25% for the first decade of this century. Furthermore, only 8 of the 27 member states saw a recovery in their real growth rate compared to the previous year, while negative growth rates persist in several eurozone and Eastern European countries.

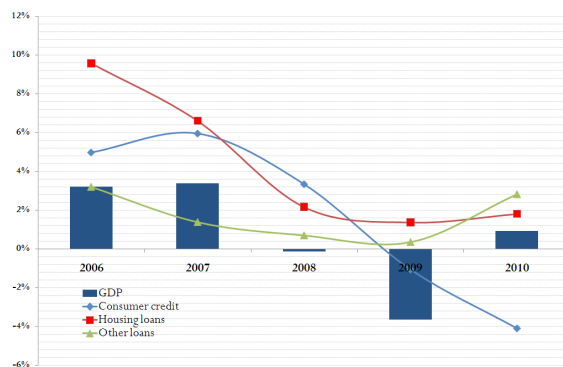
European households are not deleveraging

Relative indebtedness remained stable for EU27 households, with a modest increase in 2010; total credit now represents roughly 65% of GDP. This level is still well below the 88% in the US, where the deleveraging of households persists. Total credit to US households as a % of its GDP dropped for the third consecutive year, whereas there was an increase in the relative indebtedness of EU27 households for the second year in a row. This upward trend is also seen in relation to the disposable income of households.

Different types of credit show different recovery trends

The break-down of total credit to households shows diverging patterns for different types of credit. While consumer credit decreased even more than in 2009 – by a staggering -4.10% in 2010, a slight upward trend emerged in the sector for housing and other loans. The crisis-resilience of the housing loans market varies among member states, however; with Ireland showing a strong decrease (-9.48%), while Italy, Poland and Slovenia experienced over 20% increases (+23.32%, +21.15% and +20.73%, respectively).

Real growth rates of consumer, housing and other loans, EU-27

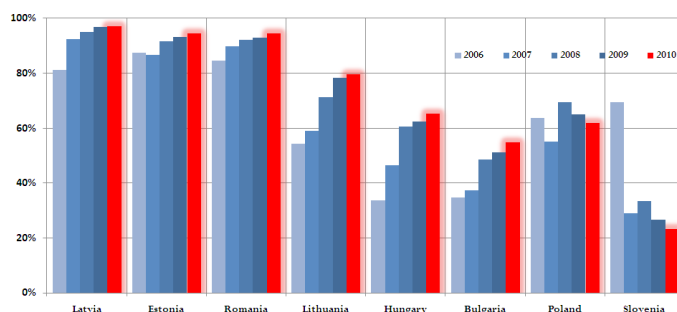


Source: Lending to Households in Europe (1995-2010), ECRI Statistical Package 2011, ECRI, Brussels.

Continuing increase in foreign currency denominated loans

The share of foreign currency-denominated housing loans continued to increase in 2010 in certain Baltic and East European countries, with the share reaching almost 100% for Latvia, Estonia and Romania. While Estonia officially adopted the euro at the beginning of 2011, this move is not expected in Latvia, Romania, Lithuania, Hungary, Bulgaria and Poland anytime soon. The resulting exposure to currency risk still causes concern.

Share of foreign currency-denominated housing loans in Baltic and East European countries



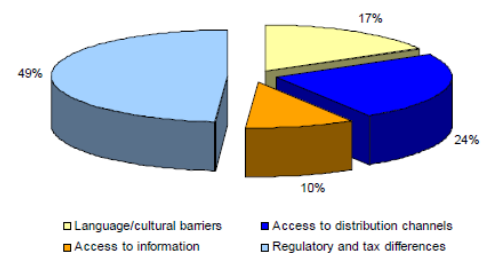
Source: Lending to Households in Europe (1995-2010), ECRI Statistical Package 2011, ECRI, Brussels.

The ECRI Statistical Package 2011 can be ordered from CEPS bookshop (<http://www.ceps.eu/books>). For more information contact Angelo.Fiorante@ceps.eu or visit www.ecri.eu/new/node/165.

Assessing competition barriers in the EU mortgage sector

A recent study requested by the European Parliament's Committee on Economic and Monetary Affairs has identified the main barriers to competition in the provision of mortgage credit in the European mortgage sector. The study points out that competition by EU mortgage providers (credit institutions and other mortgage lenders) has been reduced in recent years, following the financial crisis. Obstacles to cross-border competition are said to arise mainly from supply side factors such as: i) regulatory and tax differences, ii) difficulties of accessing distribution channels, iii) language and cultural barriers as well as iv) the lack of information sharing.

Main barriers to cross-border expansion in mortgage markets



Source: MOW (2007), lender survey.

Cross-border lending activity is still considered as a rather limited phenomenon, apart from in some new EU member states, which have a significant number of foreign banks operating in the domestic markets. Policy-making aiming to harmonise the EU mortgage market and promote competition is said to do most good if differences between member states' regulatory framework such as bankruptcy procedures in case of borrower default and legislation issues for mortgage foreclosures are closely assessed and harmonised. Facilitating better access to information on borrowers' credit history is also pivotal to promoting more competition among existing mortgage lenders and encouraging new entrants. However, it is acknowledged that "the corporate structure of credit bureaus can create incentives towards partial information sharing and, as a consequence, distort competition".

Demand-side barriers such as switching costs, e.g. restrictions, penalties and/or transaction costs applied on early redemption, and searching costs, e.g. contract complexity which limits the ability of consumers to understand and compare offers across lenders, are relevant obstacles that reduce consumer mobility. The study argues for a cooling-off period that could abate any type of searching costs, giving consumers that extra time to reflect, seek further advice or correct decisions taken hastily or on an emotional basis.

Conclusions drawn from the study indicate that the EU mortgage market structure is fairly concentrated where the five largest mortgage providers have an aggregate market share of 75% on average. In addition, the spread between mortgage loans and deposit rates have seen an increase in recent years; one that might be due to greater credit risk, but also due to less competition in the market. Rethinking ways to boost competition, increase market efficiency and provide consumers with adequate products is not only necessary, but crucial to achieving a solid single market for mortgage credit, which currently represents roughly 50% of EU27 GDP.

More information: <http://www.europarl.europa.eu/document/activities/cont/201107/20110714ATT24080/20110714ATT24080EN.pdf>

Will saving solve our debt problems?

The slowdown of the economy is affecting many people's personal finances, and compared to what we saw during the boom years in which a lot of 'bad debt' was accumulated, the mindset towards easy spending is changing, as consumers seem to be making more calculated decisions based on the budget constraints facing them. If debt was a root cause of financial instability, then saving seems to be the cure to our debt problems – at least this is what governments are trying to achieve. But what are European households going to do about their situation, given that the gloomy growth outlook in many EU countries is not going to help them to pay back their debt? Should we start rethinking our relationship to credit? In any case, credit might become more expensive as banks are about to face tougher capital requirements.

The VISA EU Consumer Barometer shows that consumer spending has been growing rather steadily, and continues to show cautious growth in 2011 as it strives to recover from the severe meltdown of 2008/2009. Philip Symes, Chief Financial Officer at Visa Europe said: "In the quarter to June, we have seen steady growth across most markets. Given the events of recent weeks which have seen global stock markets tumble and Europe politicians in crisis talks regarding sovereign debt, the findings of Q2 seem at odds with the news agenda. It is difficult to estimate to what extent recent events will dent consumer confidence in future".

Although consumption is essential to a country's growth prospects, the importance of saving should not be neglected as it is vital to sustaining a well-functioning economic system. The current global imbalances are crystallising into a real challenge for policy-makers in developed countries, many of whom are facing an ageing population that might have to rely more on personal savings to achieve an adequate standard of living after retirement.

Experts are therefore concerned about people's saving habits, and have questioned the underlying reasons for the disparity in saving between the developed and the emerging world. The textbook says that the former should spend less and save more and the latter should spend more and save less, but in reality this is not the case. Instead, the *savings glut*, a term coined by Ben Bernanke, current Chairman of the Federal Reserve, indicates that foreign reserve build-ups in emerging countries through US debt purchases contributed low long-term interest rates in the US, which facilitated cheap credit and in turn fuelled the US housing boom. Easily accessible credit lines, cheap, unsecured credit, revolving credit, and tapping home equity (a widespread US phenomenon) became the norm, and today we see that over-borrowing has put quite a burden on less financially capable consumers who struggle to make ends meet.

A survey by the Financial Services Authority (FSA) in the UK reveals interesting patterns in consumer behaviour and decision-making processes during the purchase of retail investment products. A prominent (if unsurprising) finding shows that the consumer group engaging more freely in investment product purchases has a more sophisticated risk profile, higher financial capability and prior experience.

However, the survey identifies investment barriers for a certain consumer group that had not sought financial advice for the past five years and that possessed £3,000 or more in liquid assets at the time of the interview. Despite having available funds, the main barrier to actively investing the sitting capital was due to a lack of interest or knowledge. Short-termism and affordability were other obstacles that explained the reluctance to set aside funds for a longer period of time.

Even hypothetically removing the affordability obstacle – by presenting a scenario in which the person in question would have £3,000 with which to make a long-term investment – did not change the outcome. Seven out of ten would not engage in purchases of retail investment products, regardless of the hypothetical circumstances. The FSA concludes from these responses that for a certain group of consumers the approach towards retail investment product purchases is a function of attitude rather than circumstances.

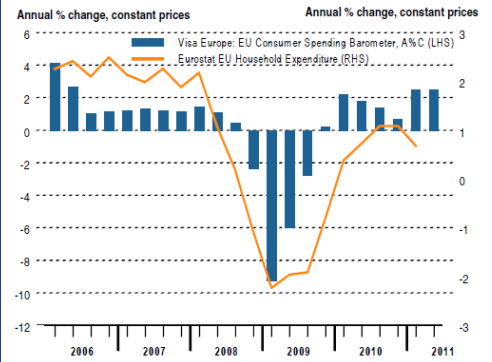
In light of this argument, a recent report by the global insurance company AVIVA entitled "Big picture thinking – towards sustainable savings" explores important aspects of saving as a key component of individual financial prosperity. The mission given to a panel of nine thinkers with different backgrounds is: how should the industry re-brand saving and all that comes with it in order to make it more appealing to consumers that today save very little or nothing? The report underlines that "the financial services industry has a key role to play in fostering that savings growth" and this could be achieved by "offering simpler products, making it easier to track and measure an individual's savings and using clearer language", but also by developing new technologies that make it easier and quicker to save small amounts more frequently. However, it is acknowledged that "a lack of access to appropriate financial services and inadequate or no financial education complicates the situation".

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Recommended reading:

- http://www.visaeurope.com/en/newsroom/all_reports/latest.aspx
- <http://www.fsa.gov.uk/pubs/consumer-research/crpr84.pdf>
- <http://www.businessresearch.eu.com/sites/businessresearch.eu.com/files/downloads/Big%20picture%20thinking%20-%20towards%20sustainable%20savings.pdf>

Visa Europe: EU Consumer Spending Barometer & Household Expenditure



Source: VISA Europe, Eurostat.

Draft high-level principles on financial consumer protection



An OECD-led Task Force has coordinated and developed common principles for enhancing consumer protection in the field of financial services. In light of what the financial crisis left in its wake, the draft principles are convoked to G20 members at a time when consumer protection and financial service market confidence are being put to the test. The lessons drawn from the crisis have pointed to the necessity of revising the traditional regulatory and supervisory framework that is in place.

The voluntary principles are designed to complement existing international financial principles by addressing the shortcomings that have emerged in recent years. The draft framework acknowledges that "rapid financial market development and innovations, the entry of non-traditional financial service providers and third party intermediaries (in some cases unregulated or inadequately regulated), and misaligned incentives for financial service providers can increase the risk that consumers face fraud, abuse and misconduct".

The approach boils down to ten key points; (i) legal recognition of financial consumer protection, (ii) oversight bodies with necessary authority and resources to carry out their mission, (iii) fair treatment, (iv) proper disclosure, (v) improved financial education, (vi) responsible business conduct by financial service providers and their authorised agents, (vii) objective and adequate advice, (viii) protection of rights and data, (ix) adequate complaints handling, and (x) the promotion of competition for providing consumers with greater choice amongst financial services.

More information:

- http://www.oecd.org/document/61/0,3746,en_2649_15251491_48469949_1_1_1_1,00.html

1. Review of the Payment Services Directive: The question of surcharges

ECRI Policy Briefs, No. 5, September 2011

Elina Pyykkö, ECRI/CEPS Researcher

The Payment Services Directive was intended to provide more price transparency for users and a level playing field for efficient competition among different payment services by decreasing the inhibiting effects of different legislation, cross-subsidisation and non-cost-based pricing. The European Commission, however, intended most of these effects to come about through market-led initiatives. In the run-up to the review of the Directive, Elina Pyykkö asks in this ECRI Policy Brief whether more could be done to promote the use of efficient payment methods.

Download: www.ceps.eu/book/

NEW!

3. European Household Credit Market Trends: The grounds for regulatory changes

ECRI Commentary, No. 7, July 2011

Elina Pyykkö, ECRI/CEPS Researcher

This ECRI Commentary provides a snapshot of the current state of European household credit markets. In order to provide an EU-level analysis without aggregating all countries into single measures, member states are divided into three classes depending on their status as a member of the European Union and consequently their general financial market landscape. The Commentary assesses how different types of member states have recovered from the financial crisis by looking at credit markets and other financial indicators. The evidence is then used to discuss what kind of basis the different stages of recovery provide for new EU-wide legislative proposals, in particular the Directive on mortgage credit.

Download: <http://www.ceps.eu/book/trends-european-household-credit-solid-or-shaky-ground-regulatory-changes>

2. Household Lending in Europe & Consumer Credit in Europe - 2011

ECRI Statistical Packages, August 2011

Angelo Fiorante, ECRI/CEPS Researcher

A collection of data on lending to households, including consumer credit, housing and other loans in Europe, covering 38 countries: the 27 EU member states, three EU candidate countries, the EFTA countries and four additional key global economies (the United States, Australia, Canada and Japan). Its purpose is to provide reliable statistical information allowing users to make meaningful comparisons between these countries. Two versions of this valuable research tool in Excel-format is available for purchase: the comprehensive ECRI Statistical Package – “Household Lending in Europe” – (Price: € 600), covers the entire retail loan market, with time series on consumer credit, housing loans and other loans to households, as well as loans to non-financial corporations and total credit to the non-financial business and household sectors. National accounts data, such as gross disposable income and final consumption expenditure, are also available in this version. The smaller ECRI Statistical Package – “Consumer Credit in Europe” – (Price: € 440), presents data on consumer credit and national accounts.

More information: <http://ecri.eu/new/node/165>

NEW!

4. What level of harmonisation in regulating EU mortgage credit markets?

ECRI Commentary, No. 6, June 2011

Karel Lannoo, CEO of CEPS & Director of ECRI

In this new ECRI Commentary, Karel Lannoo offers his assessment of the Commission’s proposed Directive regulating retail mortgage credit, adopted on March 31st. While welcoming the initiative as a first step towards creating a European mortgage market, he expresses concern over the degree of harmonisation and the fact that many provisions are left to national implementing legislation or are not, especially in the case of sensitive items, covered at all.

Download: www.ceps.eu/book/what-level-harmonisation-eu-mortgage-credit-markets

ECRI UPCOMING EVENTS

■ 18 October 13.15 – 14.30

The Shadow Economy in Europe - In cooperation with CEPS and VISA Europe

This event will discuss the challenges of combating the European shadow economy, and how electronic payments could be used in this endeavour.

Chair: **Karel Lannoo**, CEO of CEPS and Director of ECRI

Speakers: **Friedrich Schneider**, University of Linz; **Wolf Klinz**, MEP; **Davide Steffanini**, VISA Europe;

Andreas Pratz, AT Kearney

■ 22 November 9.15 – 11.30

Payment service providers face technological challenges and opportunities

Technological development is shaping the retail banking industry with more security and efficiency requirements and non-bank service providers entering the market. How can technologies be used to help banks respond to these challenges?

Speakers to be confirmed.

Please check our websites (www.ecri.eu & www.ceps.eu) regularly for updates.

■ 8 December 9.30 – 17.30

Diversity in banking in the wake of the Capital Requirements Directive IV

Banks are likely to reconsider their business models as a response to new legislative measures. ECRI and CEPS is planning to organise an event for discussing the implications of the new capital and liquidity requirements on banks’ business models, with a special focus on bank diversity.

Chairs: Prof. **David Llewellyn**, Loughborough University & **Rym Ayadi**, CEPS Senior Research Fellow

Speakers: **Philippe Lamberts**, MEP; Prof. **Reinhard Schmidt**, University of Frankfurt; Prof. **Giovanni Ferri**, University of Bari

Other speakers to be confirmed.

Attendance at ECRI events is a benefit of membership. Non-members may be admitted for €50 per session, paid in cash at registration. If not otherwise stated, meetings are held at CEPS. Please check our websites (www.ecri.eu & www.ceps.eu) regularly for updates. For organisational reasons, we cannot accept telephone registrations. **Registration:** Please register via www.ceps.eu, or contact Isabelle Tenaerts by e-mail: isabelle.tenaerts@ceps.eu or fax: +32 (0)2 219.39.11