Marco Valli
Head of Macro Research, Chief Eurozone Economist
UniCredit Bank AG

The Importance of a Level Playing Field

The crisis has shown how important bank resilience is in preserving credit flows, broader financial stability and, ultimately, aggregate welfare during downturns. The euro area banking sector and its regulators have devoted considerable effort to increasing the system's resilience to shocks. The CET1 ratio of significant institutions doubled from 7% in 2008 to more than 14% by the end of last year, and the NPL ratio has declined significantly. Stress test practices have allowed for a forward-looking assessment of banks' potential capital needs during a severe recession, while the introduction of liquidity ratios has increased the resilience of banks to sudden shocks to liquidity and funding.

Overall, the measures implemented so far to strengthen banks' balance sheets and liquidity positions should provide a good buffer in the event of a shock hitting the economy and financial markets. However, new regulation raises issues when it comes to creating or preserving a level playing field.

When regulation does not favor a level playing field: the case of cross-border banking and calendar provisioning

Banks in Europe play a fundamental role in financing growth. UniCredit – as the second largest corporate lender in Europe – is a key contributor, serving 600,000 SMEs and corporate clients. However, for banks to continue to play their core role of financing the real economy, they need a supportive and clear regulatory environment that gives them sufficient predictability to plan ahead. So far, this has often not been the case.

There are important areas where regulation can be improved with the ultimate goal of creating a level playing field. Two of these areas are firstly the treatment of cross-border banking and secondly calendar provisioning.

1. Cross-border banking groups in the EU should be preserved and supported, mainly for two reasons. First, banks with geographical diversification are generally safer than local banks, as their assets tend to be more diversified. Hence, cross-country diversification, at least in the EU, should be encouraged. Second, the euro area lacks shock absorbers and the majority of adverse shocks go unsmoothed due to poor risk-sharing mechanisms. In the U.S.A., where shock absorption is much greater than in the euro area, most of the absorption stems from more effective private risk sharing through credit and capital markets, whereas fiscal transfers between states play a smaller role. If the U.S. example were to be followed, improving the scope to counter asymmetric shocks in the euro area would not require a transfer union, but rather well-functioning credit and capital markets in which cross-border banks are important players.

In theory, the introduction of the banking union and the Single Supervisory Mechanism, alongside the fundamental improvements in financial stability through CRR/CRD IV and the European recovery and resolution framework, should contribute to breaking down the barriers to intragroup cross-border capital and liquidity flows. In reality, though, significant obstacles remain.

The impression is that European regulators are discouraging cross-border banking by allowing for national ring-fencing of liquidity and loss absorbing capacity while penalizing the prudential treatment of intra-group cross-border exposure. Cross-border banks should be allowed to move capital and liquidity

Marco Valli

freely within their group. Such free flow is crucial because it allows financial institutions to extend credit where it is most needed, thereby ensuring continued funding of the real economy throughout cyclical downturns and thus contributing to the smooth functioning of the transmission mechanism of the ECB's monetary policy. This is currently not happening to a sufficient extent, partly because of the large scope for discretionary measures at the national level, for example when it comes to intragroup exemptions in the risk and leverage frameworks.

The ultimate aim should be to have the banking union considered a single jurisdiction from a prudential perspective. Although it is clear that this would take time, it is important to acknowledge that actions such as the ringfencing of liquidity and capital, which might be regarded as optimal from a national perspective, are self-defeating at the aggregate level.

2. UniCredit has been taking proactive action in tackling the non-performing loans (NPL) issue and fully supports the establishment of a comprehensive EU strategy to address the problem of troubled loans. However, calendar provisioning of NPLs might be overly punitive where the local legal-judicial environment is comparatively less favorable. This could lead to a restriction of bank lending in those countries where structural issues already undermine the competitiveness of the system. In turn, this would imply higher fragmentation.

In general, calendar provisioning might not create the right incentives for a proactive approach to managing NPLs. Since the credit recovery time is determined predominantly by the effectiveness of the legal-judicial environment, these measures might provide an incentive for banks to liquidate loans rather than offering restructuring alternatives to debtors that are in temporary difficulty in order to release the collateral and minimize short-term costs.

Instead, policymakers should focus on harmonizing the insolvency and pre-insolvency framework at the European level. Shortening the length of judicial procedures would provide secured creditors with more certainty on the recovery of collateral. By facilitating early restructuring or giving a second chance to entrepreneurs, employment and growth would be improved.

Capital market union should prioritize equity financing for small and medium-sized enterprises (SMEs)

European SMEs receive about 75% of their funding from banks and the rest from the capital markets, whereas the situation is roughly the opposite in the United States. Therefore, I fully support the capital market union (CMU) initiative as a way to reduce the over-reliance of companies, and especially SMEs, on banks for their financing needs. In Europe, SMEs are undercapitalized and the lack of equity capital relative to other jurisdictions has a number of important drawbacks in terms of innovation, investment and potential growth. Better-capitalized firms would, in turn, ensure that banks could lend more confidently.

This is where the CMU should come more forcefully into play. However, there does not seem to be sufficient emphasis on the need for institutional investors to play a greater role in providing equity financing to SMEs. Currently, insurance companies and pension funds are severely constrained by both EU and national rules that limit their ability to invest in SMEs. For example, direct equity investment represents only around 6% of the total investment portfolio of insurance companies and this share has decreased over the past ten years.

One of the key underlying factors of this significant reduction in equity holdings has been the conservative capital requirements of Solvency II, including the punitive treatment of private equity investments, which does not properly reflect the non-volatile nature of unlisted SME investment. If regulators want to channel Europe's large savings pot more effectively into the real economy, this needs to be tackled urgently.