KFW ECONOMIC RESEARCH

KFW

Economics in Brief

No. 59, 22nd October 2014

The new ECB test and banks' equity

Authors:
Dr Tobias Rehbock, phone +49 (0) 69 7431-2686
Dr Barbara Richter, phone +49 (0) 69 7431-8221, research@kfw.de

At the end of October, the ECB will publish the results of its Asset Quality Review and its stress tests for Eurozone banks. These two exercises fulfil several purposes: the ECB gains deeper insight into the state of the institutions it is to supervise starting from November; existing problems in the banks are revealed and ideally dealt with in a timely manner; the banks get to know the ECB's informational requirements; the ECB obtains an overview of national differences in banking supervision and can work towards a harmonisation (e. g. at the start of the review the definition of "non-performing loans" was harmonised across the EU).

However, the question which banks will need more equity, if any, will take centre stage at the results presentation. At the start of the ECB review, some voiced the hope that the conclusion of the exercise would trigger a growth spurt. Other observers feared negative consequences, as they expected considerable equity enhancement to be necessary. This would also impact growth negatively. But what is the connection between banks' equity and growth?

Several channels of impact

The huge importance of banks' equity levels is a result of the insights from the financial crisis and reflects the central role of banks as intermediaries in the financial system. From this role follow two channels for the effects on growth.

The indirect channel works via the reduction of uncertainty: banks holding more equity are better able to absorb losses, are thus more stable and the danger of crisis and subsequent government intervention falls. This increases trust in the stability of the financial system and the economy as a whole and provides the private sector with the confidence necessary for investment.

The direct channel works via lending: each loan a bank gives out must be covered by a certain fraction of equity – depending on the default risk of the loan. More equity thus enables more loans that are needed to finance investment. This investment in turn increases the growth of the economy.

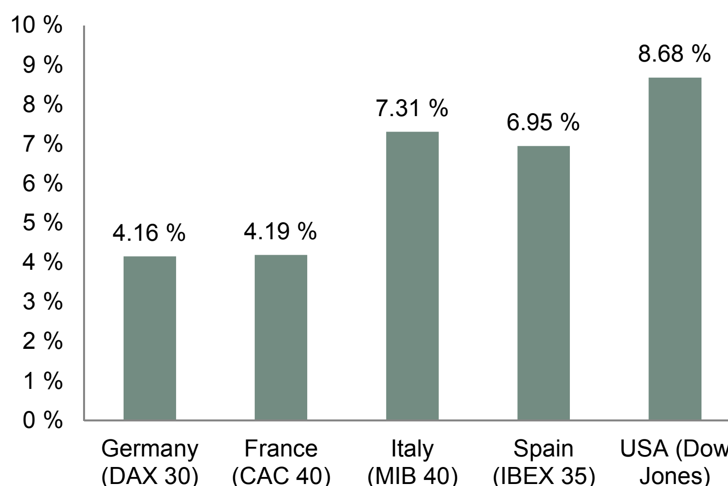
These channels also work in reverse: a lack of equity has negative consequences for growth.

How much equity is necessary?

However, the conclusion "the higher the equity requirement the better" is wrong. The increased competition over fresh equity would drive up its price and thus make lending more expensive and limit the ability of banks to build further equity by retaining earnings. The regulatory challenge consists of mandating enough equity for the positive effects to work without posing unsolvable problems for the banks.

Opinions are divided on the question of how much equity is suitable for banks. Banking regulation requires a risk-weighted equity ratio of 8 % of total assets; additionally, the EU is to introduce an unweighted equity ratio (the so-called leverage ratio) of 3 % of total assets. In the US, this leverage ratio will have to be at least 5 %. However, there are also voices (e. g. Martin Hellwig) that demand a leverage ratio of 30–40 %. Still others, among them the newly-minted winner of the Nobel prize Jean Tirole, hold that the equity ratio should not be constant, but follow the business cycle: an extra buffer in a boom can take losses in a downturn, and lending would not suffer too much. ■

Figure: Average leverage ratio of banks listed in the stock index mentioned



Source: Comdirect, own calculations

Note: This paper contains the opinion of the authors and does not necessarily represent the position of the KfW: