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1. Introduction

I would like to begin my speech with a small piece of useful historical evidence *(Chart 1).*

Return on Equity and Leverage ratio of EU banks

<table>
<thead>
<tr>
<th>RoE (%)</th>
<th>Leverage ratio (Multiple)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>2007</td>
</tr>
<tr>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>+58%</td>
<td>+50%</td>
</tr>
<tr>
<td>1998</td>
<td>2007</td>
</tr>
<tr>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>+58%</td>
<td>+50%</td>
</tr>
</tbody>
</table>

Source: Barclays Capital.

In 2007, Unicredit reported a 20% RoE and the bank was criticized for being the least profitable amongst European financial institutions. Today, most banks barely cover their cost of capital.

In 2007, average RoA was equal to 1998 but the 50% increase in leverage occurred in the period had boosted the RoE by the same percentage. Today, average RoE is barely half the 2007 level.

By now we all agree on the main factors behind the financial crisis: banks had become too big relative to the size of the real economy and this growth was entirely driven by financial assets; risk profile had become excessive through a combination of insufficient loss-absorbing buffers and liquidity safeguards; high leverage was coupled with structural funding gaps and maturity mismatches; high complexity with interconnectedness.

How could this happen?
2. The Risk Weight arbitrage

It is my firm belief that a crucial role was played by the manipulation of Basel II Risk Weights.

A few months ago, the Swiss National Bank admitted that, despite the implementation of the so-called “Swiss Finish” had placed their two G-SIFIs at the top of Capital Ratio rankings, the two banks continued to operate with the highest leverage ratios of the whole sector.

It is indeed a fact that the introduction of the Basel II IRB approach has led to a widespread arbitrage in Risk-sensitive capital requirements.

The density of Risk Weights is systemically lower once Internal Rating Based models receive regulatory approval. And the decline in Risk Weights is prevalent amongst weakly capitalized banks, when legal framework for supervision is weak and in countries where regulators are overseeing many IRB banks.

The recent contraction in RWAs reflects an extensive exercise of balance-sheet optimization rather than an increase in loss-absorption buffers: this window-dressing raises further questions about the use of internal risk assessments for the determination of capital requirements (Chart 2).

Average Capital ratio of Euro area banks  

<table>
<thead>
<tr>
<th>Year</th>
<th>Total assets annual growth (%)</th>
<th>Capital ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>16</td>
<td>8.5</td>
</tr>
<tr>
<td>2005</td>
<td>8</td>
<td>7.5</td>
</tr>
<tr>
<td>2006</td>
<td>8</td>
<td>6.5</td>
</tr>
<tr>
<td>2007</td>
<td>16</td>
<td>5.5</td>
</tr>
<tr>
<td>2008</td>
<td>8</td>
<td>4.5</td>
</tr>
<tr>
<td>2009</td>
<td>8</td>
<td>3.5</td>
</tr>
<tr>
<td>2010</td>
<td>5</td>
<td>2.5</td>
</tr>
<tr>
<td>2011</td>
<td>5</td>
<td>1.5</td>
</tr>
<tr>
<td>2012</td>
<td>5</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: BIS.
Note: Capital and Reserves as % of total assets.
3. The Risk Measurement dilemma

For policy-makers, this presents a risk measurement dilemma; from a financial stability perspective, imposing a single standardized view on risk can be counterproductive: the ability of market participants to form independent risk judgments and to base business decisions on those judgments is a key source of market liquidity and systemic resilience.

However, while preserving the legitimate diversity of individual firm perspectives, the quality of banks risk management requires further enhancement: the scope for regulatory arbitrage needs to be narrowed and market discipline must be empowered by enabling external stakeholders to compare banks performance.

The prudential framework should be strengthened by combining Risk sensitive solvency metrics with Risk neutral ones: higher Core Tier 1 ratios must be coupled with tighter un-weighted leverage ratios, as increasingly acknowledged by policy makers and market participants (Chart 3).

![Risk-Weighted capital and Leverage (BIS sample banks)](chart3)

Source: BIS.
Note: Probability of distress for a given level of Risk Weighted capital at five different leverage ratios. Sample of 66 internationally active banks over the period 2000 - 2012.
4. Profitability breakdown

If the denominator of the RoE, the conventional profitability gauge, is so arbitrary, one option could be to measure Equity (and hence all equity ratios) at market rather than accounting values.

Alternatively, it might be useful to shift the attention to what is arguably a more reliable parameter of banks profitability: the RoA. An indicator, by the way, which should also be used more extensively in management remuneration schemes.

The unquestionable evidence shows that average RoA remained constant until the crisis but later shrank by roughly one third. This is a puzzling phenomenon to explain as lower leverage should have dictated a more discerning deployment of balance sheets (Chart 4).

Return on Assets of major EU banks

Source: Barclays Capital.
The overall result derives from different performance patterns at the main divisional levels.

On average, profitability for investment banking has improved from pre-crisis level thanks to a significant cost-cutting exercise (c. 10%). This confirms that the Investment Banking business has swiftly adapted to the new environment although, interestingly, this improved performance still leaves RoE levels some 50% lower to those enjoyed in the past, as the business had to undergo a dramatic increase in required capital (Chart 5).

Conversely, profitability is lower both for Emerging Markets Banking, due to a cut-throat competition hardly justified from a Risk-adjusted perspective, and for Private Banking, due to poor investment performance and compliance headwinds in Wealth Management business models.

This leaves Retail and Commercial Banking, where pre-provision earnings have held up pretty well. But, with impairment losses roughly doubling, it should not come as a surprise that net profitability is down by at least 25% vs pre-crisis.
5. The NPL “Atlantic divide”

In truth, it is the whole approach to NPL impairments which reveals a very instructive story.

In the US, a top-down Government-led program forced banks to crystallize the bad loans and execute mandatory capital increases in the early days of the crisis, whilst providing relief through TARP.

Today, US banks are back in the game, thanks also to the massive funding subsidy on the part of the FED, by far the single most significant factor behind US banks regained profitability.

In Europe, NPLs have been growing at a spectacular rate over the last five years, in particular in the Periphery, reaching the official (yet vastly underestimated) figure of 720bn EUR at the end of 2012.

In parallel though, NPL provisioning remained very complacent, as the resulting capital shortfall would have forced legacy shareholders (and their political sponsors) to face the final show-down. The Italian banking system represents an astonishing example in this respect (Chart 6).

![Net-Doubtful-Loans to CT1 Capital ratio of major Italian banks](chart6)

(Chart 6)

Source: Quarterly reports.
Note: Q2 2013 data for Unicredit, Intesa. Q1 2013 data for others. Defined as total net problematic loans / stated Core Tier 1 Capital before any announced capital raising. For MPS includes Monti bonds.
6. The ECB Action Plan

No wonder that the monetary transmission mechanism is severely impaired throughout Europe apart from Germany.

The proposed inclusion of securitized SME loans among the ECB acceptable collaterals falls way short of what is needed: only a direct asset purchase or the creation of an inter-governmental “SME Bank” could address the resilient credit crunch.

As regards to European banks, the forthcoming Asset Quality Review offers a unique opportunity to inject market transparency, providing the necessary informational evidence to “de-zombify” the banking system by using the institutional toolkit defined last June in Brussels.

True, the new creditors’ regime will not carry legal force until 2018 but bail-in is now the rule and this principle will be hard to breach.

In parallel, it is imperative that the ECB shifts up gears in providing direct market support, or otherwise the forthcoming Loan-to-Deposit reduction will hinder the economic cycle (and banks profitability) even further (Chart 7).

<table>
<thead>
<tr>
<th>Loan-To-Deposit ratio</th>
<th>Chart 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>(%)</td>
<td></td>
</tr>
</tbody>
</table>

Source: SNL Financial, Eurostat.
7. The Fight against systemic Risk

Where does this whole process leave us in terms of fighting systemic risk and moral hazard?

In my view, pretty close to the target, but for an important structural element: the persistence of implicit subsidies between deposit-taking and trading.

I am not advocating a strict return to Glass-Steagall, but it is a fact that if only Bear Stearns, Merrill Lynch and Lehman Brothers were brought to their knees, it is also because the universal banking supermarkets could not possibly be allowed to fail.

Combining tougher leverage ratios with mandatory capital and funding separation between Deposit-taking banks and Broker-Dealers, within the same banking group if so wished, would address the too-big-to-fail syndrome at its source, making the financial system intrinsically more robust and safer. This is amongst the core recommendations of the Liikanen Group proposal (Chart 8).
8. The Way ahead

This leads me to conclude with some more general observations.

Banks perform vital functions for the wider economy and in this sense they are granted a “social license” to operate which they have the fiduciary duty to comply with. Reducing leverage, constraining the reliance on wholesale funding, improving risk controls and resolution mechanisms, and transforming the management culture are all widely shared prerequisites for better banks. And, allow me to say, largely achieved: managing a bank today, is hardly a one-way bet.

However, we need to stay clear of the “nostalgic view” of banking, the dream of a return to the good old days when finance was boring and markets never made headlines. In those days banks were possibly safer but also far more “exclusive”: less than half of the adult population had a bank account, credit rationing was the norm, based on personal judgment rather than objective criteria, and clients deposited more than they borrowed.

I do not think that today’s society would stand for a similar regime. Clients want to operate always and in real time; they want products and services addressing their business and personal needs in an accessible way and all over the world. They do not necessarily need global banks, but they expect to bank globally.

And yes, they need also Investment Banks: to invest in Markets, to cover their financing needs, to hedge their risks, to manage their global payments. Let us not fool ourselves: Investment Banking is overwhelmingly a client-driven business as regularly proved by quarterly results.

The modern world needs banks that are robust and stable, but also dynamic, innovative and proactive. Clients want banks keeping up with changes in our society, not looking backwards to the much idealized “happy days”.