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Financial & Fiscal Features Newsletter

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

Fiscal Competition & Economic Freedom

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In this issue:

Merry Christmas and a 2016 filled with fine financial and fiscal features.

IREF's FFF Newsletter brings you monthly our analysts' exclusive inside scoop on latest trends in European central banking and financial markets, and their likely future impact.

Problems executing QE cause market confidence in the ECB to dip.

by Gordon Kerr and John Butler, with Enrico Colombatto

What policy changes should we expect from the ECB in 2016?

In the past month, the mainstream media have led with the story of divergence between the policies of the US Federal Reserve (expected to raise interest rates), and those of the ECB (expected to lower rates and press on with QE).

It is clearly possible that the two different sets of policies are each correct for the respective, if divergent, economies. ECB President Draghi sounded confident, in a recent Frankfurt conference, that the ECB is on the right track.

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How healthy are Europe's banks?

by Gordon Kerr and John Butler, with Enrico Colombatto

Reports from the European Banking Authority and Bank of England claim that banks are healthy, but weak measures of capital are used.

In November the European Banking Authority (EBA) published some analysis of 105 banks, from 21 countries (including Norway), owners of 70% of European banking assets. A few days after the EBA reported, the Bank of England (B of E) published the results of its 2015 stress tests and claimed that all 7 British banks tested are healthy and well capitalised.

The EBA report was not a stress test exercise, merely a 'Transparency Exercise'. This means that no hypothetical recession scenario was modelled. Worryingly, however, some of the banks' key numbers were withdrawn the day after publication of the report. We suggest this shows that the EBA is confused about its own definition of Core Equity Tier 1 (CET1), which is the key to defining the strength of a bank. CET1 should be (approximately) the sum of common tangible equity, retained earnings and other disclosed reserves. Yet, the Basel rules allow banks to include also intangible assets and deferred tax assets – "DTAs". DTAs represent a claim banks have against future tax liabilities should they return to profit. Thus it is nonsensical to count such claims as loss absorbing capital. Intangible assets are equally unreliable, As we reported in November, about two thirds of Deutsche Bank's surprise

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CENTRAL BANKS

(cont'd) Problems executing QE..

"The ECB's monetary policy measures have clearly worked, in fact they are probably the dominant force spurring the recovery. They have been instrumental in arresting and reversing the deflationary pressures that hit the euro a year ago."

But are these policies being as successful as this assertion suggests? Let us compare our interpretations of some 2015 events with those of President Draghi. We set out some examples.

❶ In July/August we sympathised with the Bank for International Settlements' (BIS) warnings about central banks' use of "persistent exceptionally low rates…as they fumble in the dark in search of new certainties". Such low interest rates leave central banks "defenceless" in the face of future recessions and create asset price bubbles. These bubbles, we argued, generate more domestic borrowing and consumption as market participants trust central banks and fail to realise that such "recoveries" are unstable.

In contrast to the BIS, President Draghi interpreted

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(cont'd) Health of Europe's banks...

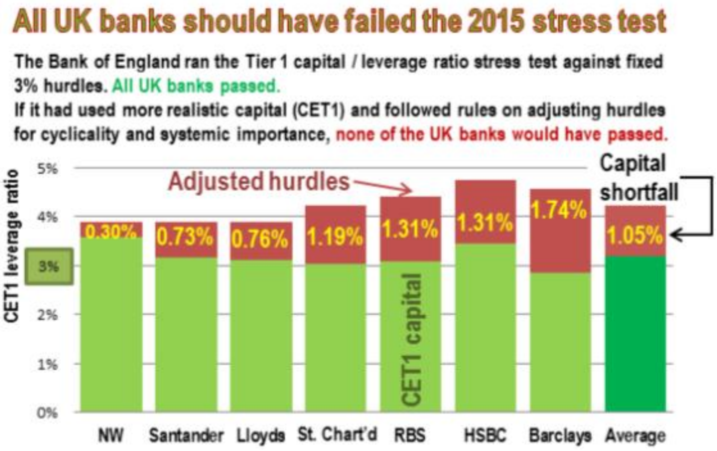
FINANCIAL MARKETS

€6bn loss was attributed to writedowns of intangible assets, a loss which emerged only because the businesses concerned are to be put up for sale.

As stated above, the withdrawal of the numbers leaves us doubting the EBA's knowledge of which measures of capital are used in its own report.

The B of E ignored the rule requiring the basic Leverage Ratio 3% hurdle to be increased over the 5 years for counter-cyclicality and systemic importance. Had the test rules been properly applied, and a more realistic measure of capital used, all 7 British banks would have failed the Leverage stress test

The B of E's report was a new set of stress tests, one year after the results we analysed in July/August. All 7 tested banks were declared to be healthy even in a future recession scenario. There was no significant change in the methodology used by the B of E, but they attempted to bolster confidence this time by undertaking Leverage Ratio tests, which were omitted in 2014.



Weakness of the Bank of England test

The B of E, in contrast to the EBA, provided plenty of detail about the measure of capital used. Its test results are weak on two grounds:

1. it used measures of capital for each bank which included excessively loose items that cannot be expected to absorb losses if the bank is under pressure. One example is deferred tax assets as explained above.
2. The B of E ignored the rule requiring the basic Leverage Ratio 3% hurdle to be increased over the 5 years for counter-cyclicality and systemic importance. Had the correct hurdle ratio been properly applied, and a more realistic measure of capital used, all 7 British banks would have failed the Leverage stress test as shown in the table. —>

Based on the EBA and B of E reports, we conclude that supervisory assurances based on the ratios of CET1 to risk weighted assets are of little value. Assessing a bank's health based on a Leverage Ratio is more useful. Yet, large portfolios of derivatives remain excluded from the exposure measure because of the rules allowing banks to delete these exposures if offsetting derivatives are purchased despite the obvious failures of such insurances in shock situations such as September 2008.

The stand-out number in the EBA report is the level of non-performing exposures ("NPEs"); 5% of the €30 trillion total of on and off balance sheet exposures, or €1.5 trillion. This is about the same level as revealed by the October 2014 stress tests. The ratio of equity (CET1 as reported by the EBA) to exposures was 4.9%.

Given the generosity of the ECB's repo, LTRO and other bank support facilities, for NPE's to be exceeding total capital inspires no confidence in the banking turnaround story.

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Ratio of CET1 capital to leverage exposure			
Bank	**Hurdle ratio**	**Test outcome**	**Excess over hurdle**
Barclays	4.575%	2.837%	-1.738%
HSBC	4.750%	3.437%	-1.313%
Lloyds	3.875%	3.117%	-0.758%
NW	3.875%	3.575%	-0.300%
RBS	4.400%	3.089%	-1.311%
Santander	3.875%	3.149%	-0.726%
St. Chart'd	4.225%	3.039%	-1.186%
Average	**4.225%**	**3.177%**	**-1.048%**

FINANCIAL MARKETS

(cont'd) Problems executing QE...

the ECB's substantial reduction in already low rates as an achievement of which he is proud:

"Taking the GDP-weighted average of the euro area 10-year government bond yields, yields fell by around 150 basis points between early June 2014 and early March 2015."

❷ A knock-on, beneficial effect of low central bank interest rates, he claimed, was the reduction in borrowing costs for euro-area non-financial companies by between 70 and 150 basis points per annum. This ignores the offsetting burden on businesses of financing more expensive assets since loose money policies have inflated asset prices.

❸ In September we discussed problems in emerging market economies, evidenced by sharp drops in currency exchange rates. We attributed this to the failure of "stimulus measures" in Europe and other developed countries to boost demand for the commodity based exports that emerging countries sell. For the ECB's President, emerging market problems are "global trade headwinds", and the ECB has implemented good policies, the proof of which is demonstrated by the euro area's modest export growth. .

Outlook for 2006

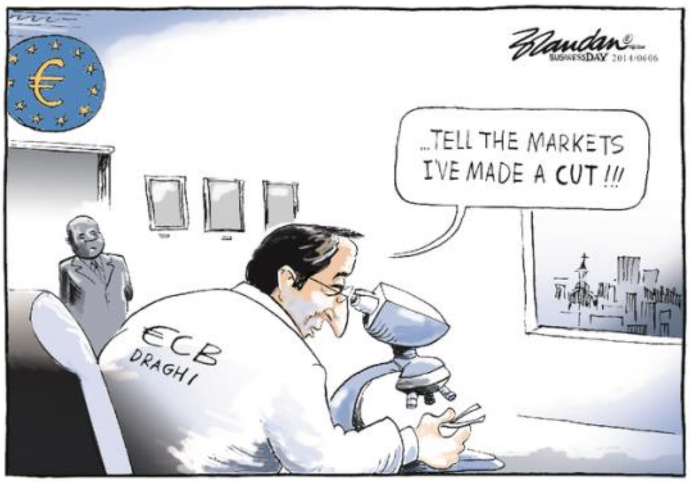
What does this presage for 2016? The ECB continues to sound determined to press ahead.

"If we conclude that the balance of risks to our medium-term price stability objective is skewed to the downside, we will act by using all the instruments available within our mandate."

Two questions arise, however, given that its recent actions were less aggressive than market speculators had hoped. Firstly, does the ECB talk strongly but secretly harbour doubts? Secondly, is it encountering technical problems in executing the policies? Markets reacted with disappointment when the ECB's Governing Council met on December 3rd and announced only moderate policy tweaks. The ECB cut its deposit interest rate for banks by only 0.1% from minus 0.2% to minus 0.3%. The value of the euro jumped by 3 cents against the dollar and European stock prices fell by 3%. Why did the ECB not do more?

It appears that QE has run into execution problems. QE operates under several rules, three of which now appear to be constraining QE firepower:

> *Low interest rates leave central banks "defenceless" in the face of future recessions and create asset price bubbles. These bubbles generate more domestic borrowing and consumption as market participants trust central banks and fail to realise that such "recoveries" are unstable.*



Three European QE rules
that now constrain its firepower

① The volume of each country's government bonds purchased must pro rate to such country's contribution to the ECB's capital. Therefore, for example, 27% of all assets purchased must be German government bonds.

② The yield on the purchased bonds must exceed the ECB's funding cost.

③ No more than 33% of any bond issue can be purchased.

Despite its ability to amend the rules – the 33% bond issue limit was increased from 25% only in September – it looks as if the ECB is running out of bonds to buy. With all of Germany's debt up to 5 year maturities trading at negative yields, markets are starting to doubt whether the ECB's bold commitment to QE can be maintained in 2016.

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Euro's appreciation against USD & GBP post-announcement

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Marx's main gripe with the state was that it will go to bed with capitalists. Just like in Slovakia in 2015. **1109**

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What was considered impossible is now reality. People are paying to part with money. Why? We explain **1074**

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