Banks & Leverage: A Trans-Atlantic Comparison

Elias Chrysostomou, CFA, Director, Research Analyst

Banking systems, credit growth and economic growth are highly intertwined, particularly in Europe. Large parts of the developed world are in the midst of a multi-year deleveraging process, resulting in a dampening effect on economic activity and GDP growth. In this paper we will examine a key part of this negative chain of events; the bank deleveraging process. Our aim is to gauge how much of that deleveraging has taken place, on both sides of the Atlantic, and whether banks are in a position to reignite credit growth in a meaningful way, i.e. in a way that can support a lasting economic recovery.

Our assessment is split into two questions to help frame the debate.

• Are European banks more highly levered than US banks?

We are often told that European banks are far more highly leveraged than their US counterparts, but the reality is far more complex than we have been led to believe.

• Have banks become too big for the economy?

Are the levels of leverage at US and European banks really a sign that they are “too big to fail”.
Question 1: Are European Banks More Highly Levered Than US Banks?

A frequent criticism of European banks is that they appear far more leveraged than their US counterparts, and this is often held up as the reason for the sluggish credit growth in Europe, particularly compared to the United States. However, the real answer is more complex than it appears and for several reasons we cannot rely on the headline leverage metrics as a true like-for-like comparison. There are fundamental differences between the two banking systems either side of the Atlantic; they are structured differently, the legal frameworks are different and even the accounting is not directly comparable. One of the more striking examples of structural difference is the mortgage market; in Europe the vast majority of mortgages are originated and held on bank balance sheets, while in the United States this is not the case, due in large part to the existence of Fannie Mae and Freddie Mac (Exhibit 1).

The approach we are going to take to improve the comparability is to attempt to adjust for the main accounting differences. Work by Thomas Hoenig, the Federal Deposit Insurance Corporation (FDIC) Vice Chairman, highlights that the leverage gap between the United States and Europe is not as wide as it might seem when the same accounting convention is used (Exhibit 2).

Hoenig’s analysis compares only the large Global Systemically-Important Banks (GSIBs) (eight US GSIBs and 15 European GSIBs). However, for a more complete picture, we need to extend the analysis to a larger sample size, ideally one that’s more representative of the banking systems. To achieve this, we have used the top 50 listed banks by assets in both the United States and Europe to proxy the overall banking systems.¹

The last major bank to transition between these two reporting standards was Deutsche Bank in 2006. Exhibit 4 is taken from Deutsche Bank’s 2006 result presentation clearly shows the dramatic difference in reported assets as a result of the accounting for derivatives; in this case the difference is 36%. The term ‘gross-up’ used illustration is merely the opposite of the ‘netting’ process described in Exhibit 3.

¹ Source: Lazard Asset Management
Unfortunately very few banks report under both US GAAP and IFRS, therefore we have to apply our own, slightly crude, adjustment by reducing the European bank assets by the gross derivative liabilities (to approximate the effects of US GAAP netting). This is not perfect, but given we are unable to replicate the ISDA2 netting and offsetting rules from reported figures, the crude netting is a reasonable approximation and it certainly helps to draw a more comparable picture (Exhibit 5).

On this more comparable measure, leverage is at its lowest in over 20 years in both geographies. More interesting still, the gap between the United States and Europe is also at its lowest point in 20 years and is currently running at half the 20 year average: 2.3x versus 5.0x (Exhibit 6).

We estimate that it would take until the end of 2016 for European banks to reach the US level of leverage, assuming that European Banks continue to shrink their loans by 1%-2% per annum and US bank leverage remains constant.3

However, the issue of banking system leverage does not end there. Leverage is not merely a function of how much equity is held against assets, but also how large a banking system is relative to the domestic economy, which brings us to the second and final question with which we frame this debate.

Question 2: Have Banks Become Too Big for the Economy?

This is the essence of the ‘too big to fail’ problem that governments and regulators have been tackling since the onset of the crisis, reversing a 20 year trend of financial de-regulation and a ‘laissez-faire’ approach to oversight. As undercapitalized banks began failing in 2008 and private capital became unwilling to step in, large injections of public funds became necessary to prevent banks (and, potentially, the system itself) from collapsing.

Exhibit 7 illustrates why this was the case and why public injections of capital have been more prominent in Europe than in the United States.

European banks were almost ‘too big to save’ and the additional burden that these rescues placed on government finances explains much of what we see today. This added burden explains why peripheral European bond yields were dangerously close to making sovereign debt burdens unsustainable in 2011 and 2012, why there has been such a powerful negative feedback loop between banks and their sovereign states and why Europe is trying to break that nexus with baby-steps towards greater integration, namely a banking union.

This suggests that leverage at the individual bank level is also a function of the overall size of the banking system relative to the broader economy – essentially, the ability of governments to rescue their domestic banking systems in times of distress. Policing this is the only way for governments to protect taxpayers from having to step in on occasion. Looking again at Exhibit 5, the stark difference
between Europe and the United States suggests there’s significantly higher ‘systemic leverage’ in Europe than is suggested by the aggregate of the individual banks’ leverage.

Let’s develop this idea further. Banks are just one part of the overall financial system and leverage outside the banking system, often referred to as the shadowing banking system, can also present risks to financial stability. Total financial institutions assets include insurance companies, pension funds, money market funds, hedge funds, central banks and other intermediaries, as well as commercial banks.

In the US, banks represent around 25% of overall financial institutions assets, while in the euro zone it’s around 50%, which explains why the gap between Europe and the United States looks slightly narrower in Exhibit 8 than it does in Exhibit 7. It is also interesting that the last time the size of the financial systems (relative to the economy), were the same across both geographies was in 2004, at the point where pre-crisis ‘irrational exuberance’ arguably began to peak. Since then, the United States has clearly done a much better job of controlling systemic leverage.

If, hypothetically, European policymakers chose to reduce the systemic risk to the US level, in order to protect future taxpayers and ensure financial stability, it would involve further shrinkage of the financial system, including bank assets. Our analysis shows that European banks would need to shrink credit by 1%-3% per annum for a further two to three years for the European system to look more like the United States. This would have the effect of reducing European bank leverage by two multiple points and bring it down to exactly the level of US banks leverage today (Exhibit 9).

To put the point another way, for a given level of leverage, European banks would have to run at two multiple points below US banks for leverage to be equalized from a systemic perspective.
In Conclusion:

• The Trans-Atlantic bank leverage gap is not as large as it appears once we establish a consistent basis on which to compare, and has narrowed materially after diverging for much of the past twenty years

• US and European banks have de-levered balance sheets to the lowest levels of the last twenty years

• European banks have systemically higher leverage given that, as a group, they are a larger part of the broader economy than US banks are of the US economy

• For Europe to offset the higher systemic leverage, 2-3 more years of bank deleveraging is required

• It’s unlikely that bank leverage is a significant impediment to credit growth, though the United States is slightly better positioned

• The notion of the ‘correct’ level of leverage for a bank is a transient one and is ultimately whatever the policymaker of the day decides it should be. However, it does not exist in a vacuum and drives other considerations, such as the impact on credit growth, systemic risk, macro-prudential policies and potential taxpayer burdens

Notes

1 To collate the aggregate raw data we have used the Credit Suisse Holt database, which provides a reliable empirical data set going back to 1994
2 International Swaps and Derivatives Association; the trade organisation responsible for the standardised contract for derivatives transactions
3 We also assume that European Banks generate a 10% ROE and pay out 50% of earnings in dividends each year

Important Information

Published on 23 March 2015.

Certain information included herein is derived by Lazard in part from an MSCI index or indices (the “Index Data”). However, MSCI has not reviewed this product or report, and does not endorse or express any opinion regarding this product or report or any analysis or other information contained herein or the author or source of any such information or analysis. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any Index Data or data derived therefrom. The MSCI Index Data may not be further redistributed or used as a basis for other indices or any securities or financial products. This is a financial promotion and is not intended to be investment advice. In the UK this document, which is supplied for information only, is for distribution only to professional investors and advisers authorised to carry out business under the Financial Services and Markets Act 2000.

This material is for informational purposes only. It is not intended to, and does not constitute financial advice, fund management services, an offer of financial products or to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management and shall not be considered as an offer or solicitation with respect to any product, security, or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited.


Dubai: Issued and approved by Lazard Gulf Limited, Gate Village 1, Level 2, Dubai International Financial Centre, PO Box 506644, Dubai, United Arab Emirates. Registered in Dubai International Financial Centre 0467. Authorised and regulated by the Dubai Financial Services Authority to deal with Professional Clients only.

Germany: Issued by Lazard Asset Management (Deutschland) GmbH, Neue Mainzer Strasse 75, D-60311 Frankfurt am Main.

Hong Kong: Issued by Lazard Asset Management (Hong Kong) Limited (AQZ743), Unit 30, Level 8, Two Exchange Square, 8 Connaught Place, Central, Hong Kong. Lazard Asset Management (Hong Kong) Limited is a corporation licensed by the Hong Kong Securities and Futures Commission to conduct Type 1 (dealing in securities) and Type 4 (advising on securities) regulated activities. This document is only for “professional investors” as defined under the Hong Kong Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong) and its subsidiary legislation and may not be distributed or otherwise made available to any other person.


Korea: Issued by Lazard Korea Asset Management Co. Ltd., 19F Seoul Finance Center, 136 Sejong-daero, Jung-gu, Seoul, 100-768.

Singapore: Issued by Lazard Asset Management (Singapore) Pte. Ltd., 1 Raffles Place, #15-02 One Raffles Place Tower 1, Singapore 048616. Company Registration Number 201135005W. This document is for “institutional investors” or “accredited investors” as defined under the Securities and Futures Act, Chapter 289 of Singapore and may not be distributed to any other person.


About the Author

Elias Chrysostomou, CFA
Director
Lazard Asset Management Limited
Elias Chrysostomou is a Research Analyst primarily covering the financials sector. He began working in the investment field in 2002. Prior to joining Lazard in 2010, Elias was a Portfolio Manager with UBS Global Asset Management. He has a BSc (Hons) in Banking & International Finance from Cass Business School, City University.