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The evolving role of banks in financing the economy

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JACQUES DE LAROSIERE:

Ladies and gentlemen. It is my pleasure and my honour to present to you Mr Gary Lynch, who is Vice chairman and General Counsel of Bank of America Corporation. We are very lucky to have him. We thank him for having come over. The subject of our talk is under the aegis of 'the evolving role of banks in financing the economy'. I would like to start off with one question to Gary, taking advantage of his position as a leader of a very large American financial corporation, is to tell us how he sees the financing of the real economy, individuals and corporates, through the banking system in the US, given the regulatory pressure.

As we all know, banks are extremely important in Europe in financing the economy, they account for around $\frac{3}{4}$ of the total financing whilst the figure is much less in the US, where financial markets are much more active and present. Therefore, the impact of regulation on banks in Europe and on financing of its economy is by definition much larger than it is in the US. Gary how do you see this issue?

GARY LYNCH:

Well, it is obvious that capital and liquidity requirements are going up, and leverage ratios have gone up in the US. It is fair to say that the US regulators see the international agreements as a starting point. So, to a certain extent there is a "gold plating" of certain requirements. For example the U.S. rules for Global Systemically Important Banks (GSIBs) and for the leverage ratio are substantially higher in the United States than in Europe.

Having said that I would add that obviously the banking system in the US is certainly safer, and more secure than prior to 2008. These requirements are not imposing any kind of real constraint on the ability of US banks to meet the lending needs of our customers in financing the economy, in part because of the fact that so much of the financing of the real economy in the United States is carried out through the capital markets as opposed to direct

bank lending.

JACQUES DE LAROSIÈRE:

I would like you to elaborate a little bit on this issue, because this is really at the root of the problem. In Europe, we have had a reduction in the lending by the banks to the economy over the last 3-4 years by around 10%, if you calculate it in terms of the stock of debt of non-financial corporations vis a vis banks. In the US, I would say, all in all, that during that same period, the stock of bank credit to non-financial corporations has gone up, perhaps by 5%. So it is a big difference.

On the other side, and that is the paradox, you have a much more vibrant capital market. So by definition the financing of the economy is better off because the banks are doing their job, and are increasing their credits, and the financial markets are also much more active and present, than they are with us. So what I would appreciate if you could elaborate a little bit on that juncture between the banks and the financial markets in terms of the financing of the real economy.

Securitisation is an issue here which is also important, and I suppose you have some views on that after the dramatic collapse of the subprimes in 2007-2008, after that, how have you seen the development of the securitisation facilities in the US?

GARY LYNCH:

With one major exception on which I will touch upon in a second, the US securitisation market has fully recovered from 2008; notably the securitisation market for auto loans, credit cards has picked back up to pre-2008 levels. There is one exception which is mortgages because the subprime mortgage crisis has left such a bad taste in the investors' mouths that the securitisation market of mortgages has not recovered in the United States.

However, having said that, the major housing government-sponsored enterprises (GSEs) - Fannie Mae, Freddy Mac - have picked up and they are really taking up that capacity through their interventions in the housing market. Effectively, the fact that mortgage securitisation market hasn't picked up and has not really hurt the economy is due to the role played by these agencies.

That is not to say that the mortgage securitisation market may not come back, at some point. It is a question of time; in addition legal issues need to be worked out. It is fair to say that no financial institution will provide representations and warranties that there are no deficiencies in the origination of a mortgage for the life of the mortgage any longer. For that market to pick up, there has to be an acceptance by the buyers of mortgage securities that the guarantees will be much more limited than they were pre-crisis and that they are now.

JACQUES DE LAROSIÈRE:

This is extremely interesting for our meeting, because in a nutshell, as I tried to explain yesterday evening, the United States economy is doing significantly better than ours. It is investing more, its productivity gains are higher, and its growth is more buoyant than it is in Europe. One of the reasons, not the only reason because we have structural rigidity that explains a lot of this phenomenon, has to do with the financing of the economy, and in the US, in a way you have solved the problem. Banks have recapitalized themselves with perhaps greater ease because of the capital market's ability to provide the equity. Banks are lending, securitisation has recovered, which is absolutely not the case in Europe, and the exception which you have rightly indicated, the mortgage sector, in a way has been picked up by the agencies. Now, we don't have agencies in Europe. We have no institutions to pick up the slack in mortgage securitisation. So I will ask the audience to ponder a few minutes on this message which is actually very interesting.

Now, perhaps you would like to touch on some other subjects; would you like to say a word on some aspects of upcoming regulation, on resolution, TLAC, or other matters pertaining to reputation?

GARY LYNCH:

I will mention first the Volcker rule that went into effect in July and I think everyone in the United States is struggling with the interpretation of what is proprietary trading. My view is that such an uncertainty will probably remain in the coming months until finally there is more clarity expressed by the regulators. Unfortunately, clarity will come not through pronouncements but rather through enforcement actions when the regulators' view is that a bank has stepped over the line, engaging in conduct that is proprietary trading, as opposed to market making.

The issue there, and again we are early on into Volcker rule application, is whether this has ultimately an effect on the liquidity of the capital market. Up to this point I don't think we have seen any diminution in liquidity in the equity markets, although clearly there is a view among the traders that there has been a fall in liquidity in the US credit market. I think the Volcker rule and its interpretation going forward is an uncertainty in the United States.

The other point I would like to make is just in terms of the regulators and prosecutors. We have gone through an era in the United States of huge fines assessed on the banks, not only US banks but on some European banks as well. I've been with Bank of America for four years now. It is fair to say, we have spent, during my tenure, close to 80 billion dollars resolving claims; a lot of that money actually has been spent on paying fines to the US government. Some of those fines have been paid for misconduct at Merrill Lynch, which is

an entity which we were forced to acquire by the government. So it seems odd to penalize us for conduct occurring at an institution before we acquired them.

Nevertheless, let bygones be bygones, we will forget about it, we have largely moved through that. I do think obviously the banking industry has to restore its reputation in the US and globally, and that is only going to come in time; certainly the subprime mortgage crisis affected the industry's credibility, affected our reputation. It did not help.

In time, as we get further away from 2008, hopefully, reputations will get better. Actually we have already seen that in terms of consumer data that slowly but surely, we are returning to pre-2008 levels.

Now, let us be clear, we are not going to be a position where a 100% of the population says they love banks. I think, in time, if we can avoid other missteps within the industry, and the levelling of these humongous fines for historical conduct, hopefully, we will get back to where we should be.

JACQUES DE LAROSIÈRE:

Thank you very much Gary. This was most enlightening. I am not going to ask for any questions from the audience, because we are short in terms of time. Let me just repeat that we are very to have had you, and that your message is full of lessons to us. Thank you so much.

GARY LYNCH:

Thank you.