Box 8

TO WHAT EXTENT HAS BANKS' REDUCTION IN ASSETS BEEN A DE-RISKING OF BALANCE SHEETS?

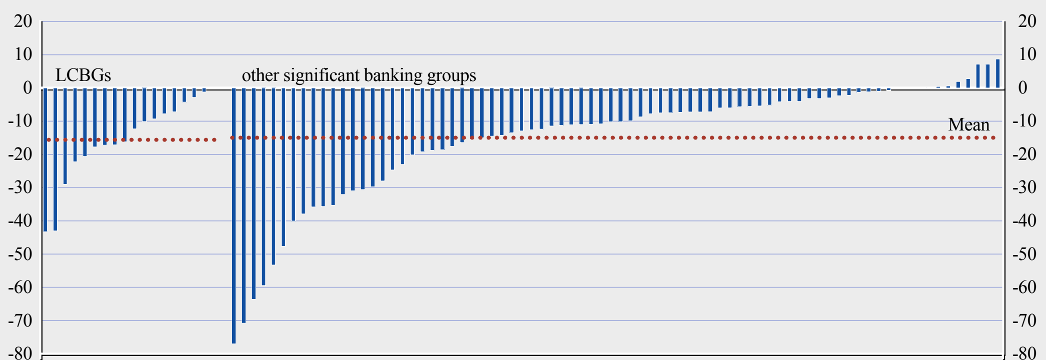
Deleveraging by euro area banks has been significant over the last years. A fall in euro area MFI balance sheets (euro area-domiciled assets only) by €4.3 trillion since May 2012 underscores euro area domestic balance sheet reduction; taking a broader view of *consolidated* balance sheets suggests an even larger figure. Indeed, significant banking groups in the euro area have reduced the size of their *consolidated* balance sheets (that is, including assets outside the euro area) by over €5 trillion – a 20% decline – since their respective peak values (which on aggregate was in the first half of 2012, though differing across banks). The extent of asset reductions has, however, varied greatly across banks with some banks reporting stable or even growing total assets, whereas banks most affected by the global financial crisis – some of which are undergoing orderly restructuring or a winding-down of operations – have cut more than two-thirds of their balance sheets (see Chart A). This raises the question to what extent the reduction in total assets has actually reduced banks' risk exposures.

Although SBGs reported a significant reduction in total assets during 2013, the decrease in risk-weighted assets was even greater (see Chart B). Indeed, whereas total assets increased each year from 2009 to 2012, on average, *risk-weighted assets* have been on an accelerated declining path ever since 2009 (see Chart B). The share of risk-weighted assets as a percentage of total assets has, on average, declined by some 13 percentage points, to around 45% of total assets, but with a range from 16% to 85% of total assets across banks. This could suggest that banks' have been more aggressive in cutting higher-risk exposures, but it has also led analysts, investors and supervisors to question to what extent the reduction in risk-weighted assets has been achieved by adjustments to banks' internal models.[1]

Information about the actual level of de-risking of banks' balance sheets can be obtained by analysing changes in *exposures at default* (EADs) – the credit risk exposure measure used in the Basel

Chart A Changes in euro area banks' total assets

(percentage decline from peak to most recent value)



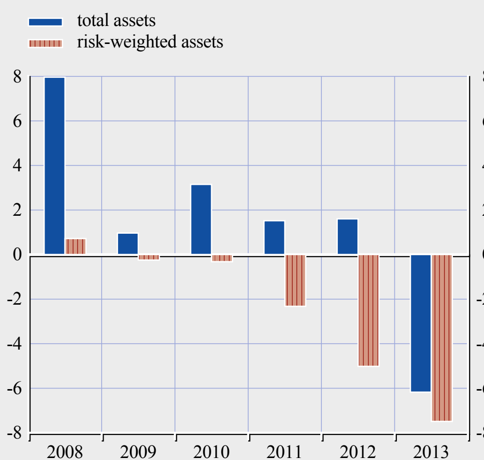
Source: SNL Financial.

1 See Box 4 in ECB, *Financial Stability Review*, May 2013.

framework – from banks' Pillar 3 disclosures. Between 2011 and 2013 data for a sample of 21 euro area significant banking groups (SBGs) for which information is available show that the aggregated credit exposure at default declined by around €682 billion, which suggests a relatively strong overall reduction in aggregate credit risk exposures. The aggregate decrease consisted mainly of a fall of €580 billion (-13%) in corporate exposures, €250 billion (-18%) in financial institution exposures and €155 billion (-45%) in securitisation exposures (see Chart C). These changes resulted in banks reducing their total credit risk capital charges by 34% from 2011 to 2013. Although the largest decrease in exposure was observed for corporates, this exposure class made up about one-third of the total credit risk exposure in 2013 and absorbed 57% of total capital requirements (see Chart D).

Chart B Changes in euro area banks' total assets and risk-weighted assets

(2008 – 2013; percentage change per annum; averages for significant banking groups)

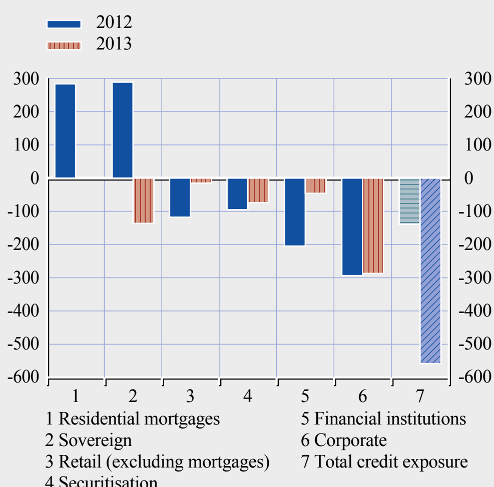


Sources: SNL Financial and ECB calculations.

A shift from capital-intensive exposures, such as corporates, towards less capital-intensive exposures, such as sovereign and secured lending, reflects changes in banks' operating environment – including loan demand – and the increased supply of sovereign debt in the euro area during the period. That said, some of the exposure changes were likely also driven by efforts by banks to de-risk their balance sheet, also with a view to meeting more stringent regulatory requirements. This was reinforced by increasing exposures to retail mortgages that are less capital intensive. Furthermore, tensions in euro area funding markets are likely to have

Chart C Changes in selected euro area significant banking groups' exposures at default

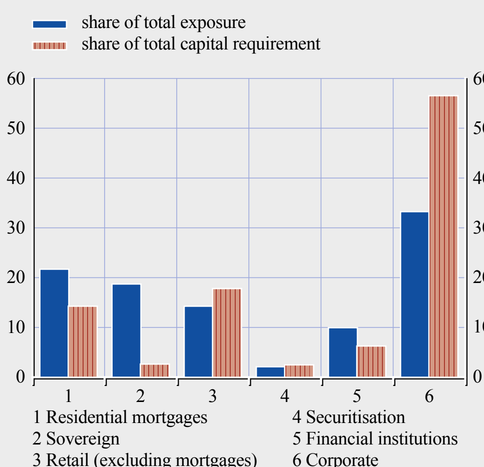
(EUR billions)



Sources: Banks' Pillar 3 reports and ECB calculations.

Chart D Selected euro area significant banking groups' exposures at default and capital requirements

(2013; percentage of total)



Sources: Banks' Pillar 3 reports and ECB calculations.

led to a reduction in exposures towards financial institutions, which was reinforced by regulatory changes in calculating the capital charge for this type of exposure. The decrease in securitisation exposures incorporates the significant reduction in the size of the securitisation market, but also regulatory changes that lead to higher capital charges for this type of exposure (e.g. more stringent market risk capital requirements under Basel 2.5).

All in all, euro area banks have significantly bolstered their loss-absorption capacities in recent years and the large reduction in euro area banks' balance sheets is likely to have contributed to lowering the level of risk confronting banks. It is, however, difficult to assess to what extent the asset shedding has led to a true de-risking of balance sheets. This is important as a deleveraging process could unduly reduce the supply of credit to the economy. The comprehensive assessment carried out by the ECB will make a significant contribution towards making banks' balance sheets more transparent. In addition, by identifying and implementing necessary action, it will contribute to banks' balance sheet repair and confidence building, which will support the banking sector's ability to extend credit.