SOUTH-EAST EUROPEAN RESEARCH CENTRE

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RESEARCH STUDENT SEMINAR

Wednesday 4 September 2019
15:30 – 16:30

SEERC Conference Room,
Proxenou Koromila Building

"Bank Liquidity Creation in Europe and its Relationship with Non-Performing Loans, Regulatory Capital, Credit Risk and Regulation"

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ABSTRACT

The collapse of the real-estate market during the recent financial crisis created an unfavorable environment for European banks. This resulted in high levels of non-performing loans concentrated in their portfolios while large banks were operating with low levels of capital. To protect banks from insolvency, international regulatory frameworks such as Basel III introduced a set of rules that banks need to follow such as increasing their capital adequacy ratios. Additionally, ECB and EU governments suggested that the levels of non-performing loans must be reduced as they cause operational problems to banks, something that eventually impedes economic growth. However, these remedial actions may affect the central role of banks in the economy, which is to create liquidity. Banks create liquidity by issuing illiquid loans that are used for large investment projects while at the same time they allow depositors to withdraw their money at any given point in time at par value. In this context, this study investigates the interrelationships among non-performing loans, regulatory capital and liquidity creation. By using a panel of around 300 Western and Eastern European banks, a GMM Panel VAR model is employed to deal with endogeneity among these variables. The results show that non-performing loans and liquidity creation affect negatively each other for large banks and positively for Central & North EU banks. Results also indicate that regulatory capital reduces non-performing loans which confirms the moral hazard hypothesis while non-performing loans have a positive impact on regulatory capital. Finally, results for EU banks on the relationship between regulatory capital and liquidity creation are in line with literature that finds a negative effect in both directions, while for non-EU banks regulatory capital has a positive impact on liquidity creation. The following empirical chapters are concerned with how a broader set of regulatory actions affect liquidity creation and how liquidity creation impacts bank credit risk.

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