

Monetary and Capital Markets Department

**Progress and Perils Along the Way to a
Banking Union:
Results from Euro Area FSAP**

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Scope

■ Euro Area policy responsibilities

- Focus on Significant Institutions
 - Stability
 - Oversight

■ Main policy areas

- Banking oversight and the Single Supervision Mechanism
- Crisis management and the Single Resolution Mechanisms
- Systemic liquidity management



Scope

■ **Connected policy areas**

- Non-Performing Loans policy
- Oversight of LSIs
- Macroprudential policy coordination
- Oversight of financial market infrastructure
- Insurance sector oversight
- Anti-money laundering/combating the financing of terrorism
- Capital markets union



Common themes

- Great progress in many areas
- Vulnerabilities unevenly distributed
- Liquidity and profitability will be fulcrums
- Fragmentation remains
- Delicate balance
 - Rules vs, discretion
 - Harmonized vs. tailored
- Can at best attenuate bank-sovereign nexus
- Better bank resolution reduces risk



Economy

- Relatively favorable macro performance
- Persistently low interest rates
 - Nominal and real
 - Eventual monetary normalization
- Low trend growth

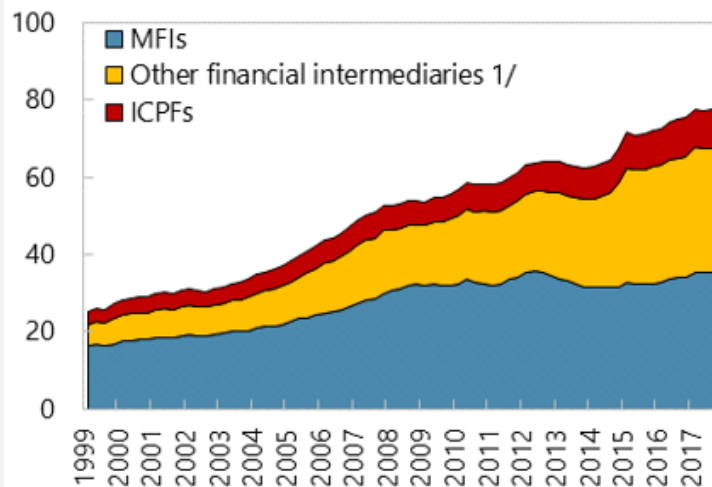


Sector

- Financial system large and complex
 - Many interconnections
 - Increasingly diverse
- Less bank financing of corporates
 - Large "other financial institutions"

Sector

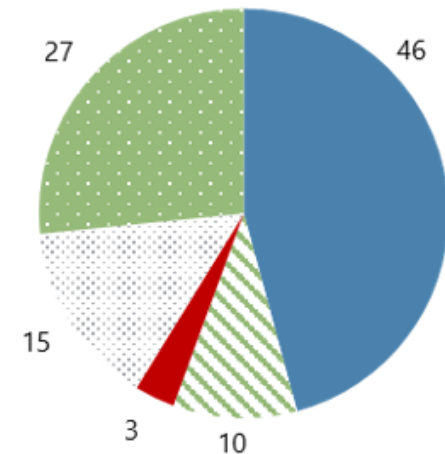
Total Assets of the Euro Area Financial Sectors
(Trillions of euros)



Since 2009, nonbanks are playing a greater role...

Share of Total Assets of the Financial Sector
(Percent, 2017Q4)

- Monetary financial institutions
- Insurance corporations
- Pension funds
- Investment funds
- Other financial intermediaries



...particularly in funding nonfinancial firms.



Stability analysis

Vulnerabilities

- Bank focus
- Risk factors
 - Slower growth
 - Europe and elsewhere
 - Financial tightening
 - Term premia
 - Corporate and sovereign risk premia
 - Political economy risks



Stability analysis

Vulnerabilities

- Brexit
 - Short term and long term
- Cyber-risk
 - Disruption
- Data gaps
 - OFIs



Stability analysis

Bank solvency

- Cover 29 large SIs
- Supervisory data
- Detailed modelling



Stability analysis

Bank solvency

Modelling

- Across markets
 - Countries
 - Sectors
- Across IRB and STA credits
 - Expected and unexpected losses
 - Expected default rates



Stability analysis

Bank solvency

Modelling

- Market risks
- Sovereign securities
- Non-sovereign securities
- FX, commodities
- RWA
- Basel III phase in
- Interest income
- Noninterest income
- Dividend policy



Stability analysis

Bank solvency

■ **Adverse scenario:**

- Minimum capital requirements met in aggregate
- Wide variation
 - Across bank categories
 - Within categories

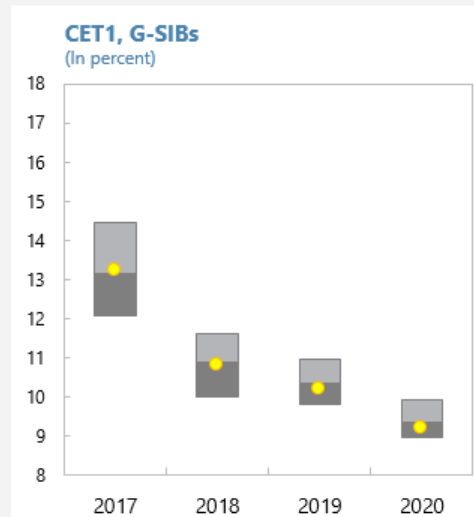
Benefits of geographical diversification and limited complexity



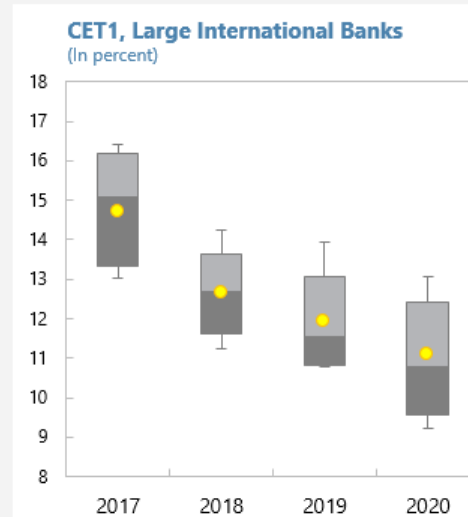
Stability analysis

Bank solvency

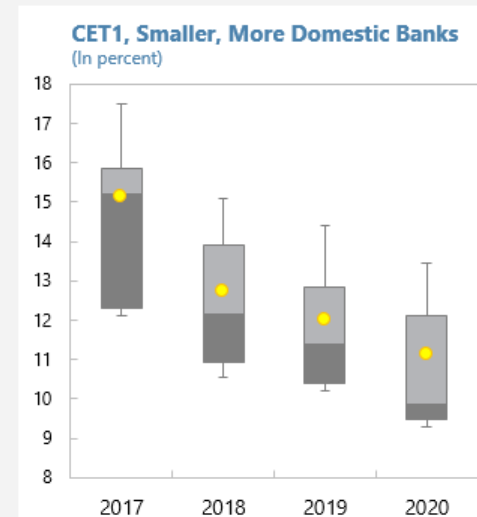
Adverse by group



ΔCET1: 399 bps



ΔCET1: 370 bps



ΔCET1: 398 bps



Stability analysis

Bank liquidity

- LCR, NSFR
- Cash flow-based tests
 - Multiple scenarios
 - Collateral freeze



Stability analysis

Bank liquidity

- Ample HQLA
 - Dollar liquidity challenges
- Banks resilient
 - Operational disruption important
- Financial tightening will affect banks unevenly
 - Internationally active non-G-SIBs generally well positioned

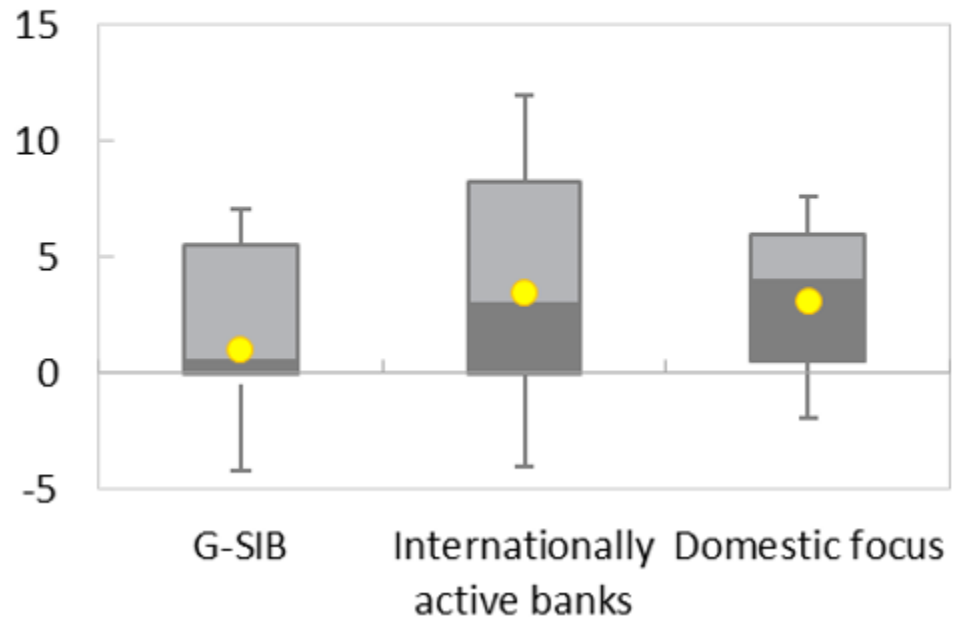


Stability analysis

Bank liquidity Results

The 5-day collateral freeze scenario reveals that several banks are vulnerable, albeit after 3 days of stress.

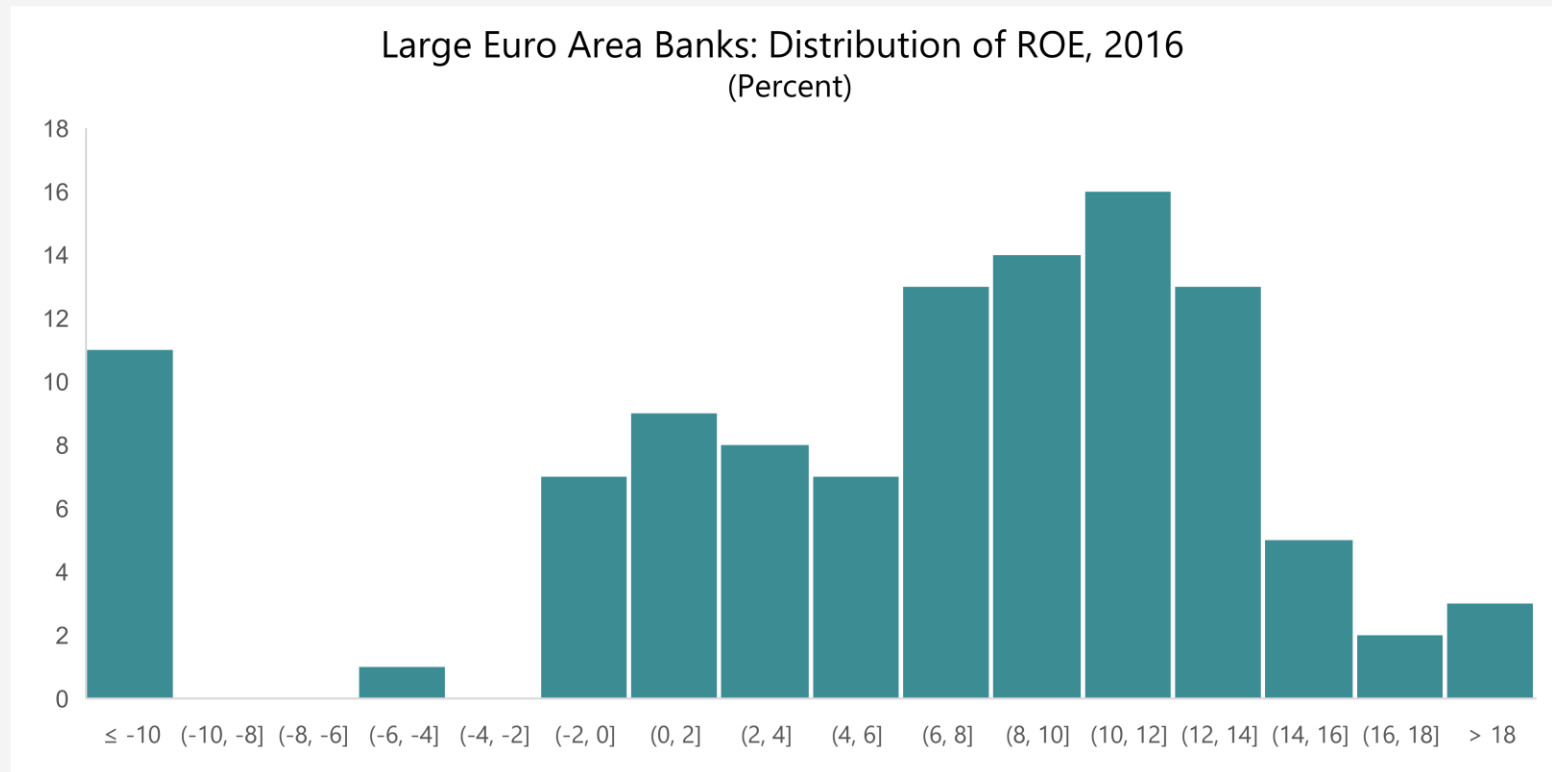
Liquidity Surplus 1/
(Percent)





Stability analysis

Bank profitability

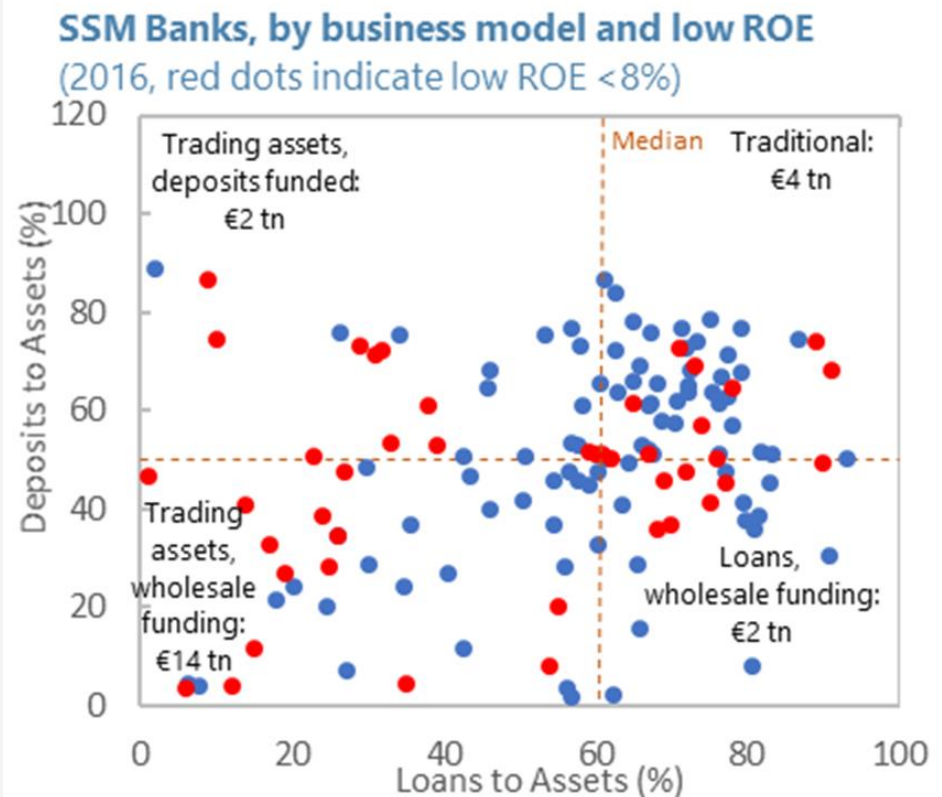




Stability analysis

Bank profitability

Weak profitability spread across business models



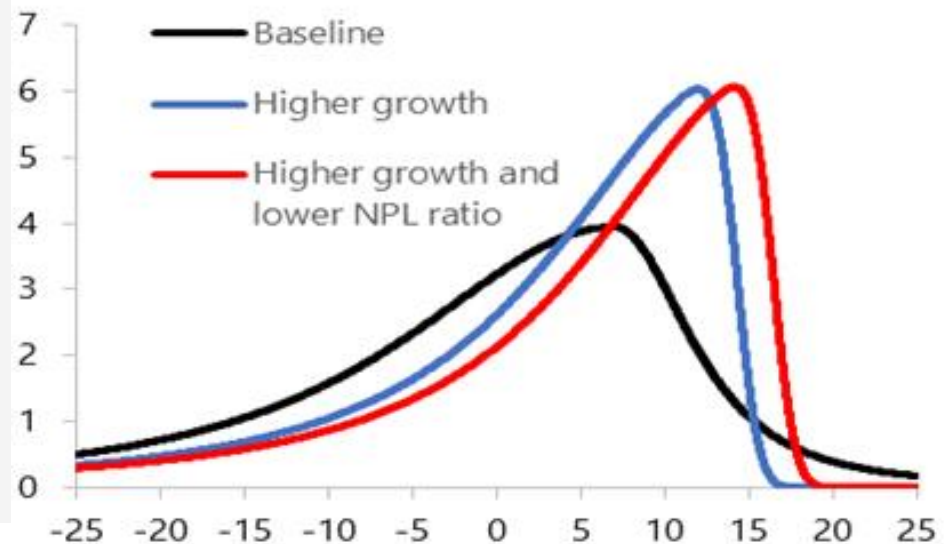


Stability analysis

Bank profitability

Quantile results

- Growth and NPLs main drivers
- Banks in the lower tail of the profitability distribution...
 - ...gain more from higher growth...
 - ...and lower NPL ratios...
 - ...but is it enough?





Stability analysis

Interconnectedness

■ Market-based measures

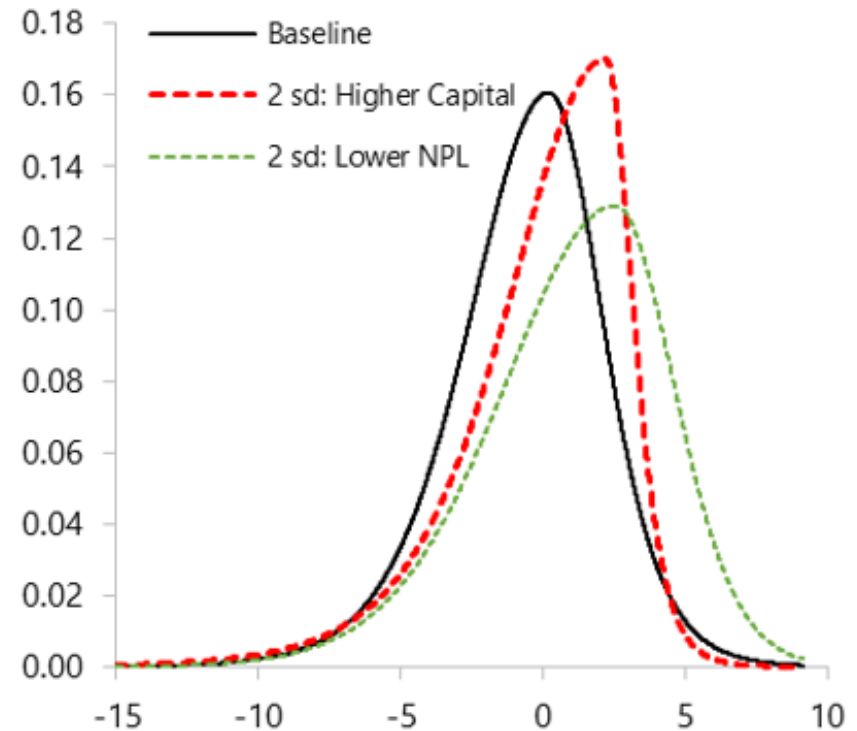
- Stronger bank fundamentals reduce spillovers from ROW
- Also for tail risks
 - Quantile regressions
- Stronger fundamentals increase resilience to inward spillovers without aggravating outward spillovers



Stability analysis

Interconnectedness

Probability of Spillovers 1/
(Probability)





Banking oversight and the SSM

Main findings:

- Impressive achievements
- Solid approach to supervision: intensive, intrusive, consistent
- Balance between consistency and individual risk assessment needs constant attention
- Good progress on NPLs, market risk, operational risk, interest rate risk in the banking book, corporate governance



Banking oversight and the SSM

Key issues

- Resources
 - Expensive decision making
 - Uncertainty over the availability of resources
 - Competing priorities with NCAs
 - Consistent quality
 - Reallocation across countries



Banking oversight and the SSM

Key issues

- Powers and supervisory perimeter
 - Bank-like activities
 - Third-country branches
 - Fragmented regulatory framework
 - Various and divergent national-level regulations/legislations
 - Sanctions, enforcement, resolution



Banking oversight and the SSM

Key issues

- Gaps
 - Related party, country risk, major acquisitions
- Divergence from international standards
 - Capital, liquidity, large exposures



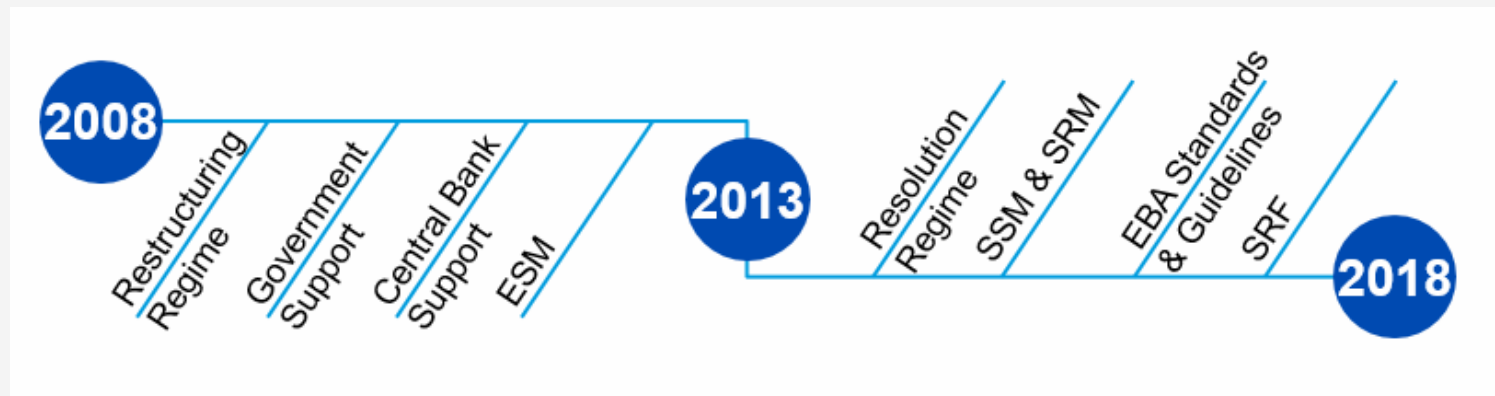
Macroprudential policy coordination

- Macroprudential oversight functions well
- Nonbank financing of the corporate sector
 - Commercial real estate
- Wider availability and application of “borrower-based measures”
 - Limits on loan to value ratios



Crisis management and the SRM

Timeline





Crisis management and the SRM

Cases

MPS	precautionary recapitalization by Italian government with Commission approval
Venetian banks	liquidated with state aid under Italian law with Commission approval
BPE	sold to Santander. Only BRRD use.
ABLV	voluntary liquidation (eventually)



Crisis management and the SRM

Lessons from cases

- Need to
 - align the conditions and triggers of the resolution, state aid, and liquidation regimes
 - subject to introducing adequate flexibility
 - strengthen liquidity support before and in resolution
 - 'pre-schedule' resolution



Crisis management and the SRM

How many regimes?

- BRRD/SRM
 - SI+
 - LSI
- National frameworks
- State aid rules
- ESM
- Legacy cases



Crisis management and the SRM

How many regimes?

- Mandatory bail-in without exceptions and inconsistencies between regimes creates incentives to 'escape' the SRM

- Fragmentation in resolution
 - Fragmentation in resolution costs
 - Fragmentation in funding costs
 - Fragmentation in the banking union



Crisis management and the SRM

Recommendations

Operational Agility

- Early intervention
- Advance resolution preparation
- Resolution decision-making
- Financial stabilization tools



Crisis management and the SRM

Recommendations

Financing in resolution

- MREL
- SRF funds
- EDIS & SRF backstop



Crisis management and the SRM

Recommendations

Liquidity in resolution

- multiple sources through ELA, DIS, and SRF
- early identification of usable eligible collateral
- short-term government guarantee to CB liquidity provision
 - Mechanism for cross-border groups
 - Retain CB independence



Crisis management and the SRM

Recommendations

Architecture

- Consistency of conditions and triggers
- Consistency of burden-sharing requirements
- Administrative liquidation tool
 - an administrative liquidation tool to complement the SRB's toolbox



Crisis management and the SRM

Recommendations

Architecture

- Pared back state aid oversight
 - for SRB resolution decisions and the use of the SRF and DIS funding on a least cost basis according to open and fair procedures
- Financial stability exemption
 - from 8% mandatory bail-in requirement before access to public funds (including SRF) *in extremis*



Systemic liquidity management

- Arrangements for emergency liquidity assistance (ELA) should be enhanced
 - Further harmonization and ultimately centralization
 - ECB best placed to coordinate ELA preparations and judge criteria
 - Cross-border institutions



Systemic liquidity management

- The ECB should enhance “horizon scanning”
 - Detect emerging liquidity strains
 - Link horizon scanning to prudential supervision.
- Future: liquidity management framework to transition from crisis-related settings
 - Developments in regulations and markets structure
 - Advanced signaling



Capital markets union

- Decreasing reliance on bank debt
- Domestic bias
 - National regulation and supervision
 - Divergent insolvency rules and creditor rights regimes
 - Disparate taxation of cross-border investment income
- Efforts concentrated on helping SMEs and long-term projects financing
 - Securitization
 - Simplification of prospectuses



Capital markets union

Investor base development is priority

- More convergence on implementation of international reporting standards
- Preferential treatment of financial collateral related to cross-border claims in cases of insolvency
 - Currently the case for ISDA derivative contracts.
- Withholding tax streamlining, ex ante exemptions
- Harmonization of supervision
 - Stronger central monitoring and enforcement capabilities
- Tax treatment equality between debt and equity



Reactions

- Generally positive
- Mixed views on
 - Regulation of liquidity risk (BCP 24)
 - Systemic risk exemption
 - Administrative liquidation tool
 - Paring back state aid rules
 - More coordination of ELA provision



Subsequent

- EA FSAP followed up in Art. IV consultation(s)
- EA FSAP informs EA country FSAPs
 - Malta, France, Italy, Austria, ...
- Cyprus Cooperative Bank case
- “ECB to Stress-Test Bank Liquidity Starting Next Year, Nouy Says” Bloomberg, 2018-10-04
- “EU leaders to boost bailout fund role, but duck talks on deposit insurance” Reuters, June 26, 2018



Document availability

- <https://www.imf.org/en/publications/cr/issues/2018/07/19/euro-area-policies-financial-system-stability-assessment-46100>
- <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Stress-Testing-the-46102>
- <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Risk-Analysis-46105>
- <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Detailed-Assessment-of-46107>
- <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Insurance-Investment-46104>
- <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Bank-Resolution-and-46106>
- <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Liquidity-46103>
- <https://www.imf.org/en/News/Articles/2018/07/17/na071918-the-euro-area-financial-system-on-going-transformation>