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
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
Context

Sector

- Financial system large and complex
  - Many interconnections
  - Increasingly diverse
- Less bank financing of corporates
  - Large “other financial institutions”
Since 2009, nonbanks are playing a greater role...

...particularly in funding nonfinancial firms.
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
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)

G-SIB
Internationally active banks
Domestic focus active banks
Stability analysis

Bank profitability

Large Euro Area Banks: Distribution of ROE, 2016
(Percent)
Stability analysis

Bank profitability
Weak profitability spread across business models

SSM Banks, by business model and low ROE (2016, red dots indicate low ROE < 8%)

- Trading assets, deposits funded: €2 tn
- Trading assets, wholesale funding: €14 tn
- Loans, wholesale funding: €2 tn

Median
Traditional: €4 tn
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?
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)

- Baseline
- 2 sd: Higher Capital
- 2 sd: Lower NPL

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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

2008
- Restructuring Regime
- Government Support
- Central Bank Support
- ESM

2013
- Resolution Regime
- SSM & SRM
- EBA Standards & Guidelines
- SRF

2018

Euro Area Financial Sector Assessment Program
Autumn 2018
## Crisis management and the SRM

### Cases

<table>
<thead>
<tr>
<th>Institution</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>MPS</td>
<td>Precautionary recapitalization by Italian government with Commission approval</td>
</tr>
<tr>
<td>Venetian banks</td>
<td>Liquidated with state aid under Italian law with Commission approval</td>
</tr>
<tr>
<td>BPE</td>
<td>Sold to Santander. Only BRRD use.</td>
</tr>
<tr>
<td>ABLV</td>
<td>Voluntary liquidation (eventually)</td>
</tr>
</tbody>
</table>
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
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