Completing the repair of the EU banking sector

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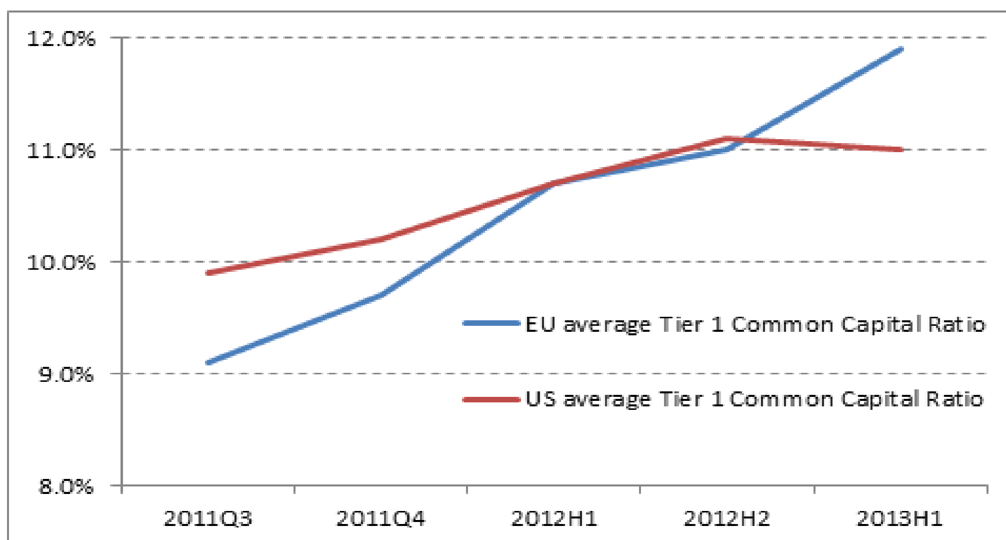
The adjustment in EU banks' balance sheets is making good progress…

Supervisors and regulators push for strong risk management in firms, requiring them to identify, measure and steer risks adequately, and to back test whether measures taken have proven to be effective. Such procedures are not only crucial for banks’ business, but also for public authorities like the EBA. It is important for us and national authorities, decision making committees and central banks all over the world to assess the effectiveness of measures taken to overcome weaknesses and repair banking systems.

In my speech today, I will focus on the EU banking sector and on the progress made so far. And I will measure this progress in repairing balance sheets with the metrics defined by the G20 Leaders in 2009.

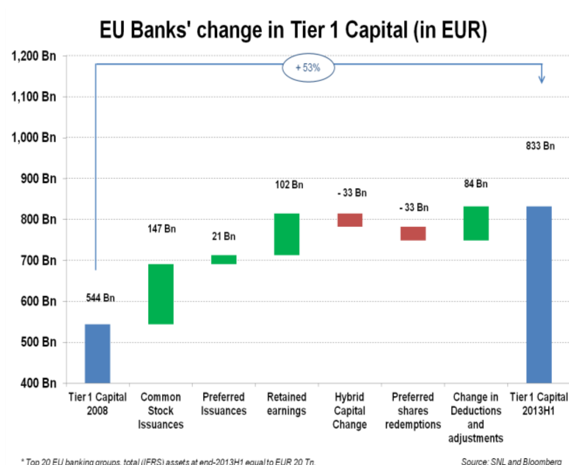
One of the core components of the regulatory reform package was the request to improve the quality and increase the level of capital available in the banking system. This went along with the strengthening of liquidity management and with the development of specific rules on liquidity buffers.

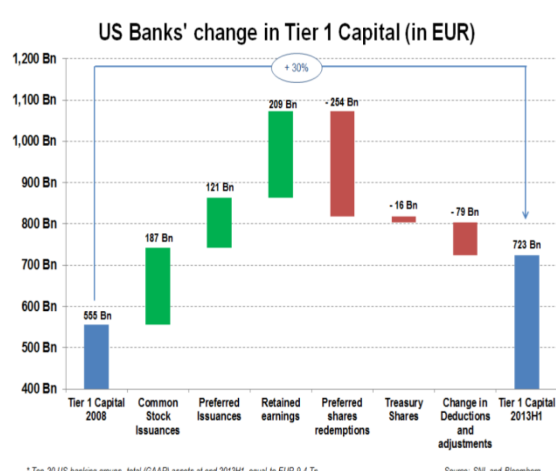
The question is therefore where the European banks stand with respect to capital and balance sheet restructuring. Following the EBA's recapitalisation exercise, completed in 2012, the Common Equity Tier 1 ratio (CET1) for the largest EU banks stood at 11.9% at June 2013, against 11.1% for the largest US banks.



If we assess the capital adequacy according to the fully loaded Basel 3 standards, which are supposed to be in place in 2019, the Core Tier 1 ratio (CT1) of the largest EU banks drops at 8.4%, showing a shortfall of around EUR 70 bn. This shortfall looks largely manageable, as it is just slightly in excess of the profits realised by the same banks in 2012.

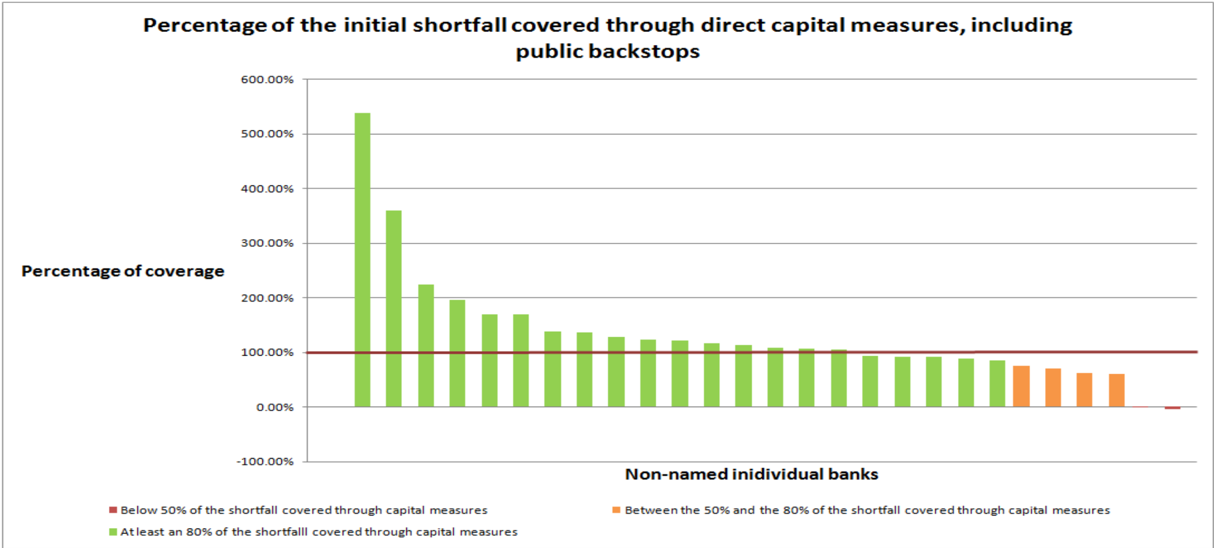
There is a perception, though, that US banks have strengthened their ratios through genuine capital increases, while EU banks have done the adjustment mainly through a less credible reduction in Risk Weighted Assets (RWAs). I will come back to this, but for now let me just say that this perception is not justified by the data. Overall, it is worth noting that US banks have issued fresh equity and to a larger extent retained earnings, but also done more buy-backs. Indeed, the largest 20 banks in the US and in the EU had approximately the same absolute amount of Tier 1 capital at the end of 2008, and the European banks have increased capital more than their transatlantic competitors.





In fact, the EBA's recap exercise has triggered capital increases rather than reductions in RWAs. It is also fair to acknowledge that reductions in RWAs are not bad per se. With respect to capital ratios we most certainly prefer to see fresh money in the banks, but we should not underestimate that banks'

balance sheets needed –and still need– restructuring of the asset side, as well as de-risking in order to achieve a solid path towards more sustainable business models. This has also taken place over the last couple of years, although we need to monitor that as little harm as possible is done to lending to the real economy in order to revitalise and foster growth in Europe.



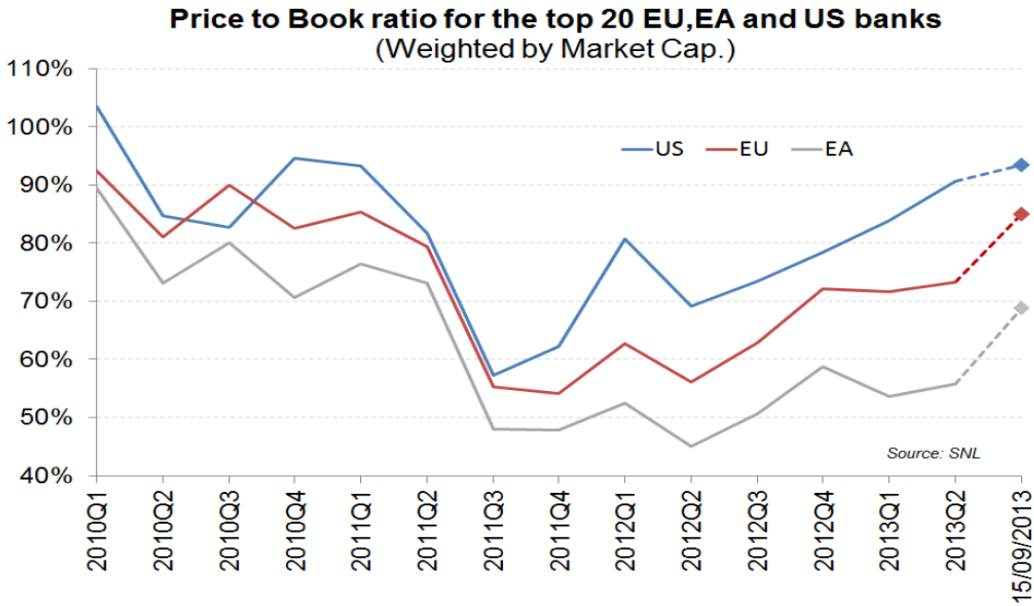
As regards the structure of banks' balance sheets, also the leverage ratio is getting close to the regulatory benchmark (10 bps below the 3% regulatory target at end 2012). Also in this case, EU banks are now at a similar level to their US peers, if we rely on similar accounting standards. Indeed, it is common knowledge that the comparison with US banks is deeply affected by differences in accounting standards, as the IFRS standards used by EU banks lead to a larger balance-sheet size than US GAAP. The latter allows in fact for a larger scope for netting of assets and liabilities, especially in derivatives business. The Vice-Chairman of the US Federal Deposit Insurance Corporation (FDIC) has recently presented a comparison based on harmonised IFRS-like concepts, leading to the conclusion that EU largest banks indeed have a lower leverage ratio than their US counterparts, but the difference (about 45 bps) is much smaller than usually thought and is driven by a small group of outliers which have been further raising their capital levels in the course of 2013.

Lastly, the liquidity coverage ratio (LCR) for the monitored banks was 109% on average at end-2012, i.e. above the final 2019 100% target and well above the 2015 60% requirements agreed in Basel.

… but the turning point in markets' confidence has not been reached yet

Notwithstanding the efforts taken to improve regulation and banks' activities to comply with the new rules, we know that there are large discrepancies between regulatory measures on the one hand and market perception on the other.

Evidence of this mismatch can be found looking, for instance, at banks' price to book ratios, which still reflect a lack of market confidence in banks' balance sheets in the EU (and especially in the euro area). Why is this lack of confidence so persistent in Europe? And what can be done to move forward?



Firstly, the focus should be on asset quality. Concerns exist about the adequacy of asset values reported by banks. In particular, there are doubts on the impairment recognition, implying that corrections of assets values on European banks' balance sheets have not taken place to the necessary extent. At a first sight, US banks seem to have done a better job in cleaning up their books, mainly through disposals of assets at deeply discounted values. This has been facilitated by a more liquid secondary market for bank assets and, in particular by the major role played by the government-sponsored entities (GSEs), Fannie Mae and Freddie Mac.

Hence, there is a need to have a clear picture of the quality of banks' assets in Europe, in order to dispel remaining concerns and reassure potential investors on the robustness of EU banks.

EU-wide Asset Quality Reviews (AQRs) and especially the Balance Sheet Assessment (BSA) to be conducted by the ECB before taking up its supervisory responsibilities for banks in the Euro area, could be an important catalyst to overcome these concerns.

The lack of comparability of asset quality across EU banks causes an additional challenge in Europe. This is due to different definitions of key aggregates, like for instance the definition of Non-Performing Loans (NPLs).

The EBA cannot run an Asset Quality Review directly, but has already agreed to a recommendation requiring all national competent authorities (NCAs) in the EU to assess the quality of banks' assets. More importantly, the EBA is providing national supervisors and the ECB with common definitions of NPLs and forborne loans. Common yardsticks, European processes and methodologies and some degree of independent review should help overcome the remaining uncertainties.

There is also room for improvement in the deleveraging process, where further progress will be beneficial. A simple comparison of the situation at the end of June 2013 and at the end of December 2008 shows that the adjustment process has taken place without any significant aggregate reduction of balance sheets size of EU banks. However, this overall perspective conceals significant underlying changes: firstly there has been a shift of assets and market shares across EU banks; secondly bank assets have continued to grow during the crisis until spring 2012, and since then they have started declining. Finally, there has also been a geographic shift, with a massive repatriation of assets - a point on which I will come back later.

The deleveraging has been conducted mostly by abandoning non-strategic markets rather than changing business models, but there is some evidence that sales of portfolios and lines of business are now taking momentum. Some evidence suggests that banks, and their national authorities, do their utmost to frontload the adjustments needed to pass the AQR and the stress test in 2014. In that respect, the experience of the 2011 stress test is instructive, with banks raising EUR 50 bn of capital ahead of the exercise.

Sales of business lines and portfolios, capital issuances, increase in provisions and even in NPLs – which may reflect to some extent the reclassifications of forborne loans that anticipated the new definition of NPLs – show that important changes are taking place, and should be supported. There is always, amongst politicians and regulators, some concern that setting the bar too high in terms of AQR and deleveraging could end up in procyclical behaviours. I maintain the opposite view, that pushing banks to complete their balance sheet adjustment is essential to kick start lending and to see a positive contribution from the banking sector to the recovery of the European economy.

Another important issue to be addressed is the consistency of the methodologies for computing RWAs. The de-risking process has focused on the most capital intensive business lines: trading and derivatives business, commercial real estate lending, international leasing, shipping and project finance. EU banks are seen as having pushed more for “optimising” RWAs rather than deleveraging: in aggregate, balance-sheet size has not changed much, while RWAs have decreased significantly. The perception was that banks were trying to tweak internal models to artificially boost capital ratios. This is what led to a lack of trust in risk weighted metrics for capital adequacy, and to scepticism on the real nature of the balance sheet repair of EU banks.

Indeed, there is some evidence that changes in RWAs are not entirely justified: there is an increasing gap between the RWAs calculated under Basel 1 and Basel 2. The decrease in average risk weights (RWAs/EADs) starting from December 2008 is particularly steep for sovereign and retail portfolios, and this notwithstanding a major sovereign debt crisis and a significant deterioration in unemployment. While there might be justifications for decreasing RWAs, as for instance the roll out of IRB models and real de-risking, regulators face the imperative to seriously analyse the issue and take actions to restore market confidence in RWAs.

The EBA work on RWAs confirmed that there are inconsistencies, but also that the problem can be fixed. Since our analysis is still in progress, it is too early for identifying a full set of policy options. But let me at least mention three possible lines of intervention:

standardised disclosure, which should allow market participants to identify those drivers of differences in RWAs that are easily justified in terms of portfolio composition or roll-out of internal models;
supervisory convergence, as one of the main findings of our work is that different practices of national authorities are important drivers of differences across banks;
benchmarking and the possible use of some constraints to internal risk parameters, in order to deal with differences stemming from bank practices, which are excessive and cannot be justified on the grounds of prudence.

We need to reach a stage where the risk weighted requirements are "biting", while the non-risk weighted metrics, such as the leverage ratio, are only employed as a backstop. Needless to say, we also need consistency in the non-risk-weighted measures, with globally harmonised definitions of leverage, based on gross aggregates, without netting and carve outs, and not dependent from the differences in accounting standards.

The last aspect I want to touch upon is about the restructuring and changes in business models. Here again, we need to stress the significant evolution that is already taking place. Around 25% of EU banks assets are under state aid regimes, subject to the strict restructuring requirements imposed by the European Commission. Banks are radically redesigning their business models, reducing loan to deposit ratios, exiting markets and refocusing on core business, deleveraging and cutting costs. However, we have experienced a relatively low exit from the market (less than 40 banks, against almost 500 in the US). Moreover, many banks have not needed direct capital support during the first phase of the crisis and have not felt equally compelled to a radical review of their business models. As for the upcoming regulatory changes, it should be noted that for a long time EU banks have aimed at identifying the smallest possible efforts to comply with the new regulatory requirements, instead of capturing the opportunity for more radical changes in their operating structures and medium term strategies.

I believe that progress in this area could be facilitated by the new framework for recovery and resolution. If taken seriously, recovery and resolution plans (RRPs) impose a serious reconsideration of the structure of banking firms. Senior management and boards should take greater ownership and use this tool to drive the change process, in close discussion with (and challenged by) their supervisors, who remain responsible for the resolution side.

In this field, the EBA has issued a recommendation that 39 cross-border banking groups complete their recovery plans by the end of the year, followed by consistency checks and the identification of good practices. Moreover, a more EU-wide process, and a truly integrated approach to resolution in the Euro area and other countries participating in the SSM, could mend the main loophole that has led to a shortage of restructuring activities, namely the lack of a Single Market-wide perspective in the whole process. This brings me to discuss the fragmentation of EU markets.

… and the balkanisation of the Single Market needs to be addressed

The adjustment process has been driven mainly by national authorities. Even in cases in which EU taxpayers' money was used to recapitalise the banking sector, the present legal set up has left no

space for direct supervisory intervention on banks at the EU level, besides the traditional EU Commission State Aid controls.

A certain resistance in deploying direct measures at EU level –and with clear burden sharing arrangements- led to a situation where national authorities remained in the driving seat. Home and host authorities have both been focused on ring-fencing, with the former pushing for a de-risking in foreign jurisdiction and a re-focusing on domestic counterparts, while the latter aimed at keeping as much capital and liquidity as possible within local establishments.

The drop in cross-border banking has been associated with a parallel dis-integration within cross-border groups, which have chosen to some extent, or have been forced by supervisory authorities, to match assets and liabilities on a country-by-country basis.

The Single Market is hampered in its main function as a channel for redistributing savings from countries with surpluses to countries with deficits. At the same time, this has led, during the most tense moments of the crisis, to a collapse in trust amongst supervisors, and therefore in cooperation.

The EBA has been extremely active in addressing this issue. We have been increasingly using our mediation toolkit, with some important successful outcomes. But the creation of a more integrated framework for resolution could be the real game changer. While I think the legislative proposals that are being finalised are a major step forward, I also have some concerns about the integrity of the Single Market.

Firstly, joint decisions on Recovery and Resolution Plans (RRPs) are of crucial importance, as in their absence authorities will already be inclined to ring-fence local establishments in good times, for fear that in a crisis they may have to deal with a non-cooperative solution. Therefore, it is difficult to understand why the EU legislation, in contrast to the FSB principles, does not make it compulsory for competent authorities to achieve such agreements. The SRM will provide for a completely integrated set up, largely overcoming this problem in the Euro area and in other participating Member States. But if cooperation with authorities from non-participating Member States fails to deliver an agreed framework, we risk a split within the Single Market. Secondly, even when agreements are reached and signed, it is possible that competent authorities disagree on the interpretation of the RRPs in the specific circumstances of a crisis. This calls for a rather strong role to be attributed to a European body, which could preside over the actual enforcement of the agreements, through mediation.

Let me also stress the importance of bail-in requirements to break the adverse loop between banks and their sovereigns. Discussing with investors, I am still surprised when I see how much importance they attribute to the nationality of the banks: the strength of the safety net and the implicit support of the respective sovereign still have an overwhelming weight in assessing the resilience of the banks. But already now, with the Communication of State Aid issued by the Commission, and even more in a few years from now, when the legislative framework for bail-in will be in place, investors will have to take losses before any possible public intervention is considered, which means that they will have to be much more attentive to the quality of the bank than to the standing of its sovereign.

Sound conduct of business as a prerequisite for restoring confidence

I would like to conclude with a few observations on the relevance of conduct issues, also for completing the repair of the EU banking sector. Recent experience shows that conduct regulation is required not only in order to protect consumers but also to ensure the resilience of the banking sector. Three examples illustrate this inter-dependence and the need for coordination between prudential and conduct objectives: (i) residential mortgages; (ii) payment protection insurance; and (iii) self-placement of financial instruments.

Firstly, we have seen in the mortgage markets in many countries – in the EU and beyond – that firms' conduct towards consumers poses a risk not only to consumers (for example through excessive charges and interest rates, unfair complaints handling procedures or unfair arrears handling), but also to financial stability (as imprudent lending standards towards consumers, such as non-income verified loans or high loan-to-value ratios, may fuel an 'asset bubble' in the mortgage and housing markets in the long run). When such bubbles explode, they can have a significant impact on the viability of firms and the stability of the system, unless they can be deflated slowly, or prevented from deflating by externalising the costs and risks to taxpayers and arrange for central banks to provide credit guarantees, liquidity, low interest rates, or other such measures. It is for this reason that, in June this year, the EBA published Good Practices for Responsible Mortgage Lending, and continues to increase its effort in this area.

A second example is the mis-selling of payment protection insurance (or PPI). PPI enables consumers to insure repayment of loans if borrowers become ill or disabled, pass away, lose a job, or face other circumstances that may prevent them from servicing their debt. Throughout the 2000s, some of the biggest UK banks cross-sold PPI contracts in excess of 50 million when placing mortgages, loans, credit cards or other banking products. However, as of July 2013, complaints have been received for more than 10 million of these contracts, with consumers claiming that they were not made aware that they were taking out a PPI contract or they were forced to subscribe to PPI contracts as a precondition for being able to obtain a loan. The compensation scheme that the UK regulators finally imposed was substantial. As of today, the industry's total provision for PPI compensation pay-outs has amounted to over £17bn, with the final cost estimated to be well in excess of £20bn. The prudential impact of these conduct issues is therefore substantial, as the amounts provisioned potentially undermine the viability of many UK banks and puts the credibility and stability of the system at risk. EIOPA has already started looking at this issue, and the EBA is minded to join their efforts in order to avoid that similar episodes happen again elsewhere in the EU.

The third and final example is the so-called "self-placement" of financial instruments by banks. Self-placement refers to the practice of credit institutions selling proprietary financial instruments – such as common equity shares, preference shares, hybrid securities and debt – to their existing retail banking customers. Self-placements have been seemingly attractive investments for consumers because, in the low interest rate environment that has been prevalent across the EU since 2008, these products have been promising much higher yields than deposits. On the other hand, they have been attractive to credit institutions too, because self-placements have been an inexpensive way to raise funds that are eligible regulatory capital for the purposes of strengthening banks' capital positions. Here, the

interdependence between ‘prudential’ and ‘conduct’ works the other way round: under pressure to meet prudential regulatory demands, some banks have been selling proprietary financial instruments to their retail customers. In this process, significant conduct issues and consumer detriment have shown up. We are currently carrying out some work with our ESMA colleagues and the preliminary findings suggest that often, these proprietary financial instruments were sold – or more accurately mis-sold – as being “as secure as deposits” and protected by a deposit guarantee scheme, or sold without disclosing information on their possible risks or were outright unsuitable for the consumers who bought them, such as pensioners for instance.

Given this interdependence, an adjustment process that overlooked conduct issues would be resting on weak foundations. Dealing with these concerns in an appropriate way will be an important component of the necessary change in business models.