EUROPEAN BANKING AUTHORITY

Roubini Global Economics & the EBA

The Outlook for Europe Post the Macro Stress Scenarios

21 May 2014

The repair of the EU banking sector: Where are we?

EU-wide stress test 2011

- Pre-emptive capital raising
- Credit sensitivities
- Disclosure (capital and sovereign)

EU-wide recapitali-sation

- 9% after sovereign buffer
- EUR 204bn capital strengthening
- CT1 ratio of 11% comparable to US
- EU CT1 sufficient if RWA can be trusted

AQRs

- EBA recommendation
- Common definition of NPL and forbearance
- CAs responsibility
- PIT assessment of capital, with minimum threshold

EU-wide stress test 2014

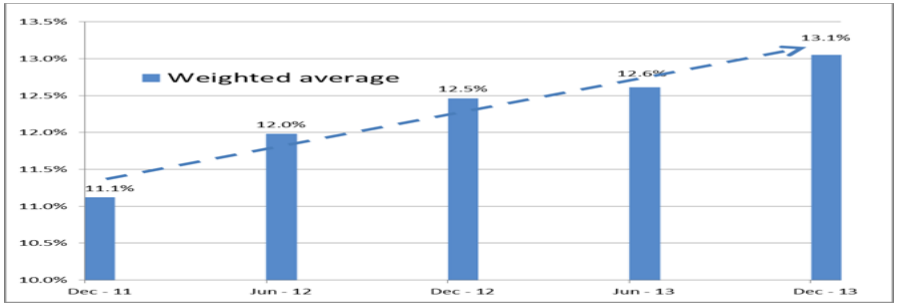
- Forward looking assessment and reaction function
- Significant frontloading

RWA consistency

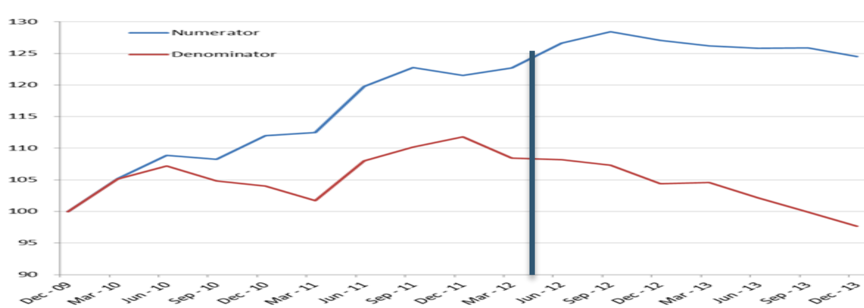
- Ongoing, leading to supervisory consistency, transparency and benchmarking

Capital strengthening: from the EBA recap exercise to "frontloading" ahead of stress test

Tier 1 capital ratio–weighted average (source: EBA Risk Dashboard)

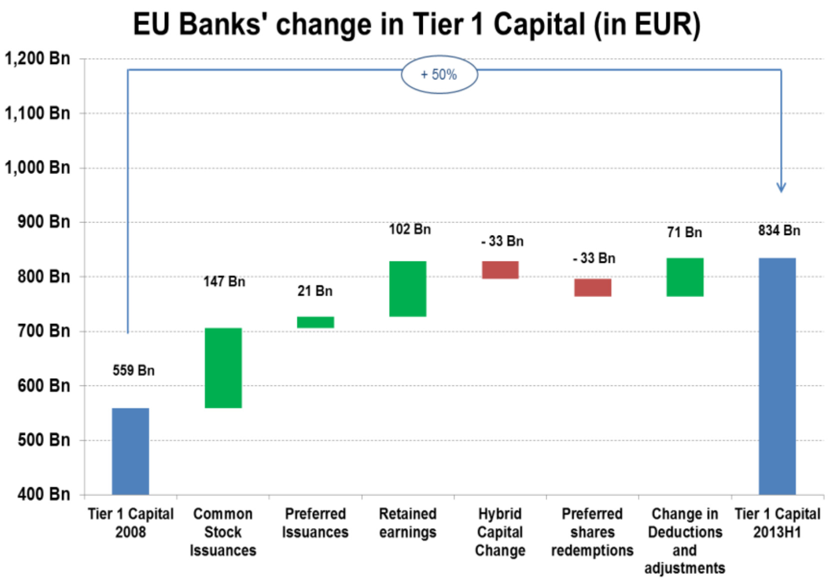


Evolution of Tier 1 capital ratio components (December 2009=100, Source: EBA Risk Dashboard)



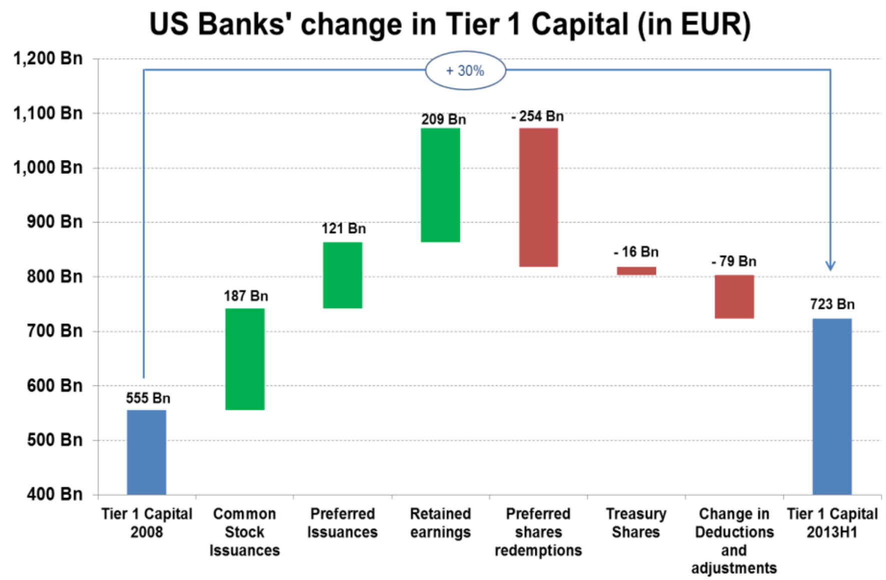
- EU banks' capital positions maintained upward trend. T1 capital ratio weighted average peaked at **13.1%** (up 2 p.p. since Dec-2011).
- **Core Tier 1 ratio** after the EBA's 2011 Recommendation **reached 11.7%** (from 10% in Dec-2011).
- Capital offerings continued in Q4 2013 and first months of 2014, both common equity and hybrids. **Capital raised** – including proceeds from initial public offerings and divestments – is **EUR35bn since July 2013:**
    - **Examples** since July 2013**:** Italy (EUR 10.2bn); Greece (EUR 8.8bn); Spain (EUR 6.1bn); Austria (EUR 3.4bn).
- **CoCos issuance** around **EUR 13bn** (**Q12014**); total **CoCos' market size EUR 73bn and forecast over EUR 100bn in Q42014**.
    - **15 AT1 offerings** of European banks in **Q1 2014**, compared to 8 offerings in total in 2013.

Capital strengthening in the EU and US banks



* Top 20 EU banking groups, total (IFRS) assets at end-2013H1 equal to EUR 20 Tn.

Source: SNL and Bloomberg



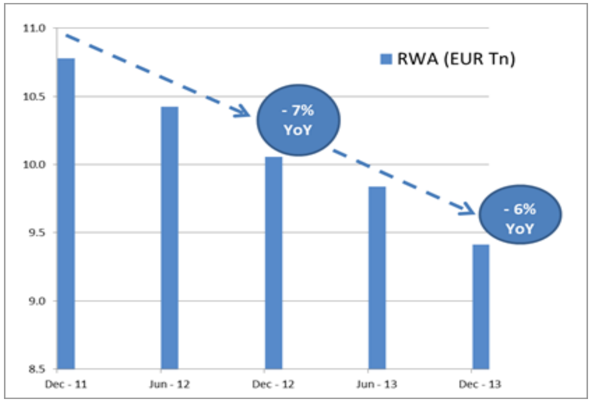
* Top 20 US banking groups, total (GAAP) assets at end-2013H1 equal to EUR 9.4 Tn.

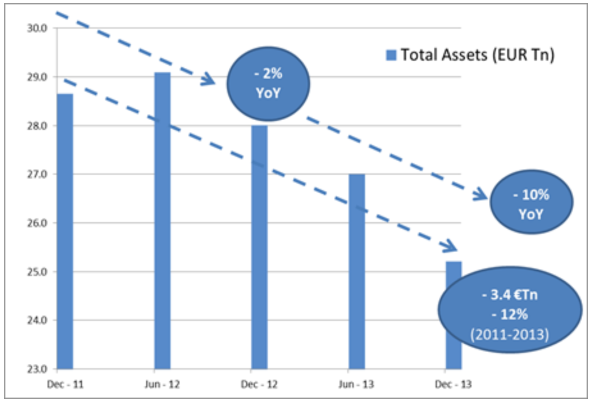
Source: SNL and Bloomberg

- EU banks’ capital positions are on a comparable basis to those of US banks.
- 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 EU banks have increased capital more than their transatlantic competitors.
- US banks have issued more fresh equity and retained earnings to a larger extent, but also conducted significantly more buy-backs.

De-risking and deleveraging

Total assets and Risk-weighted assets – EUR tn (source: EBA Risk Dashboard)

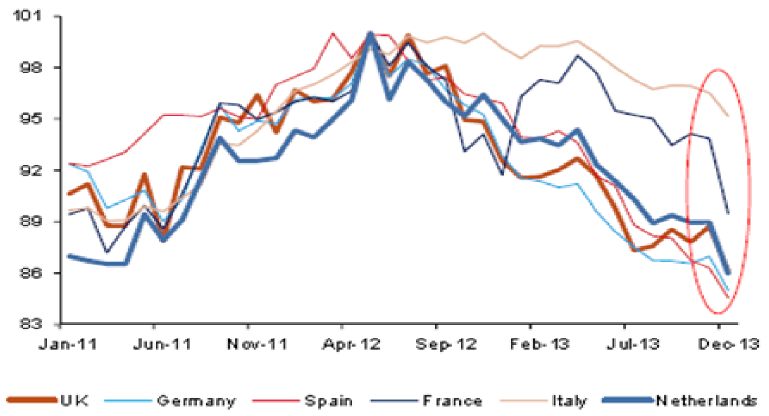




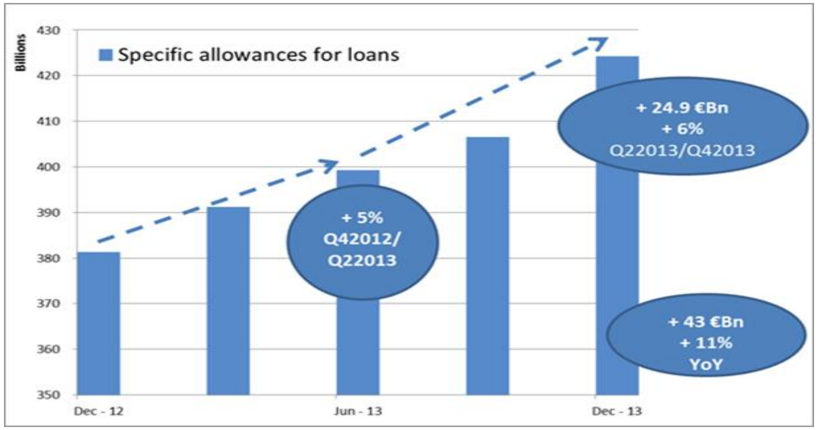
- European banks have accomplished **significant adjustments on the asset side** by
  - cutting risky assets; and
  - shrinking their balance sheets.
- The EBA constrained deleveraging in the 2011 recap exercise, so the adjustment first focused on de-risking – with questions raised on the genuine nature of this adjustment; since spring 2012 also the deleveraging process took speed.
- The position on the CET1 ratio has been broadly addressed, the correction on the leverage ratio has also accelerated in recent months.
- **Positive developments, but no room for complacency**. The AQR has to assess the reliability of these figures and banks may end up needing additional capital. Banks and Supervisors need to be prepared and ready to take actions as a result of these exercises.

Frontloading: Deleveraging and provisioning

Banking system total assets, rebalanced to 100. A significant decrease in balance sheets at the end of the year (Source: ECB data)



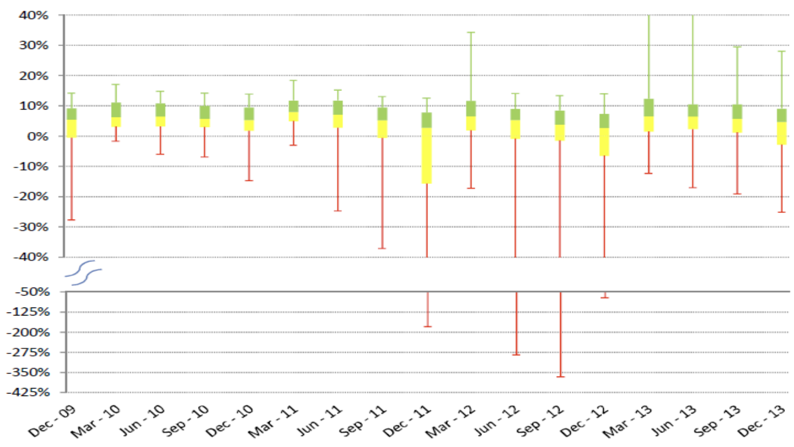
A significant increase of specific allowances for loans, Source: EBA Risk Dashboard



- **Accelerating bank deleveraging** in **December 2013** (AQR cut-off date). S**overeign bond holdings** were reduced and **LTRO repayments** accelerated.
- Increased cleaning of balance sheets ahead of the AQR, with banks **frontloading impairments: a**dditional **provisioning of EUR 25bn** between Jun2013 and Dec2013. Also the recent increase in NPLs might to some extent reflect the new EBA definitions, contributing to a more reliable picture.
- Balance-sheet 'clean-up' for European banks are expected to sell a record **EUR 80bn of noncore loans** in 2014, compared to EUR 64bn in 2013.
- Analysts expect deleveraging to continue, especially in **investment banking**, **trading** and **cross-border wholesale assets**. Deleveraging is expected to be targeted to portfolios and **geographies**.

Profitability: modest recovery stalled

Evolution of ROE (Source: EBA Risk Dashboard)



- Return on equity (**RoE**) (weighted average) has decreased **to 2.7%** (at the end of Q4).
- Cost-cutting plans contributed to reducing core costs, but due to **restructuring and litigation costs** the average weighted **cost-to-income ratio has increased (from 59.6% in Q3 to 63.3% in Q4)**.
- **Banks plan to improve their efficiency** mainly by **reducing the overheads** and **disposing non-profitable units**.
- **Further costs from restructuring, misconduct fines and settlements are expected** to affect profitability in future. The size and scale of the bulk of charges should become clearer in 2014, but they could easily depress returns and delay capital payouts.
- Banks have targeted cost programs of around 10% of expense base of which one-third has been achieved

What drives the EBA stress test methodology

Motivation

Why?

Microeconomic perspective
- Assessing cross border groups
- Comparability across markets

Macroeconomic perspective
- Concentrations and correlations
- Systemic shocks

What?

- Consistent, relevant and efficient EU-wide stress test
- 124 consolidated banks, 28 jurisdictions, 80% of total assets in the EU

Components of EU-wide stress test

Tools
- Comprehensive, consistent and relevant scenario
- Constrained bottom-up methodology (key features, risk quantification, templates)

Trans-parency
- Detailed disclosure to inform supervisors and market participants

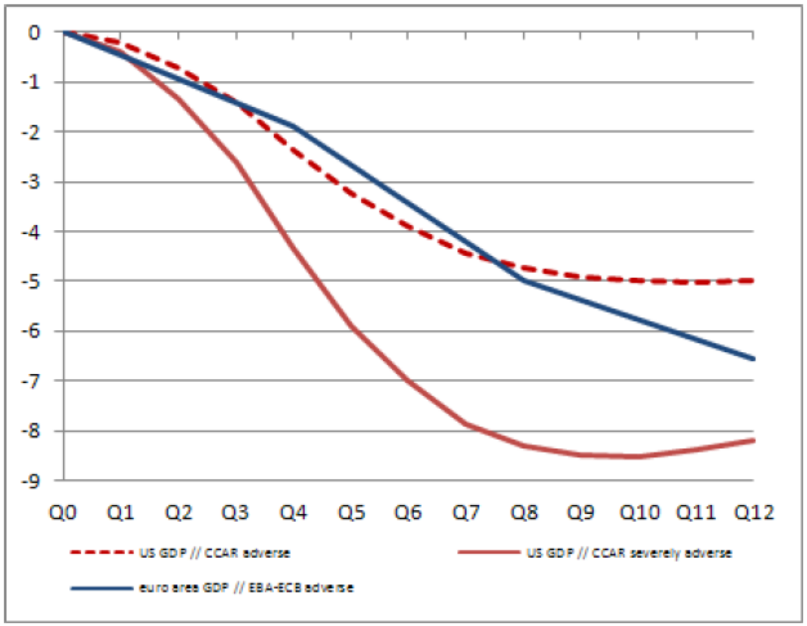
Co-operation
- Cooperation amongst supervisors and other involved parties

Overview key features (1/2)

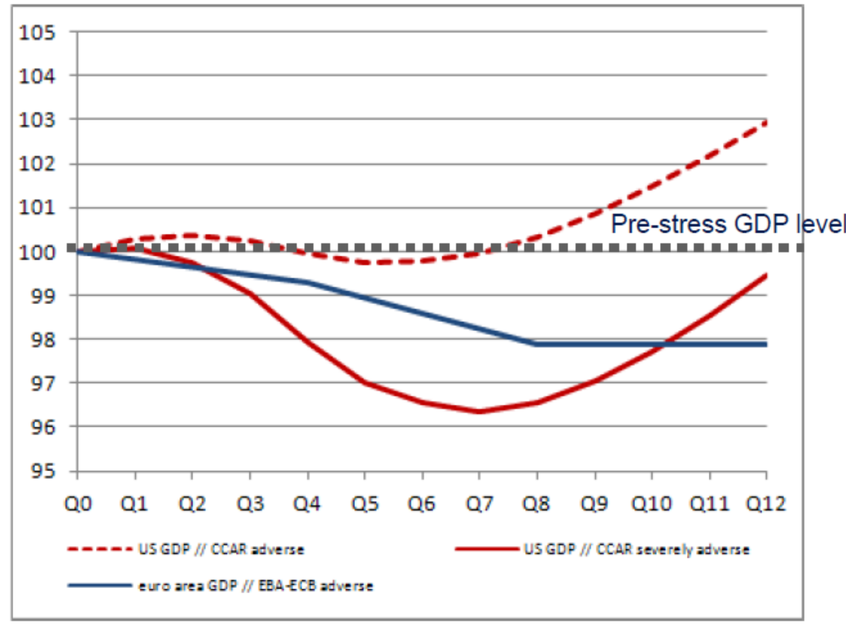
Consolidation	• Highest level of consolidation • Perimeter of the banking group as defined by the CRD/CRR
Scenario	• Common baseline and adverse macro-economic scenarios and stressed market parameters for positions sensitive to a change of market prices • CAs may develop additional sensitivities to incorporate country specific features
Time-horizon and reference date	• Consolidated year-end 2013 figures • Scenarios applied over a period of three years (from 2014 to 2016)
Capital	• CET1, with transitional arrangements; CoCos converting into CET1 or written down upon trigger are reported if trigger is above the CET1 ratio in the adverse scenario • CAs may, in addition, assess the impact of the stress test on other yardsticks • Common application of prudential filters

Comparison to CCAR – domestic GDP ratios

Cumulated impact on domestic GDP
(percentage deviation from baseline)



Domestic GDP levels incl. baseline
(pre-stress Q0 GDP is scaled to 100)



Source: ESRB

Overview key features (2/2)

Hurdle rate

- 8% Common Equity Tier 1 ratio for the baseline scenario
- 5.5% Common Equity Tier 1 ratio for the adverse scenario
- CA may calibrate possible supervisory measures based on a ladder of intervention points and set higher hurdle rates

Static balance sheet

- Zero growth assumption for baseline and adverse scenario and same business mix
- Assets and liabilities that mature replaced with similar financial instruments in terms of type, credit quality and original maturity; no workout of defaulted assets
- Exemption due to mandatory restructuring plans announced before reference date

Risk coverage

- Solvency stress test – credit risk, market risk, sovereign risk, securitisation, cost of funding, non-interest income and costs, operational risk; no liquidity stress test
- CAs may include additional risks but results reported under common approach

Process

- EBA responsible for common methodology, templates, disclosure
- Competent authorities responsible for quality assurance and reaction function
- Outcome of AQR may inform starting point

Funding costs-constraints imposed in three steps

Sovereign spread → **Funding costs** → **Lending rates**

Sovereign spread

- Banks are required at a minimum to reflect the changes in their domestic sovereign bond spreads in the funding costs

Funding costs

- Wholesale funding costs should be adjusted by at least 100% of the change in sovereign bond spreads at the appropriate maturity
- At a minimum 50% of the increase in sovereign bond spreads (relevant maturity) should be passed through to corporate deposits rates
- At a minimum 30% of the increase in sovereign bond spreads (relevant maturity) should be passed through to household deposits rates

Lending rates

- Banks should not assume an ability to pass through more than 75% of the increase in total marginal funding costs to new lending
- For residential mortgages banks should instead apply a cap of 50%

Overview sovereign risk methodology

Scope	• Sovereign exposures (direct debt exposures as well as indirect exposures to central and local governments) • Assessed at fair value (HfT, AfS, fair value through profit and loss) and amortised cost positions
Methodology	• All fair value positions: application of market risk methodology for impact of changes in market prices • Regulatory banking book positions excl. AfS: application of credit risk methodology for impairment estimates based on rating migration defined by ESRB/ECB
Impact on P&L	• Direct P&L and OCI impact for positions accounted for at fair value; common 'minimum' transitional requirements for prudential filters, e.g. including 20% of unrealised losses in 2014, 40% in 2015 and 60% in 2016 • Further impairment estimates for regulatory banking book assets excl. AfS
Impact of RWA	• RWA increase due to worsened risk parameters in IRB and STA for full banking book

Overview disclosure: 9 templates, 12k data points

P&L	• Main P&L items like net interest income, net trading income, impairments for financial assets and other comprehensive income	~130
Credit risk	• Exposure, RWA, value adjustments, provisions, default and loss rates • No disclosure of credit risk parameter	~6,500
Market risk	• Market risk position by main risk types	~40
Securitisation	• Securitisation exposure, RWA and impairments	~50
Sovereign	• Sovereign exposure by country, maturity and accounting treatment	~4,930
RWA	• RWA by risk type	~50
Capital	• Capital position, components, adequacy including, stressed • Capital restructuring	~310

Cooperation in the European stress testing universe

- Common methodology, templates
- Data hub for final dissemination
- Benchmarking tools for competent supervisors

- Responsibility for quality assurance
- Assessment of banks' assumptions, data, estimates and results
- Definition and communication of any additional sensitivities
- Supervisory reaction function

- Common scenario (in cooperation with ECB, NCAs)

Going forward: Overview of the main risks and vulnerabilities in the EU banking sector

Main risk (source: EBA Risk Dashboard) | **Addressed in EU-wide stress test?**

		Bank risk	Risk drivers	Level of risk	Forward Trend	Addressed in EU-wide stress test?
Capital	Pillar 1	Credit risk	Asset quality	🔴	→	☑
		Market risk	Hightened volatility, hedge effectiveness	🟡	↑	☑
		Operational risk	Cost cutting	🔴	→	(☑)
	Pillar 2	Concentration risk, IRRBB and other	Interest rates	🟡	→	☑
		Reputational and legal	LIBOR/Euribor investigations, mis-selling	🔴	→	(☑)
		Profitability	Margins, asset quality, provisions workout, business model changes	🔴	→	☑
Liquidity & Funding		Access to funding and Maturity distribution	Market confidence, pricing	🟡	↓	☑
		Funding structure	Geographical fragmentation of funding markets. Leverage.	🔴	↓	☑
Environment		Regulatory environment	Timing and scope of implementing regulatory initiatives	🔴	→	
		Fragmentation	Continued lack of confidence, sovereign/bank link, national-only regulatory/policy initiatives	🔴	→	☑
		Sovereign risk	Fiscal policy and effectiveness, budgets imbalances	🔴	↓	☑

- Most main risks seen for the banking sector are directly addressed via the risk types in scope of the EU-wide stress test.
- Operational and reputational risk requirements are not explicit yet in the stress test and depend on assumptions made by banks. In future need to think about conduct and IT risks
- Only regulatory risks are not covered.

Thank you!

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