The EU banking sector - risks and recovery
A single market perspective

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ESM | 30 January 2017

Contents: repair and recovery in the EU banking sector

Repair

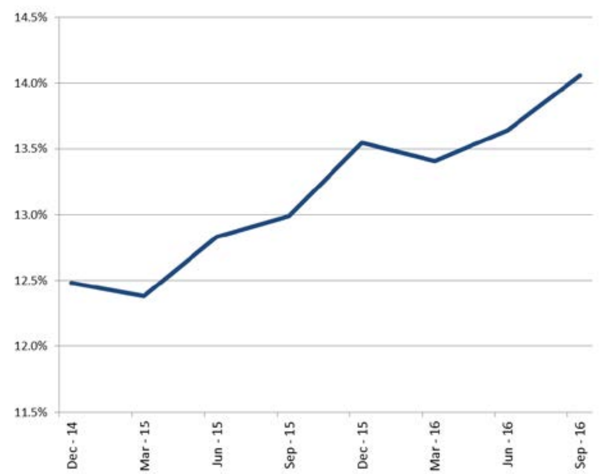
- Capital
- Funding markets

Recovery

- Profitability
- Asset quality
  - A single market perspective on NPLs
  - Possible measures for dealing with NPLs

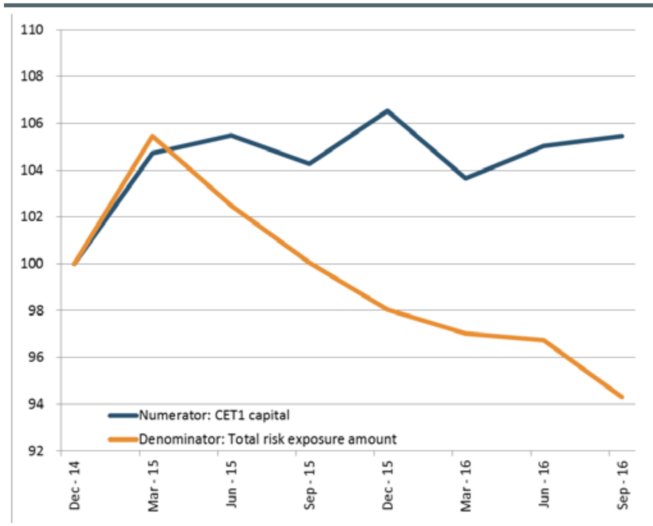
Strongly rising CET1 ratios, supported by decreasing RWA and increasing capital

CET1 ratio (weighted average).



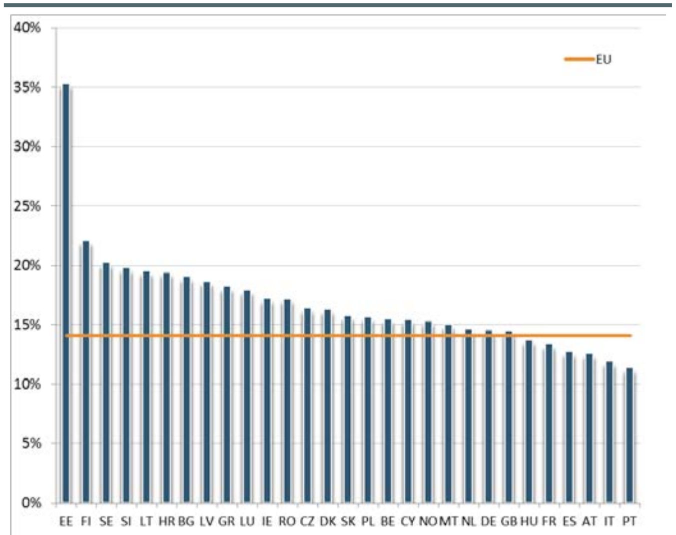
- The CET1 ratio has increased by 50 bps to 14.1% in Q3 2016. This effect is explained by the growth in capital (mainly driven by higher 'retained earnings') as well as a decrease of RWAs.
- On a fully loaded basis, the CET1 ratio showed a similar development, increasing by 40 bps to 13.6% when compared to the past quarter.
- Also for T1 and total capital ratios the trend was comparable.

CET1 ratio: trends of numerator and denominator.



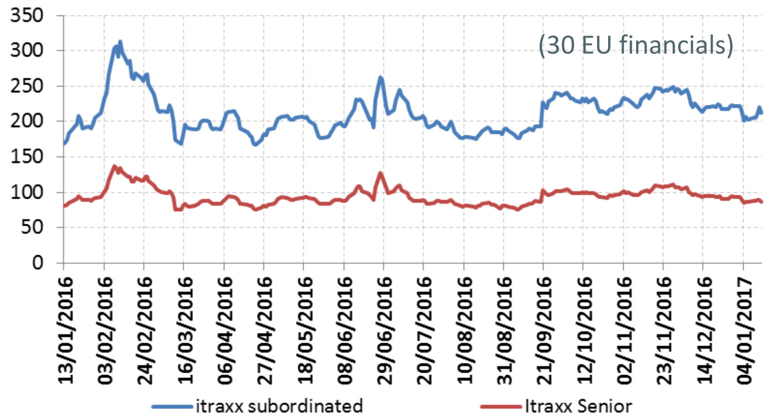
Source for all charts: RDB (Q3 2016 data).

CET1 ratios (weighted average by country).



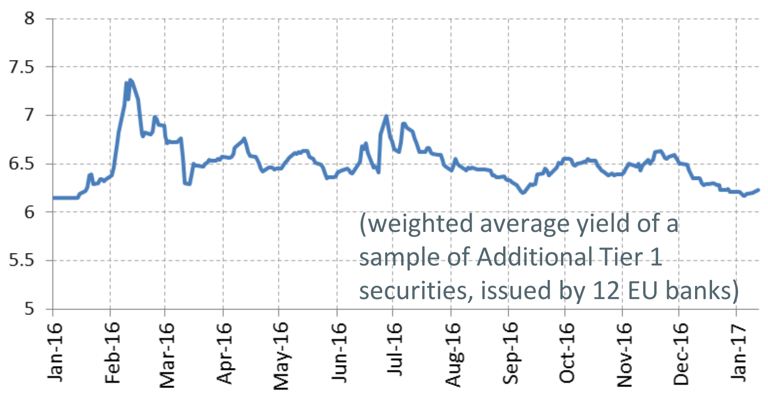
Strong start of banks' funding market into the new year

iTraxx financials of sen. unsec. and subord. funding.



There was a roll-over of respective iTraxx indices on 19 / 20 September, for which reason a widening of the spreads can be seen at this date

AT1 mid yield composite (in %).



Source for above charts: Bloomberg, EBA calculation.

- Strong funding market activity in the first two weeks of 2017: low new issuance premia, secondary market spreads slightly compressing and demand for European bank debt was very strong from investors with ample cash positions.
- Issuance activity included AT1s, T2s, senior unsecured, senior non-preferred, and covered bond issuances, from core and peripheral countries.

Business model and impediments to sustainability

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Non performing loans

- Expensive to maintain
- Misallocation of capital

Urgent & actionable

Costs

- Restructuring, regulation and IT spending
- Conduct redress costs globally since 2007 estimated at more than USD 220 bn

Competition

- Fin tech = Future competition in individual services
- Peer to peer & Payments systems

Long term strategic planning required

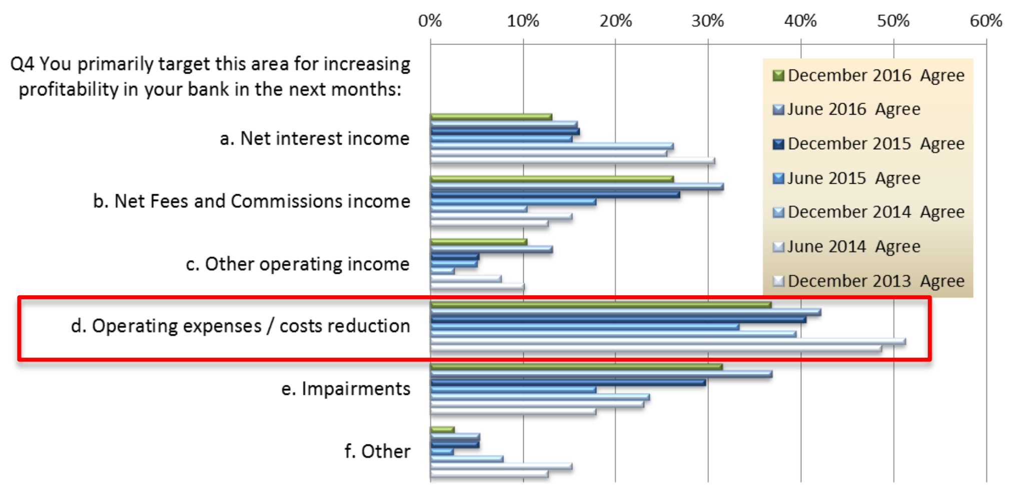
Low interest rates

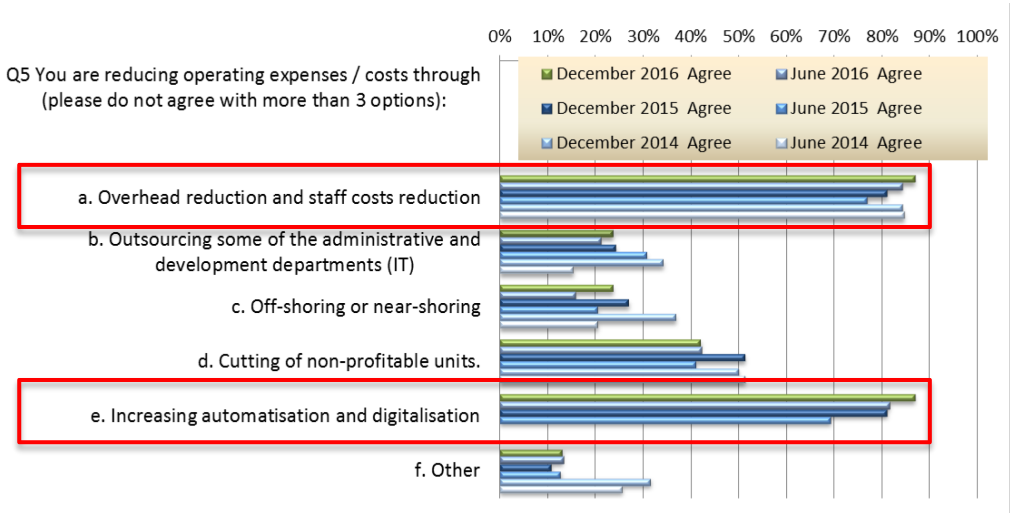
- Very narrow net interest margins and legacy products
- Sharp switch may do more harm!

exogenous

Costs reduction remains in banks' focus for increasing profitability

Banks' primary targets for increasing profitability and cost reduction measures.



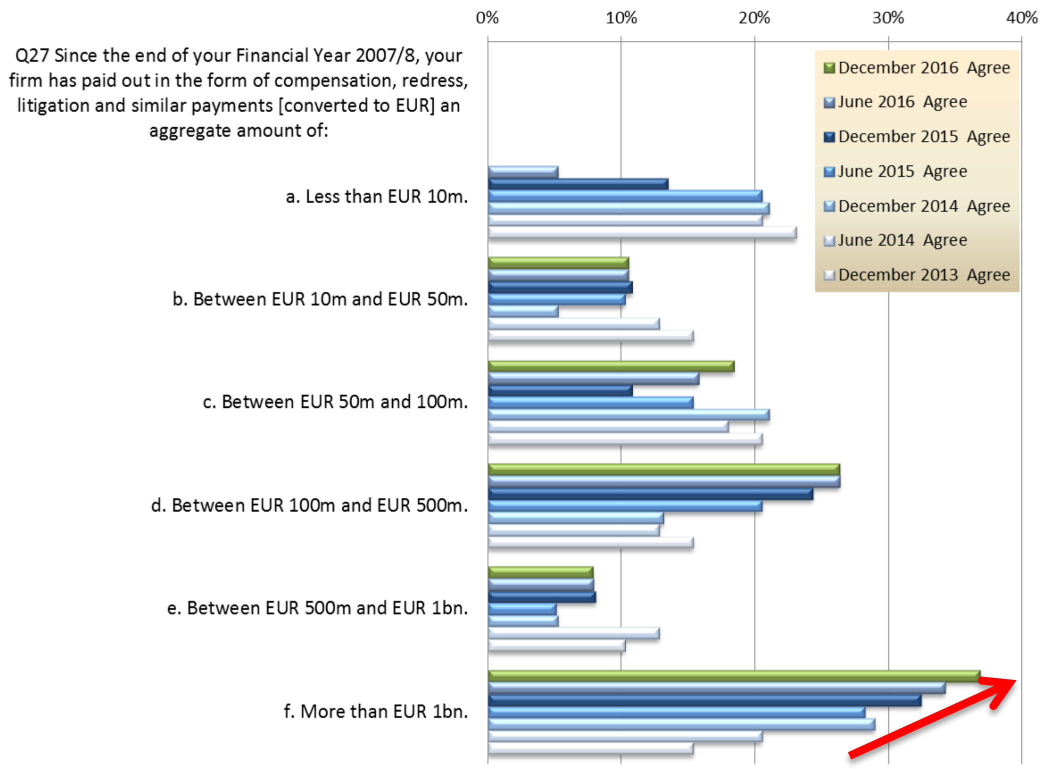


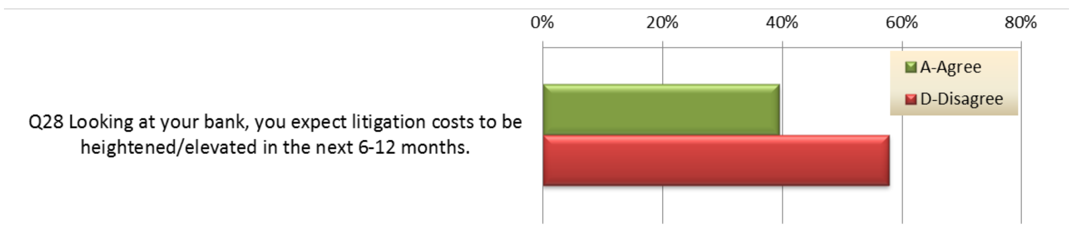
Source : EBA Risk Assessment Questionnaire for banks (year end 2016).

- About one third of the banks target cost reductions as their primary target for increasing profitability, according to the results of the EBA's Risk Assessment Questionnaire (conducted in October / November 2016).
- This shall mainly be reached by reduction of overhead / staff costs as well as increasing automatisation / digitalisation (nearly 90% agreement).

Conduct costs remain a drag on banks' profitability

Banks' primary targets for increasing profitability and cost reduction measures.



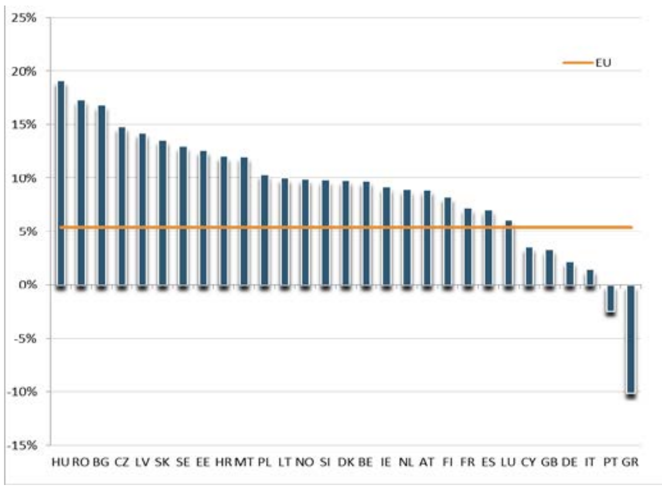


- Over 44 % of respondents to the EBA's Risk Assessment Questionnaire have paid out more than EUR 500 million in compensation, litigation and similar payments since the financial year 2007/08 (according to the RAQ, as of December 2015 agreement with this statement was 42 %).
- The share of banks having paid out more than EUR 1 billion further increased from 32 % in the December 2015 RAQ to 37 % in the December 2016 RAQ.
- 40% of the banks assume litigation costs to be heightened in the next six to twelve months.

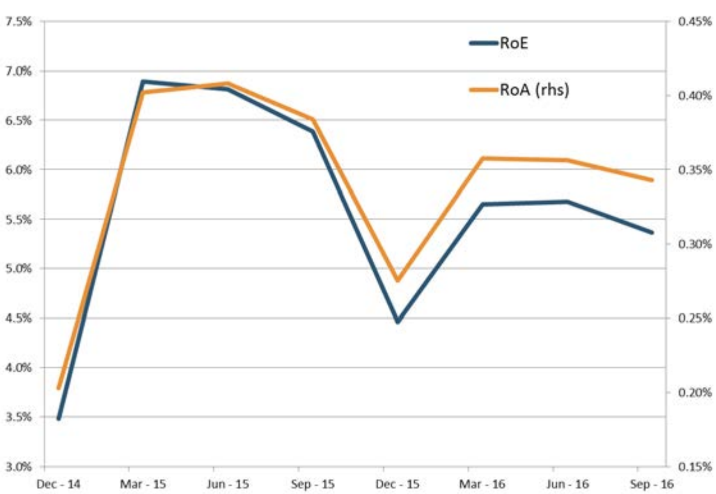
Source for all charts: EBA Risk Assessment Questionnaire (year end 2016).

Profitability remains subdued

RoE (weighted average by country).



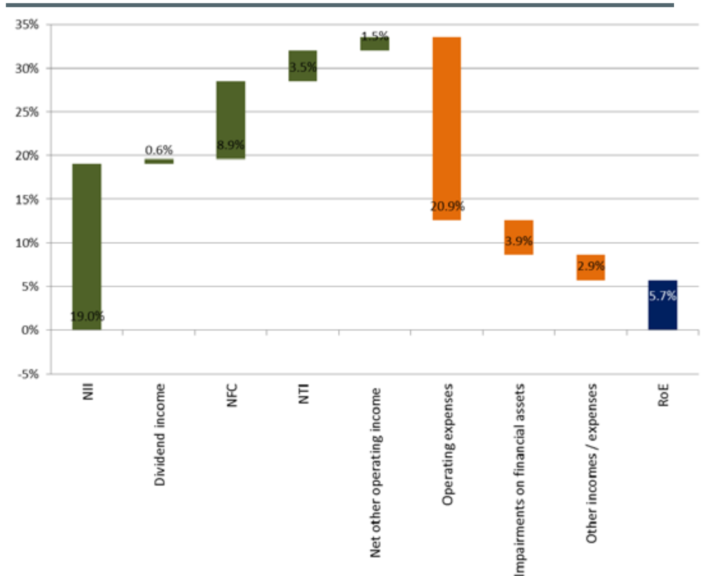
RoE vs. RoA (weighted average).



Source for all charts: RDB (Q3 and Q2 2016 data).

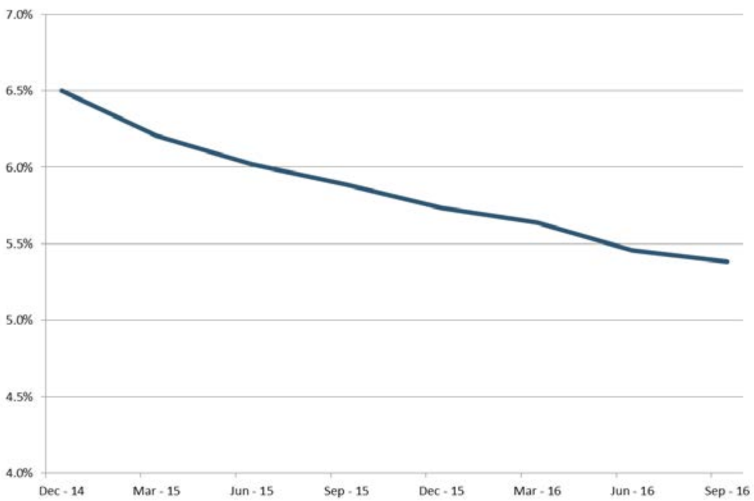
- The annualised return on equity (RoE) in Q3 2016 decreased to 5.4%, one percentage point (p.p.) below the third quarter last year. The RoE also decreased when compared to Q2 2016 (5.7%).
- Banks' interest income (at 19.0% of banks' equity per June 2016) is not sufficient to cover their operating expenses (at 20.9% of banks' equity). Fees and commissions income do not grow enough to compensate for banks' impaired capacity to generate net interest income (Q2 / RAR data).

Decomposition of RoE (EU aggregate) — June 2016



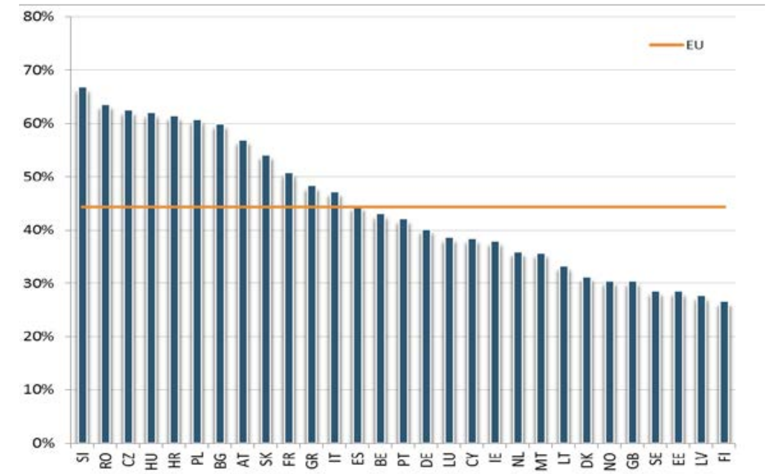
Asset quality remains poor, with only slightly improving NPL ratio

NPL ratio (weighted average).



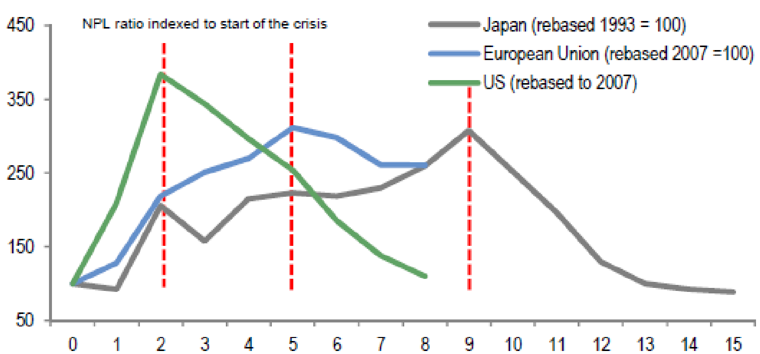
Source: EBA RDB (Q3 2016 data).

Coverage ratios (weighted average by country).



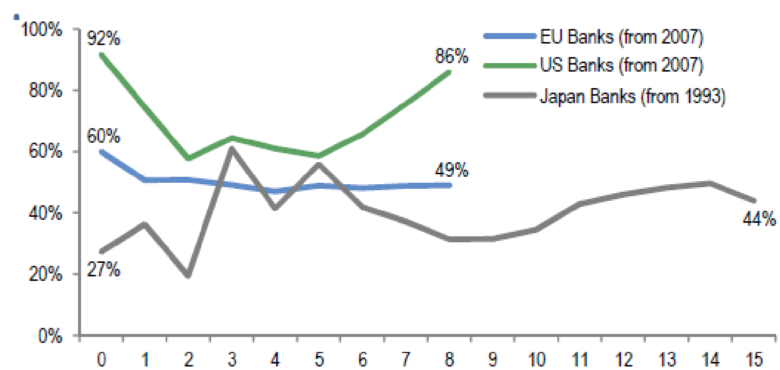
- NPL ratio has continued the trend of previous quarters, decreasing 10 bps to 5.4% in Q3 2016.
- The coverage ratio for NPLs has improved, increasing by 50 bps to 44.3% in Q3 2016.

European Banks' NPL recognition faster than Japan early 90s crisis but slower than US banks



Source: FDIC, FSA Government of Japan, World Bank, J.P. Morgan estimates for EU 2015e data. NPL ratio defined as Non Performing Loans as % of total loans.

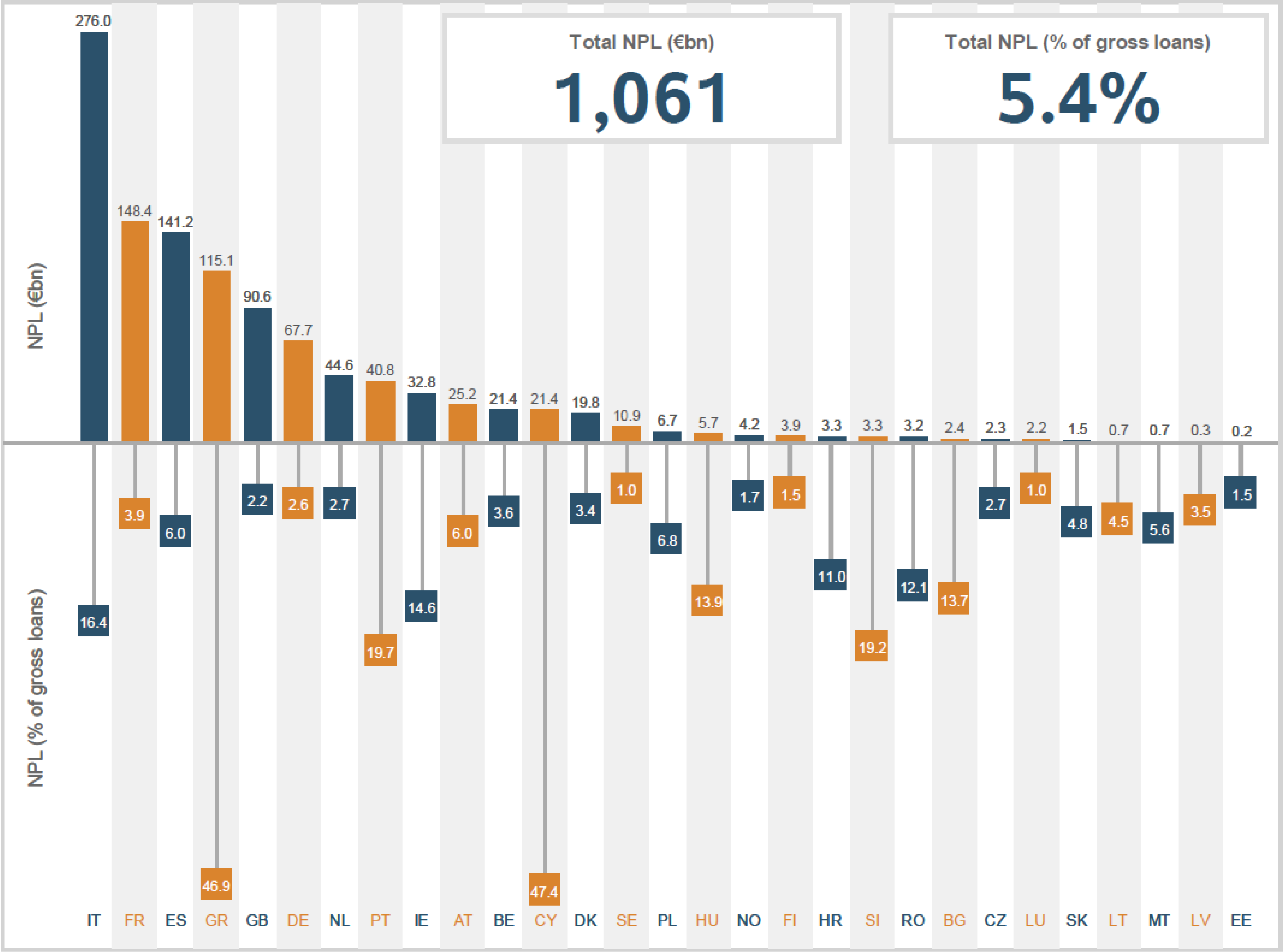
European banks' NPL coverage too low to clear



Source: ECB, FDIC. Note: FDIC insured institutions; All Domestic Banks for Europe. NPL coverage defined as provisions as % of NPLs

Source: JPM

NPLs in the EU: country breakdown (June 2016)



Source : Supervisory reporting data (Q2 2016).

Significant differences across countries, but an EU problem

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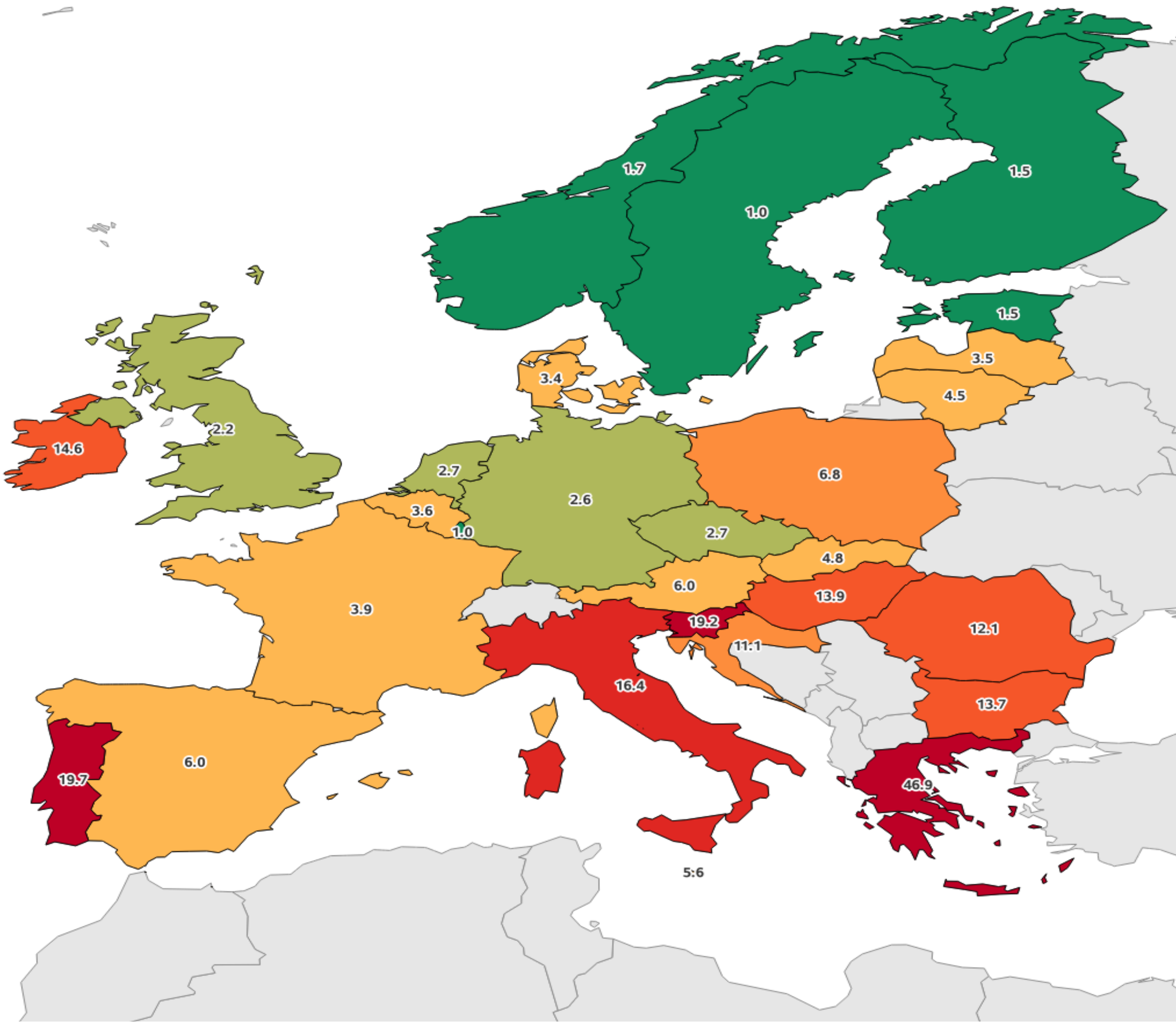
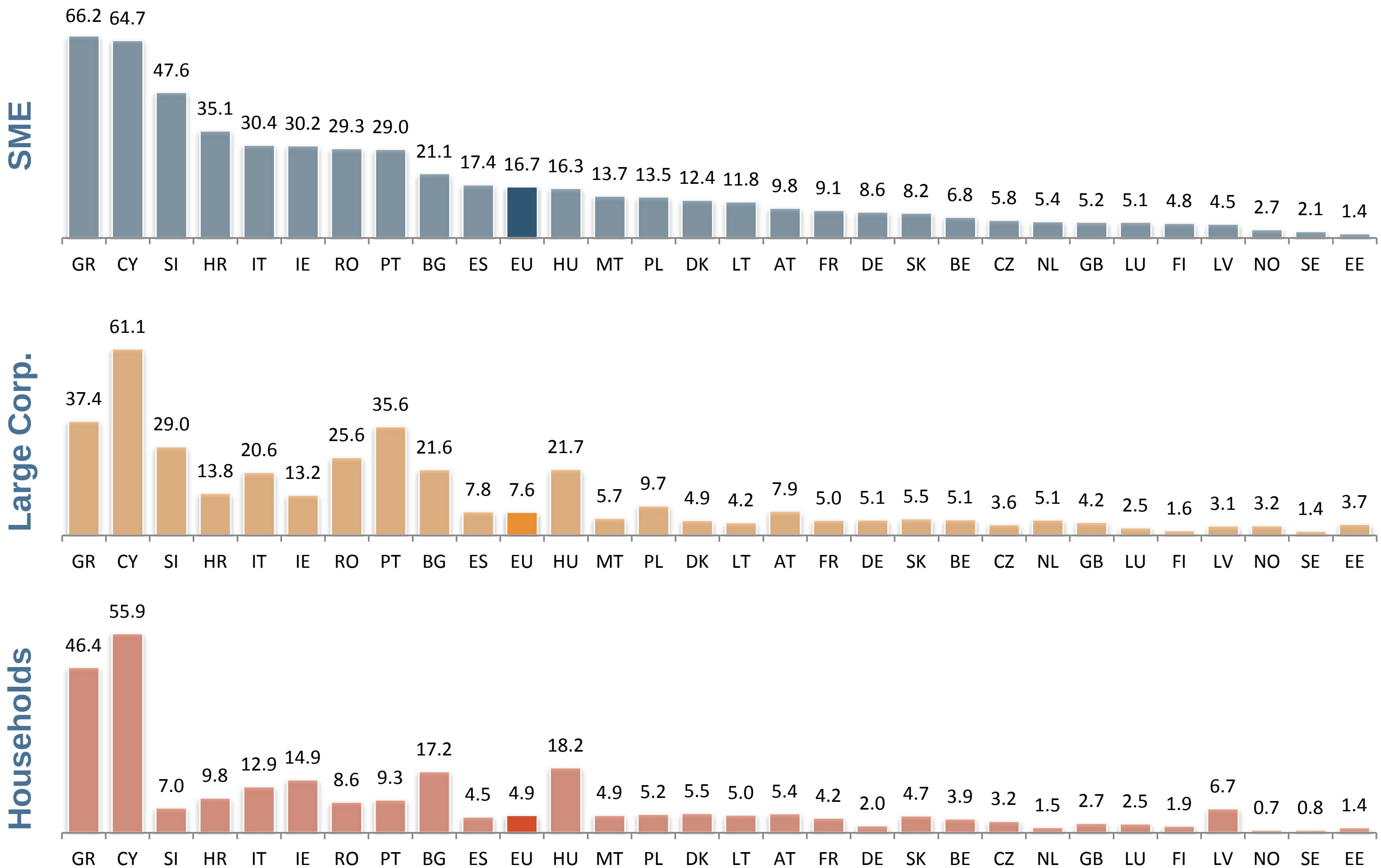


- **More than EUR 1 trillion NPLs in the EU**
- **10 countries with NPL ratio above 10%**
- **Bank/sovereign link**
- **Spill-overs**
- **Impairment of lending channel for monetary policy**

Source : Supervisory reporting data (Q2 2016).

Breakdown of NPLs ratio by counterparty



Percentage values.

Source : Supervisory reporting data (Q2 2016).

NPLs: Market failures and market impediments

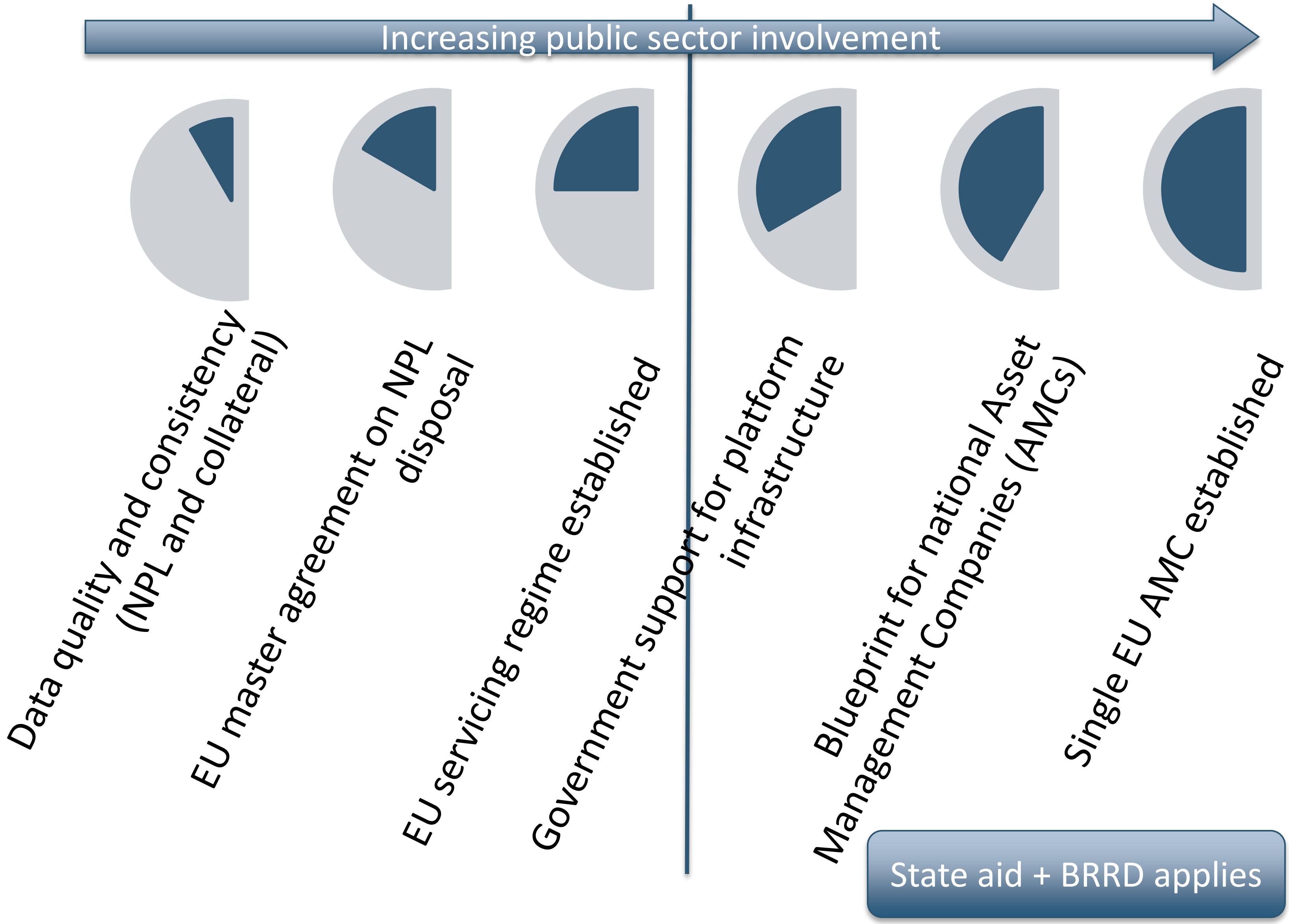
Market failures :

- **Banks' incentives to dispose at a loss**
- **Structural failures such as legal systems**
- **Information asymmetry between buyers and sellers**
- **Intertemporal pricing problem and first mover disadvantage**

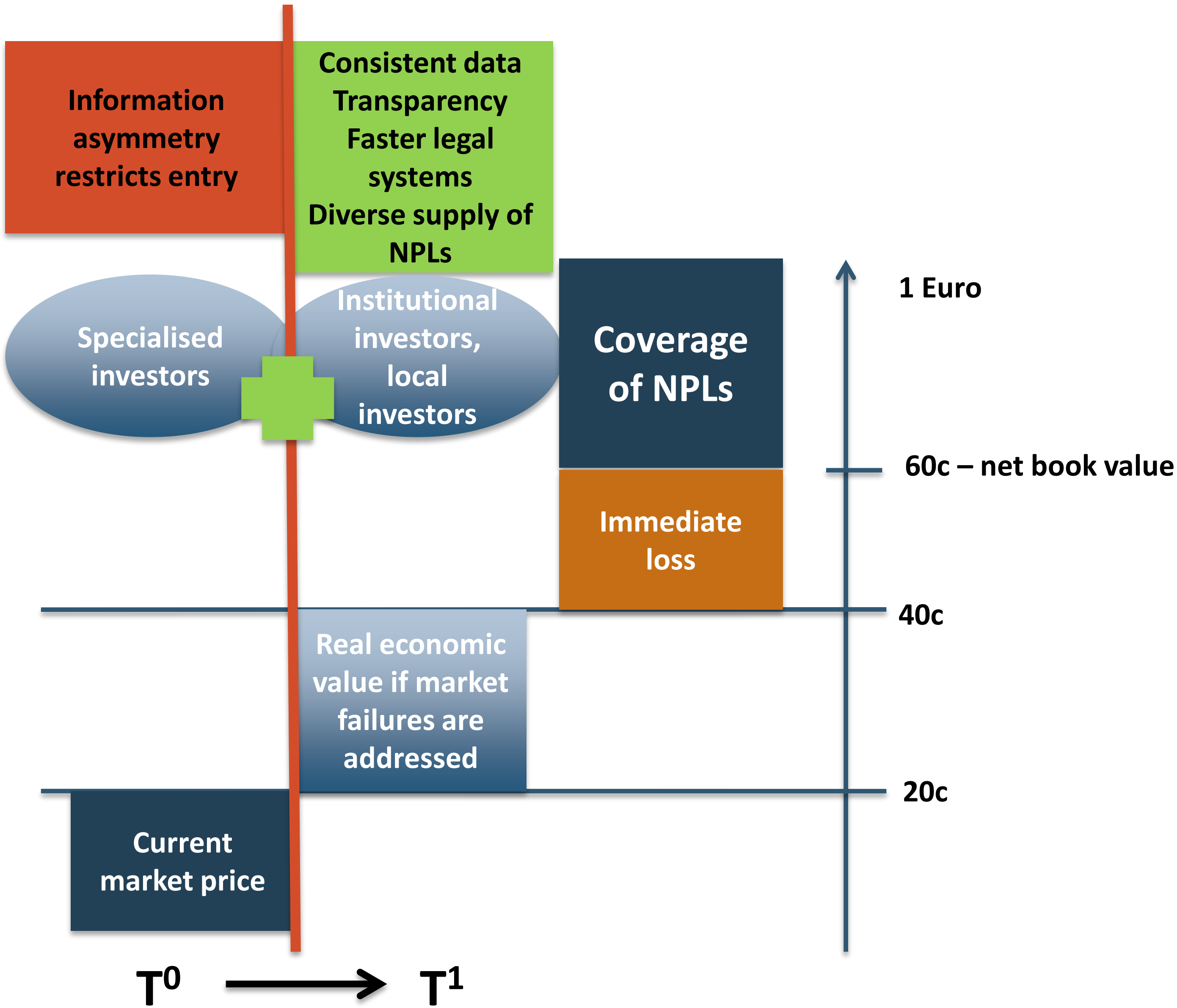
Corrective actions

- Incentivise action through supervisory pressure and tax changes .
- *Fix legal and insolvency regimes*
- *Consistent **data, easily** available to investors,*
- ***Transparency of existing NPL deals***
- *Simplify and **standardise legal contracts***
- Overcoming market illiquidity issues by providing price clearing at "real economic value"

A spectrum of official sector actions



Addressing market failures



AMC some possible features

1. Stress tests are used to identify the total envelope of potential state aid for each bank

- e.g., capital shortfall against P2 minimum capital requirements under a three year adverse provisioning assessment reflecting stressed market prices.

2. Assessment of real economic value vs current market prices is designed, by asset class/geography.

3. The AMC is established with government support

- AMC crowds in funds from private investors.

4. Banks transfer some agreed segments of their NPLs to the AMC at the real economic value,

- Under due diligence from the AMC and accompanied by full data sets available to potential investors.
- The transfer of assets to an AMC would in the first instance hit existing shareholders at any transfer price below book value.
- The difference between current market prices and real economic value could be the theoretical extent of state aid under precautionary recap but in this interim period financed by AMC capital and private investors.

5. The AMC sets a timeline (e.g. three years) to sell the assets at the real economic value.

- If that value is not achieved, the bank must take the full market price hit. A recapitalisation is exercised by the national government as state aid with the full conditionality that accompanies that.

FAQs

- **Are existing shareholders safeguarded?** No, they bear an immediate loss if the net book value is higher than the transfer price to the AMC (i.e. the real economic value) and are diluted if the eventual sale price is lower than the transfer price and a recapitalisation is necessary.
- **Are BRRD rules suspended?** No, the BRRD applies, in particular the concept of precautionary recap.
- **Are State aid rules ignored?** No, if the clawback clause is activated because the eventual sale price is lower than the transfer price to the AMC (i.e. the real economic value), the bank is recapitalised and State aid conditionality – including burden sharing – applies.
- **If an EU-wide AMC is established, will there be a risk of losing any EU money?** No, since if eventual sale price is lower than the transfer price to the AMC (i.e. the real economic value) a clawback clause applies.
- **Would there be burden sharing across EU countries?** No, since if the clawback clause is activated, it is the Member State injecting capital in the bank

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Overview of the main risks and vulnerabilities

		Bank risk	Risk drivers	Level of risk: Last quarter (memo) Level	Last quarter (memo) Expected Trend	Current quarter Level	Current quarter Forward Trend	Contributing factors/interactions
Capital	Pillar 1	Credit risk	Slow reduction of NPLs, structural and market impediments for NPL reduction, risk of rising impairments	🟥	→	🟥	→	Banks only slowly reduce their non-performing legacy assets. Among the main impediments to a faster reduction are slow judiciary and repossession processes as well as inefficient secondary markets. Also, low market prices for NPLs, which are often below their net book values, negatively affect the bank' efforts to reduce NPLs. Even though flows of new impairments are currently rather low in historical comparison, they might again increase, depending on future economic developments in emerging and developed markets.
Capital	Pillar 1	Market risk	Heightened market volatility, risk from declining market liquidity	🟥	→	🟥	→	Financial markets have remained volatile, increasingly driven by political events. Volatility is expected to persist. There is a persistent risk of a sudden decrease in market liquidity, which would additionally accelerate market volatility.
Capital	Pillar 1	Operational risk	Risks from IT outsourcing, fragmented and ageing IT systems, cyber attacks	🟥	→	🟥	→	As banking operations increase their dependence on IT platforms and telecommunication networks, concerns about connectivity and outsourcing to third party providers have increased. Operational risks are also negatively affected by fragmented and ageing IT systems. Cyber-attacks remain a threat.
Capital	Pillar 2	Concentration risk, IRRBB and other	Low interest rate environment	🟨	→	🟨	→	The current low interest rate environment remains a burden on banks' profitability. But also a potential increase in interest rates might in the short term pose additional threats to banks' profitability, with faster-rising refinancing costs than interest income. An environment of low interest rates contributes to banks' increased appetite for higher risk exposures.
Capital	Pillar 2	Reputational and legal	Existing and new cases of misconduct, lengthy processes till settlement	🟥	→	🟥	→	Compensation and redress payments remain high. Lengthy processes until cases of harmful practices are settled add to uncertainties among consumers and banks. New occurrences of misconduct regularly come up.
Capital	Pillar 2	Profitability	Low interest and fee income, stickiness of costs	🟥	↑	🟥	→	Declining interest and fee income negatively affect banks' operating income. Profitability is additionally negatively affected by the stickiness of banks' costs.
Liquidity & Funding		Access to funding and maturity distribution	Reduced issuance volumes amid heightened market volatility	🟨	↑	🟨	→	Perceptions of heightened uncertainties have intensified and negatively affect banks' funding markets. In periods of heightened market stress, banks significantly reduced their issuance volumes of both unsecured and secured debt during recent months. However, most of the banks had already met their issuance needs for the year before so that they have not been under pressure to go to the markets at such time. Banks' maturity profile is unevenly distributed in the medium term.
Liquidity & Funding		Funding structure	Important role of central bank funding and deposits	🟨	→	🟨	→	Banks remain vulnerable in their funding mix to heightened market volatility. Most banks still have to issue MREL eligible instruments to meet own requirements, which might also negatively affect their funding costs. Central banks continue to play a major role in banks' overall funding mix. There is also a high weight of deposits in banks' funding mix. Even though deposits contribute to a stable funding mix, they might be volatile in severe stress scenarios.
Environment		Regulatory and legal environment	Risk weighted assets	🟨	→	🟨	→	Regulatory uncertainty includes, but is no restricted, to change in respect of risk weighted asset requirements, including potential minimum risk weights for sovereign exposures.
Environment		Fragmentation	Asset quality, profitability	🟥	→	🟥	→	Fragmentation of asset quality and profitability remains high among jurisdictions. The political risk might further negatively affect fragmentation.
Environment		Sovereign risk	Political risk, debt overhang	🟥	→	🟥	→	Increased political uncertainty adds to elevated risks from banks' sovereign exposures, driven by their increased volatility. Risks from a large debt overhang in some countries remain high.