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Where there is a will, there is a way: completing the repair of the banking sector in Europe

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1. Introductory remarks

The balance sheet repair of the EU banking sector has progressed, contributing to restore the trust of market participants in European banks. The EBA has coordinated a joint supervisory effort to increase the quantity and improve the quality of capital of EU banks. As a result, since 2011, banks have increased their highest quality capital ratios by 500 basis points (bps), from an aggregate 9.2% Core Tier 1 ratio in 2011 to 14.2% Common Equity Tier 1 (CET1) ratio in December 2016. Common equity increased by nearly €200bn in the period from December 2013 to December 2015. Major EU banks' capital ratios are now comparable to their US peers. Extensive asset quality reviews (AQRs) have been carried out in most EU countries in order to identify problematic assets and strengthening banks' provisioning policies.

Capital strengthening and the identification of problem assets have been pivotal in re-establishing confidence in EU banks, but have not proved enough for the complete repair of the banking sector. According to the most recent data, the stock of non-performing loans (NPLs) currently stands at about one trillion euros and the average NPL ratio is 5.1%, with ten jurisdictions reporting average NPL ratios of over 10%. Therefore, cleansing banks' balance sheets remains the last and crucial step in this repair process. This is now imperative because of the scale of the NPL problem across the EU and its impact on economic recovery, with capital trapped in non-performing investments rather than used to finance the economy. Also, high levels of NPLs are a significant drag on banks' profitability and capital generation, raising concerns as to the long term viability of business models.

There is debate on whether asset quality is a European or rather a national problem. In my view, while it is certainly true that there are differences in NPL levels across countries, three arguments suggest this is a Single Market issue. The first is the high absolute volume of NPLs in the EU, including in its largest economies. The second one is the direct and indirect exposure of large EU banks to NPLs across borders. The third relates to banks' inability to resume new lending in some jurisdictions, which hinders the effective functioning of the transmission channel of monetary policy and holds back economic growth across the EU.

In this speech, I will first recall the range of actions needed to tackle the issue of legacy assets in banks' balance sheet and encouraging the disposal of those assets. I will then focus on our proposals for restarting the secondary market for NPLs.

2. No silver bullet but a comprehensive toolkit

Very often, especially lately, the discussion on NPLs tends to be very much polarised. On one side, there is a clear preference for a market-based solution, possibly encouraged – or forced – by some sort of supervisory action in line with current rules on resolution and State aid. On the other, there are calls for acknowledging the exceptional nature of the crisis and, thus, for a public intervention conducted under a temporary exemption from current rules – evocatively referred to as Bank Recovery and Resolution Directive (BRRD) "holiday".

Both are corner solutions and, by construction, sub-optimal. The first could create financial instability in the form of fire-sales of NPLs determining, in turn, the resolution of large parts of the EU banking sector in the face of widespread market failures. The second one – in de-facto superseding post-crisis rules – would reignite moral hazard and dent the public's confidence in the regulatory reforms.

I believe, however, that there is room in between these solutions for an acceptable and incentive-compatible comprehensive policy response. According to the report on the dynamics and drivers of non performing exposures in the EU banking sector we published last year, tackling the NPLs legacy requires indeed a broad strategy and a wide range of actions.

The first area where actions are needed relates to ongoing supervisory work. Banks have to develop a strategy for dealing with NPLs, strengthen their internal procedures, improve their arrears management, and more generally make NPL management active, efficient and informed. Supervisory guidance is needed on collateral valuation, including valuation methodology and possibly minimum requirements for re-valuation as well as on effective arrears management and NPL resolution governance inside banks. Setting realistic qualitative and quantitative targets should be part of the strategy, also for giving a clear sense of direction to investors and other market participants. The Single Supervisory Mechanism (SSM) of the ECB has recently made important progress in these areas.

The second area relates to structural issues such as the judicial system, insolvency procedures and out-of-court restructuring. It is clear that the lengthier the recovery procedures, the wider the ask/bid spread, with an adverse effect on banks' incentives to dispose of NPLs. Recent experiences show that reforms in this area can prove a key ingredient for a successful resolution of asset quality problems. The judicial system could be strengthened through improvements in the process, as well as adjustments of insolvency procedures; a more frequent usage of out-of-court restructuring would also be beneficial and shorten recovery periods; finally, accounting and tax regimes can be reviewed with the objective of positively affecting the incentives for banks to deal promptly with NPLs.

The last area relates to the need of a functioning secondary market for loans to facilitate the disposal of NPLs. I will focus on this topic in the last part of my speech.

3. A missing market for NPLs disposal

NPL transactions are almost a textbook example of market failure. First, the absence of easily accessible, comparable data on loan, debtor and collateral characteristics generates asymmetric information. Second, an inter-temporal pricing problem occurs since, at present, markets are illiquid and shallow. There is, therefore, a first mover disadvantage to sell into such a market.

Forcing banks to write-off or dispose non-performing loans in a very short period of time in the absence of a deep and liquid secondary market for impaired assets and with remaining structural impediments may lead to an inefficient spread between bid and ask prices. In such conditions, and in the absence of efficient market clearing prices, system-wide NPL sales may create financial stability concerns amidst questions about the viability of the sector as a whole. This could also imply a redistribution of value from banks to the few specialised investors operating in the market.

Corrective actions are, therefore, necessary to address market failures and revive a well-functioning secondary market. First, improving price discovery is key. This can be achieved by enhancing the quality, quantity and comparability of data available to investors, but also by providing transparency of existing NPL deals as well as simplifying and standardising – to the extent possible – legal contracts. Second, addressing the inter-temporal pricing problem implies overcoming the current market illiquidity issues and allowing banks to sell to prices closer to the "real economic value" than to current market prices for troubled assets. This would entail the public sector to step into the market at a price reflecting the long-term value of NPLs – or future efficient clearing price – with a view to selling into a deeper and more liquid market at a later date. This would be a Treaty compatible State aid as long as the transfer price is lower or equal to the real economic value.

I believe that purely private sector solutions are not sufficient given the present scale of the problem and market failures. Historical examples of success in the disposal of non-performing assets demonstrate the key role of the official sector in kick-starting the market, at least for some segments. In several cases, this has involved governments, or special purpose entities sponsored by public authorities, directly taking over impaired assets or supporting with guarantees their sale to private investors.

4. Incentive structure in the design of asset management companies (AMCs)

To date, a patchwork of national solutions with different characteristics has been trialed for the disposal of troubled assets. National approaches have determined an uneven speed of adjustment across countries, but also implied long negotiations among the different – private and public – stakeholders involved, uncertainty for investors, and risks in the execution phase.

A common European approach could instead provide the following benefits: clarity and simplicity for both banks and investors in understanding the interaction with relevant State aid and BRRD rules and the underlying data and mechanisms of the AMC; enhanced credibility of the initiative and confidence that a due process is followed in the implementation phase; lower funding costs and higher operational efficiency; critical mass on both the supply and the demand side, making a significant contribution to accelerating the process of repair in banks' balance sheets.

When I first put forward the proposal of a European-backed AMC, I suggested that public support could be used to provide capital, which would in turn crowd in private funding. A hypothetical example would be an AMC purchasing up to a quarter of total outstanding NPLs (about EUR 250 billion), which could be capitalised to the tune of EUR 20 billion. The solution must be in line with BRRD and State aid rules. Further it should avoid any risk mutualisation for legacy assets.

Banks with NPLs ratios above a given threshold (e.g. 7% NPL ratio) would be required to transfer certain assets to the AMC by supervisors. This would require the standardisation of data according to pre-agreed formats provided by the EBA.

In terms of process, I envisaged some relatively simple steps. Firstly, stress tests would be used to identify the total envelope of potential state aid for each bank. Such a stress test could take a number of forms, ranging from a full balance sheet assessment against complex adverse macro scenarios to more targeted assessments, such as the impact of increasing provisions to meet stressed market price target levels over a three year timespan.

The stress test may also, in isolated cases, identify the need for the immediate resolution – for instance for banks failing in the baseline scenario. As an example, the stress test could be used for identifying the capital shortfall against Pillar 2 minimum capital requirements.

The State aid envelope calculated in the stress test identifies the theoretical amount of government support that would be allowed for each bank's precautionary recapitalisation. In turn, the difference between the current market prices and real economic value would determine the actual amount of State aid that would be deployed to facilitate the transfer of NPLs.

An assessment of real economic value vs current market prices would be carried out and 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 the AMC would hit in the first place the existing shareholders provided the transfer price to the AMC is below the net book value of NPLs. This may be accompanied by a liability management exercise and some bail in of junior debt to equity as determined by European Commission under State aid rules.

At the time of the transfer to the AMC, the bank would bears losses equal to the possible difference between the book value and the real economic value. The assets would be irrevocably transferred at the point of sale. If within a specified time frame the market price remains below the real economic value, the AMC would be compensated by calling upon a guarantee issued by the government of the Member State where the bank transferring the assets is headquartered. To ensure that banks keep skin in the game and avoid moral hazard issues, a mechanism could be introduced to ensure an appropriate compensation of the government.

The mechanism would take the form of a parallel issue of equity warrants to national governments at the time of the asset sale to the AMC, with a penal strike price which would be triggered if the (actual or estimated) sale price at the predefined date remains below the transfer price.

While the AMC could sell the assets at any point in time, there would be a limited timeframe (e.g., three years) for achieving the real economic values and reducing the additional impact of the sale on banks. If that value is not achieved within the timeframe or the assets remain unsold, the bank must take the full market price hit that, if necessary, would be covered by warrants exercised by the national government as State aid with the full conditionality that accompanies that.

The warrants ensure that the AMC capital is fully protected and any ensuing cost must be borne by shareholders and, if necessary, national governments. This element is important also to avoid that a European scheme entails any element of mutualisation of risks, which would not be politically acceptable at this stage. The objective is that the State aid should reflect only the removal of market imperfections and, therefore, any price improvement due to increased confidence or economic growth would accrue to the AMC. The protection against moral hazard provided by the warrant should be a key element to be considered in the calibration of the burden sharing element at the moment of transfer of the assets.

5. A critical review of our proposal

The main challenge in drafting our proposal for an EU AMC was to identify a system of incentives, which was beneficial – or not too detrimental – for any stakeholders and compatible with the current regulation and the need to avoid moral hazard. A key objective that we outlined in our

AMC proposal was to achieve a clean break for the bank, with a sale bringing NPL levels down in a single shot and allowing its management to focus on restoring the sustainability of the business model. At the same time, we wanted to make sure there were no disincentives to offload assets at unrealistic prices.

Our proposal was designed as a sketch rather than a turn-key solution to promote the debate and move forward quickly. We were aware that many details were missing and some aspects deserved additional analysis. Still, it was important to move the discussion forward from the diagnosis of the disease to the search for concrete solutions as well as to start sharing ideas on the technical details.

I think we have achieved this objective. Over the past months we have collected supporting views, comments and requests to clarify some elements. Based on the feedback received, we have considered possible options, ranging from fine-tuning our proposal to moving to a completely different setting.

Clearly, other approaches are possible. The simplest way is to ensure a clean sale at conservative prices that may be below the real economic value but to accompany this with immediate recapitalisation. This entails full burden sharing at the point of sale but eliminates uncertainty. The flip side is that uncertainty is avoided at the expense of crystallising investors' concerns upfront. An upfront solution could also prove more challenging for national governments, which might have to step in if the bank is unable to raise the necessary funding in private markets.

Also, an immediate and full burden sharing of the junior bond-holders could reduce the incentives for banks and authorities to proceed with the transfer of the assets. If, as we believe, there is a failure in the NPL secondary market, junior bondholders would be affected without any possibility to benefit from the recovery of the prices once the markets restart. Therefore, some mechanisms – conversion of bonds into equity or write-up clauses – could reduce the redistribution effect and leave some upside also for the bondholders. But this risk could be anyway mitigated by a proportionate approach to initial burden sharing, which recongises the additional protection from the later potential exercise of warrants.

There is also the option of doing nothing and leaving the response to a purely private solution. On the latter, however, I note that it does not facilitate the rapid cleansing of the balance sheet of the EU banking sector, which is clearly needed. The inaction so far shows, in my view, that the public sector involvement is necessary.

6. An EU blueprint for national AMCs

Some of the negative reactions on the EU AMC project appear largely driven by concerns over mutualisation – or risk sharing – of legacy assets and about unnecessary and over-centralisation.

Our original proposal was designed specifically to avoid any mutualisation by tracing any potential losses of EU equity back to national governments in the form of a guarantee. Nonetheless, it is clear that this issue would be politically difficult. Moreover, the scale of an EU AMC – while offering considerable advantages of economies of scale and critical mass for stimulating the secondary market for NPLs – could also create technical challenges. Whilst I remain convinced that a single EU AMC offers the most traction for cleaning up NPLs quickly in the most neutral manner, if a truly EU solution is perceived as too ambitious and far-reaching, a reasonable alternative is the use of a blueprint for a national AMC, where our scheme would be applied consistently across each EU country but with AMCs established at the national level.

The blueprint cannot, however, be reduced to an empty shell, but should set common elements to be used at the national level and include at least the entry criteria, the data requirements and due diligence as well as the exit criteria. In this case, both the EU AMC and an EU blueprint would provide clarity on what is not acceptable under State aid rules and ensure consistent and comparable approaches. They would also contribute to reduce information asymmetries by defining harmonised data requirements and formats.

Still, and allow me to be clear on this point, only an EU AMC would represent a truly European solution to a European problem. An EU response would ensure credibility, also by removing execution risk due to possible local interference, and attract significantly reduced funding costs, which would not materialise with various national approaches.

7. Conclusions

The repair of the banking sector has been carried out under challenging external conditions and while the institutional set up for banking regulation, supervision and resolution was being completely overhauled.

At several stages there have been voices arguing for EU-wide actions to tackle the crisis – among others, proposals for a pan-European bail-out fund in the immediate aftermath of the Lehman default, for non-mutualised EU guarantees on bank funding at the height of the sovereign debt crisis, for a direct recapitalisation of banks under stress by the European Financial Stability Fund (EFSF). The uneven distribution of bank fragilities, at different stages of the crisis, has always hindered a common solution. Member States have been reluctant to enter European schemes when they did not perceive their national banks to be particularly affected by the problem of the moment. Even putting national schemes under a common European umbrella, without any form of mutualisation, has not been considered a viable option.

I have no doubts that the superior speed of reaction and effectiveness of the policy response to the banking crisis in the US rests on the federal nature of their programme, the TARP, and on the close correspondence between the boundaries of the domestic market, the jurisdiction of the authorities responsible for supervision and resolution, and the scope of the safety net and support measures.

However, we can be satisfied with our achievements. The establishment of the EBA and then the move to the Banking Union allowed for truly European responses in a number of areas. EU banks are now on a much stronger footing, better capitalised and with a healthier liquidity position. The average NPL ratio is now on a declining path since 2014. Still, at the current pace we won't be able to reach pre-crisis levels for many years to come. The process has to accelerate.

As EU-wide solutions do not seem to be politically viable, the development of common blueprints for national AMCs could be an important step forward to facilitate the fast cleansing of banks' balance sheets.

The first step is enhancing the quality and consistency of data. Based on a mandate we have received from the Commission, we are already working on possible common templates and definitions for NPL due diligence. This is an important – and undisputed – step for improving the functioning of the secondary market.

With a common blueprint for AMCs the ambitious targets being defined by supervisors could be more easily met, within a more compressed time frame. Well capitalised banks will be able to complete the process without the need of resorting to government support. But weaker and smaller banks, while still fully solvent, might find it difficult to accelerate the adjustment and would benefit from a support programme to tackle asset quality problems in a decisive manner, restructure their business and restore sustainable profitability. The EBA staff has conducted extensive work in this area. Today I tried to summarise the main elements of our proposals. But the technical details are open for discussion and may be adjusted. What is important is that we have a common will to deal with the asset quality issues in a coordinated fashion and that we share the sense of urgency that the subject matter requires.