EUROPEAN PARLIAMENT

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A
ECONOMIC AND SCIENTIFIC POLICY

Economic and Monetary Affairs

Employment and Social Affairs

Environment, Public Health and Food Safety

Industry, Research and Energy

Internal Market and Consumer Protection

Re-capitalisation of banks supervised by the SSM

Monetary Dialogue December 2013

COMPILATION OF NOTES

EN

2014

Re-capitalisation of banks supervised by the SSM Monetary Dialogue December 2013 Compilation of Notes

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Re-capitalisation of banks supervised by the SSM

Monetary Dialogue 16 December 2013

COMPILATION OF NOTES

Abstract

The papers of this compilation, prepared for the December 2013 session of the Monetary Dialogue, comment on various economic aspects regarding the balance sheets of EU banks supervised by the SSM, how can a sufficient re-capitalisation of the European Banking system be ensured most effectively, which institutions ought to be involved at the national and EU level and what's the role of these institutions in terms of funding.

IP/A/ECON/NT/2013-04 **January 2014**

PE 518.742 **EN**

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHORS

Karl WHELAN, University College Dublin
Guntram B. WOLFF and Silvia MERLER with research assistance performed by Giuseppe DALUSIO, Bruegel, Brussels
Daniel GROS, CEPS, Brussels
Sylvester C.W. EIJFFINGER, CentER and EBC, Tilburg University and CEPR with research assistance performed by Louis RAES, Tilburg University

RESPONSIBLE ADMINISTRATOR

Dario PATERNOSTER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: poldep-economy-science@ep.europa.eu

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to:
poldep-economy-science@ep.europa.eu

Manuscript completed in January 2014
© European Union, 2014

This document is available on the internet at:
http://www.europarl.europa.eu/studies

DISCLAIMER

The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the publisher is given prior notice and sent a copy.

CONTENTS

INTRODUCTION **4**

1. Principles for Re-capitalising Europe's banks
by Karl WHELAN **5**

2. Ending uncertainty: Re-capitalisation of banks supervised by the SSM
by Guntram B. WOLFF, Silvia MERLER and Giuseppe DALUSIO **19**

3. The asset quality review and capital needs: Why re-capitalise banks with public money?
by Daniel GROS **41**

4. Re-capitalisation of banks
by Sylvester C.W. EIJFFINGER **55**

INTRODUCTION

Despite the actions taken to strengthen banks' balance sheets in recent years, confidence in the euro area banking system remains week, partly because of underlying concerns over low capitalisation of some banks. The results of the Asset Quality Review and the balance sheet assessment to be conducted by the ECB in the first quarter of 2014 may indicate the need for financial support (recapitalisation) for EU banks supervised by the Single Supervisory Mechanism (SSM). The adequate re-capitalisation of euro area banks and subsequent implications for the resilience of the banking sector and the stability of the financial system have already been on the economic policy agenda for several years.[1] In December 2012, the European Council agreed on the key building blocks of the future Banking Union.[2] The first pillar - the Single Supervisory Mechanism (SSM)[3] - will bring the EU's largest banks under the European Central Bank's direct oversight up from September 2014. This is a prerequisite to use the European Stability Mechanism (ESM) as an instrument for the direct recapitalisation of euro area banks.[4]

The papers of this compilation that were prepared for the December 2013 session of the Monetary Dialogue between the European Parliament and the ECB comment on various economic aspects regarding the balance sheets of EU banks to be supervised by the SSM, such as how a sufficient re-capitalisation of the European Banking system could be ensured most effectively, which institutions ought to be involved at the national and EU level and what the role of these institutions in terms of funding could be.

The contributing experts call the attention to the considerable degree of uncertainty regarding the quality of banks’ balance sheets, the valuation of assets and the rules under which losses will be handled. They point out, that the ECB should communicate the central parameters underpinning the upcoming stress testing exercise as early as possible, in particular as regards the treatment of sovereign debt and systemic risk as well as the magnitude of the stress test. The experts also generally agree on writing down senior bond liabilities or converting them into equity before public money is used to bail out banks. The main argument put forward is that markets discriminate better than governments between banks which are viable and banks which are not. While the protection of private-sector deposits is generally considered a priority, our experts emphasise that non-deposit liabilities should be bailed in before any government or ESM intervention. Last but not least, concerns about the 'fog of uncertainty' that still surrounds the timing of the setting up and implementation of the backstop mechanism are expressed.

---

1 See for example IMF Executive Board conclusions on 2013 Financial Stability Assessment with the European Union: http://www.imf.org/external/np/sec/pn/2013/pn1329.htm

2 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134353.pdf

3 http://www.europarl.europa.eu/news/en/news-room/content/20130906IPR18829/html/Green-light-for-single-supervisor-for-banks

4 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Principles for Re-capitalising Europe's Banks

Karl WHELAN

NOTE

Abstract

Mario Draghi has acknowledged that there is a "fog of uncertainty" surrounding Europe's banks and the upcoming comprehensive assessment should help to dispel it. To be credible these tests need to uncover capital shortfalls at a significant number of banks and these shortfalls must then be made up quickly. This paper argues that before public money is used to bail out insolvent banks, senior bond liabilities should be written down or converted to equity. Similarly, the Commission's new state aid guidelines are correct in insisting on conversion of subordinated debt to equity as a condition for state investment in banks that are declared solvent but cannot raise private funds. If states are unable to recapitalise their banks, there is a strong shared public interest argument for using ESM to recapitalise banks. Protection of deposits of households and SMEs should be a priority but non-deposit liabilities should be bailed in before ESM participates.

CONTENTS

EXECUTIVE SUMMARY **7**

1. INTRODUCTION **8**

2. WHY STRESS TESTS AND RECAPITALISATION? **9**

2.1. Information Problems: Opaque Balance Sheets 9

2.2. Problems Caused by Under-Capitalised or Failing Banks 10

2.3. Europe's Banks: Clarity Required 10

3. WHEN AND HOW TO USE PUBLIC MONEY? **12**

3.1. Insolvent Banks 12

3.2. Solvent But Under-Capitalised Banks 13

4. WHY SHARED FUNDS FOR RECAPITALISATION? **15**

REFERENCES **17**

EXECUTIVE SUMMARY

- Europe's banking sector is objectively under-capitalised, both relative to the tougher capital standards required by Basel 3 and relative to what is necessary to re-assure creditors that their investments with banks throughout Europe are safe despite the likely problems in coming years with bad loans.
- Bank balance sheets are difficult for potential creditors to assess and bank executives of weak banks are incentivised to act in a way that may run counter to the good of the economy or the banking sector as a whole. For these reasons, the upcoming comprehensive assessment of the banking sector, followed by mandated recapitalising, is an essential step in strengthening Europe's banks and pulling the economy out of its slump.
- Public money should only be considered for the purposes of bank recapitalisation when all options that do not threaten financial instability have been exhausted.
- In the case where a bank is clearly insolvent, liabilities to bond-holders should be written down or converted to equity. This includes senior bonds. The current European policy of delaying bail-in of senior bonds until 2018 is counter-productive and may cost the European governments a lot of money.
- Where a bank is declared solvent but is unable to raise funds to reach the capital ratios required by regulators, the EU's new state aid rules are correct to insist on conversion of subordinated debt to equity as a condition for state aid. ECB President Mario Draghi has objected to this rule on the grounds that it could damage subordinated debt markets. An alternative viewpoint is that subordinated debt is better replaced with contingent capital which automatically converts when a bank falls below a specific capital threshold.
- When a Member State is not able to recapitalise its banks, there are strong European public interest arguments for using the ESM to do this task. While ESM investments should be structured so as to protect the taxpayer as far as possible, there is also a strong common public interest in maintaining financial stability in the euro area.
- Despite the limited reaction elsewhere in the euro area, the approach taken in Cyprus of writing down deposits and then imposing capital controls should be avoided if at all possible. While depositors appear to have viewed these actions as a one-off event, their application elsewhere would likely to be highly damaging to financial stability.
- At a minimum, deposits of households and SMEs should be protected as a matter of priority in line with the hierarchy of creditors set out in the draft recovery and resolution directive.

1. INTRODUCTION

Problems with Europe's banks have played a crucial role in restraining growth in the years since the onset of the global financial crisis. Europe's banking sector is objectively under-capitalised, both relative to the tougher capital standards required by Basel 3 and relative to what is necessary to re-assure creditors that their investments with banks throughout Europe are safe despite the likely problems in coming years with bad loans.

In an ideal world, problems related to under-capitalised banks could be sorted out by the private sector. Banks that were insolvent would negotiate with creditors to be re-capitalised via writing down their liabilities while banks that were solvent but needed more capital would obtain new equity investments at a market rate from private sector investors. Alas, we don't live in an ideal world and the banking sector is riddled with informational problems that make this sector function in a completely different way to the markets of simple neoclassical theory. These problems mean that governments need to play an active involvement in regulating the banking sector and, on occasion, it may be necessary to use public money to maintain the stability of this sector.

In June 2012, the euro area's leaders agreed in principle for the first time that, potentially, the public money used to recapitalise banks could come from a joint European source in the form of the European Stabilisation Mechanism (ESM). As a precursor to this being possible, it was agreed that the ECB should take over as the supervisor of the euro area's banks and that it should perform an intensive round of balance sheet assessments and stress tests.

To be credible these tests need to uncover capital shortfalls at a significant number of banks and these shortfalls must then be made up quickly and without damaging financial stability. This raises an important debate about how public money should (and should not) be used to recapitalise banks. This debate is a complex one and there often are tensions between the key goals of protecting financial stability and preventing taxpayers from making losses.

In this paper, I first discuss the economic principles underlying the need for a set of government-mandated, strict and honest assessment of the European banking sector, followed by a process of mandatory re-capitalisation of weak banks. I then focus on the potential role the public sector should play in re-capitalising banks focusing on the public interest arguments for this role as well as on how governments should behave towards bank creditors during this process. Finally, I discuss the arguments for the use of the European Stabilisation Mechanism to re-capitalise banks under certain conditions.

2. WHY STRESS TESTS AND RECAPITALISATION?

Before considering the questions of how recapitalisation of European banks should work, it is worth briefly outlining why the current process of government-mandated balance sheet assessments and stress tests is required.

Whenever a government intervention in the economy is considered, it is useful to consider the market failures that warrant such a policy. In the case of stress tests and recapitalisation requirements, the market failures relate to two different areas: First, the informational problems associated with the opaque nature of bank balance sheets and second, the negative externalities that the actions of weak banks inflict on the rest of the economy.

2.1. Information Problems: Opaque Balance Sheets

If the valuation of bank assets was a simple business and creditors could easily assess a bank's solvency then there would be little need for banking regulation or stress tests. Losses on assets would be seen by all and banks would either be forced to raise new private sector capital or, if the losses implied insolvency, to inflict losses on creditors.

In reality, bank balance sheets are extremely difficult to assess. Actual and potential creditors seeking to establish the soundness of a bank have to consider a range of difficult issues.

- In assessing the quality of a bank's loan book, you can read its occasional reports and find data on the fraction of loans classified as performing or non-performing. In practice, however, banks can differ in the ways they report non-performing loans (NPLs). For example, loans can be prevented from moving into non-performing status by restructuring agreements that do not change the underlying credit quality. Further complicating matters when assessing European banks is the fact that regulatory requirements for reporting NPLs differ across European countries.[1]
- Even if a bank's reporting of its NPLs could be trusted, it is still difficult for outsiders to assess the likely losses on a portfolio of bad loans. Weak banks tend to be cautious about booking provisions on these loans and the amounts booked often depend on highly subjective opinions about the value of the collateral underlying loans.
- Banks generally provide limited information on their liquid financial assets. For example, while they will generally report their holdings of sovereign bonds, they are often reluctant to report the exact details of these holdings, i.e. whose sovereign bonds they own and their maturity. Big international banks also tend to have very large and complex derivative positions that carry risk that is almost impossible to assess on the basis of their published reports.
- Investors often rely on a bank's reported capital ratios to assess their underlying solvency. These ratios, however, depend on a myriad of complex discretionary decisions and regulatory standards. Both the definitions of various types of capital as well as the denominator in capital ratio calculations (risk-weighted assets) depend on more factors than most investors can feasibly assess. For example, details of the Internal Ratings Based models used to generate estimates of risk-weighted assets are not made available to the public (and might not be of much use to most people even if they were). As Andy Haldane (2012) has noted, Basel risk-based capital ratios appear to have had little power in predicting past bank failures.

[1] See Barisitz (2013) for a summary of the issues relating to definitions of non-performing loans.

2.2. Problems Caused by Under-Capitalised or Failing Banks

These information problems – which mean that bankers tend to have a much better understanding of their asset quality than outside creditors – can lead to a wide range of bad economic outcomes.

For example, bankers who know their bank is failing but are not reporting the true figures have an incentive to "gamble for resurrection" by seeking out highly risky investments with a potentially high upside. History is littered with stories of bank executives engaging in highly risky or even illegal behaviour in order to save their bank or else prevent the public from seeing its true state. These actions can end up having a serious impact on the bank's creditors by raising the total amount of losses and may also cost the taxpayer if the bank's creditors are bailed out because of deposit insurance or other guarantees.

Banks that are in a weak position but are not quite failing can also cause problems for the economy. The executives in these banks will also have an incentive to hide their bank's true position to prevent creditors from worrying and pulling their funds from the bank. In addition, the bank's shareholders often do not have a good understanding of underlying asset quality and are likely to wish to remove executives who "come clean" and admit that the bank needs a fresh infusion of equity. Capital raising of this type tends to be unpopular with shareholders who often (perhaps wrongly) view it as diluting the future flow of dividends they are likely to receive.

Given these pressures, management at weak banks may seek to increase their capital ratio by reducing the denominator in the capital ratio formula, i.e. by cutting risk-weighted-assets. This reduces the amount of credit available in the economy and re-allocates bank assets towards supposedly "risk-free" assets like sovereign bonds and away from assets with higher risk weights such as loans to small businesses.

While these actions of private sector bank executives may be rational and maximising from their own narrow perspective, they can do severe damage to the wider economy and the banking sector as a whole. As stressed in Andrew Crockett's (2000) famous speech and formalised in academic papers such as Adrian and Shin (2010), negative shocks to the economy become exacerbated when banks react by restricting credit. The negative effects on the economy of tightening credit can act to further worsen asset quality and deepen an economic slump. Crockett argued that governments should aim to preventing these kinds of outcomes via what is now known as *macro-prudential policy*. The upcoming round of balance sheet assessments and mandated re-capitalisation is a good example of sensible macro-prudential policy. It may not be popular with individual banks but it will act to strengthen the banking sector as a whole.

2.3. Europe's Banks: Clarity Required

Many of the negative factors associated with weak banking systems are evident in Europe today. With the euro area economy in a slump now for over half a decade, investors understand that there must be serious problems with asset quality at European banks. However, given the opaque nature of bank balance sheets, it can be difficult to assess the size of the problems at any individual bank or indeed the scale of problems affecting banks in different countries.

For example, it is well known that Ireland's banking crisis cost the state over EUR 60 billion while UK-owned banks also incurred additional large losses in the Irish market. Spain is a much larger economy than Ireland (its GDP is about six times bigger). Like Ireland, Spain has gone through a major property boom and bust though, unlike Ireland, house prices in Spain are still falling. This might lead the casual observer to expect the recapitalisation requirements of the Spanish banks would be far larger than those at Irish banks. However,

the detailed report produced by Oliver Wyman (2012) suggested that recapitalisation requirements for Spanish banks should not be larger than EUR 60 billion.

From an outside perspective, it is hard to know what to make of these estimates. On the one hand, it may be that Oliver Wyman are correct and Ireland's bankers just turned out to be much more reckless than their Spanish counterparts.[2] On the other hand, Oliver Wyman's would hardly be the first publicly-commissioned report to downplay the true extent of difficulties affecting a banking sector. The all-time prize in this regard goes to Price Waterhouse Coopers, who produced a report on Anglo Irish Bank in early 2009 which declared that "*Under the PwC highest stress scenario, Anglo's core equity and tier 1 ratios are projected to exceed regulatory minima (Tier 1 – 4%) at 30 September 2010*."[3] The capital hole in the bank ended up being over EUR 30 billion and by September 2010 the bank was a major factor in the country's inability to borrow on sovereign debt markets.

Given the significant uncertainties about asset quality at various European banks, many creditors have decided to simply avoid providing funds to any banks that are deemed as potentially risky. Deposit flight from Europe's periphery has largely ceased, thanks mainly to Mario Draghi's "whatever it takes" assurances reducing concerns about the break-up of the euro. However, concerns about credit risk at banks remain and many banks in Spain, Portugal, Ireland and elsewhere are still heavily reliant on the Eurosystem to fund their operations. With this supply of funds not seen by investors as a reliable long-term source of stable funding, these banks are still under severe pressure to deleverage and this is weakening the supply of credit in countries that are already suffering from fiscal contraction and problems with private debt burdens.

For these reasons, it is essential that Europe's banks be exposed to a wide-ranging, independent and credible set of balance sheet assessments and stress tests. The European Banking Authority (EBA) has undertaken stress tests of this type before but it is widely accepted that these tests were insufficiently tough or rigorous. The new assessments under the centralised authority of the ECB have the potential to bring far greater clarity than these previous stress tests. In particular, the application of common techniques for earmarking NPLs and for provisions will be helpful in improving transparency -- "lifting the fog" as Mario Draghi has put it.

As noted above, however, to be credible these tests need to uncover capital shortfalls at a significant number of banks and these shortfalls must then be made up quickly. Only once transparency in relation to bad loans has been improved and banks have been recapitalised are we likely to see a return of trust in Europe's banks.

Of course, even stress tests run by an independent authority are not perfect. The technical challenge for the ECB in assessing the balance sheets of so many different banks is considerable. And the ECB may feel under pressure to "take it easy" on banks given concerns about whether there are adequate backstops in place to supply recapitalisation funds. Still, even with these caveats, the signs are good that the upcoming tests promise to be more serious and useful in promoting transparency than previous exercises.

[2] Though, of course, Oliver Wyman did award Anglo Irish Bank its "best performing large cap bank" prize in 2006, noting "A centralised loan approval process has helped the bank maintain high asset quality and minimise the risks of portfolio concentration."
See http://ftalphaville.ft.com/2011/02/11/485311/worlds-best-bank-2006-vintage/

[3] This report is still publicly available on the Irish Department of Finance website at http://www.finance.gov.ie/documents/publications/other/2009/anglopwc.pdf

3. WHEN AND HOW TO USE PUBLIC MONEY?

While there is widespread agreement now that the upcoming comprehensive assessment should play an important role in highlighting weaknesses in the European banking sector, there is far less agreement about how these weaknesses should be addressed. In particular, the role that should be played by governments and private creditors in recapitalising banks is a subject of great controversy.

Here, I consider the potential role of public funds in recapitalising banks in two different cases: One in which a bank has been found to be insolvent and the other in which a bank is found to be solvent but weakly capitalised. In both cases, I assume that the state in which the bank operates has the capacity to provide the initial investment without causing strain on the public finances. I return to this issue in the next section.

3.1. Insolvent Banks

Consider the first case, in which a bank is found to be clearly insolvent, with its assets falling well short of its liabilities. For now, I am going to assume these banks have sufficient non-deposit liabilities so that writing off these liabilities would restore solvency.

In this case, the new European Commission's state aid guidelines introduced in July correctly insist that equity must be written off and subordinated debt either written down or converted to equity (depending on the extent of the negative capital position). These guidelines are the minimum possible level of protection that should be afforded to the public purse when consideration is given to assisting failing banks: Those who provided funds to banks in the full knowledge that those funds would be at risk should the bank fail must lose out when the bank does indeed become insolvent.

Where cases of bank insolvency become more serious is when capital shortfalls cannot be made up by writing off equity and subordinated debt. In relation to these situations, the current position in relation to European guidelines is unclear. The European Council has agreed a draft Bank Recovery and Resolution Directive (BRRD)[4] which sets out a clear hierarchy for the treatment of liabilities when banks are put into resolution. Most importantly, it states that "*eligible deposits from natural persons and micro, small and medium-sized enterprises shall have a higher priority ranking than the claims of ordinary unsecured, non-preferred creditors*".

This suggests that, in principle, European leaders are willing to restructure senior unsecured bonds to restore banks to solvency. This can be done via some combination of writing down senior bonds and conversion of some part of the bonds to equity: Insolvent banks can be restored to solvency via write-downs of senior debt while privately-owned equity can be provided by converting some of the remaining debt to equity.

There remains some confusion in public debate in some countries about how this kind of bail-in would operate given that most senior bonds rank equal with deposits via "pari passu" clauses. These clauses, however, only apply to the treatment of claims in a liquidation. There is nothing that prevents governments from overseeing a process in which both senior bonds and deposits receive haircuts but the deposits are "topped up" by the state after they have been transferred to a separate institution.

The current state of play in relation to bail-in on senior debt, however, is that the BRRD only envisages the bail-in tool being applied from 2018 onwards. The argument put forward in the draft directive is that this approach is necessary "to reassure investors and market counterparties and to minimise its impact."

[4] http://register.consilium.europa.eu/pdf/en/13/st11/st11148-re01.en13.pdf

My assessment is that argument for delays in the application of the bail-in tool are flawed. Financial markets need to be clear in the future about the risks that they are taking when investment money with banks. The only way to provide assurances that these risks are low is to restructure banks so that they are very well capitalised. Write-downs and bail-in of senior bonds at failing banks will, in many cases, be sufficient to achieve this outcome. Using public funds to bail out senior bond holders over the next few years could also re-capitalise banks but would be no more effective at doing so, would cost the public money and could set a bad precedent with investors wondering whether bail-in of senior bonds actually would occur at all from 2018 onwards.

One argument against bailing in senior debt is that it could have financial stability implications. Bailed-in debt could belong to other financial institutions and contribute to their failure which could lead to financial instability. Ultimately these arguments have to be assessed on a case-by-case basis but, in general, any knock-on impact should be dealt with directly by stabilising the affected institutions rather than requiring governments to provide the funds to avoid bond write-downs.

The use of bail-in tools should allow many insolvent European banks to be restored to solvency without requiring public funds for recapitalisation. If, however, public funds are still required to meet regulatory capital requirements so that a bank ends up with a mixture of public and private forms of equity, then public equity investments should be structured in a way that reduces risk for the public and incentivises early retirement of the public equity. For example, publicly acquired equity could come with warrants that would see the government obtain a higher stake in the bank if its shares are still in existence after a particular time period has elapsed.

3.2. Solvent But Under-Capitalised Banks

Now consider the second case, in which a balance sheet assessment finds a bank solvent but with regulatory capital ratios that are below the level required by regulations. In many cases of this type, it may be possible for banks to find private sector investors willing to inject new equity into the bank, in which case there are no questions about public investment.

The tricky questions in this case relate to what happens when a solvent but under-capitalised bank is given the opportunity to raise private capital but fails to do so. The Commission's revised state aid rules from July require that subordinated debt be bailed-in prior to any state funds being used to add to the bank's recapitalisation.

Mario Draghi has argued against this approach of forced conversion of subordinated bonds in this case in which a bank is solvent but still falls below the capital ratios required by regulators. In a letter to Commissioner Almunia dated July 30 that has since been leaked, Draghi argued against this approach on the grounds that subordinated bonds should be an important instrument in building up the loss-absorption capacity of European banks and that this requirement could damage the market for these bonds.[5]

Draghi's letter argues adding a new source of credit risk ("precautionary recapitalisation after failing a stress test") would change the nature of subordinated debt and perhaps damage the market for such instruments. He notes also that this approach is inconsistent with the approach to bank resolution being developed in the draft BRRD. His letter also noted that bail-in of subordinated bonds may not be necessary for state investments in

[5] At the time of writing, a copy of this letter can be found at http://ep00.epimg.net/descargables/2013/10/21/e4c63829a1ef61f17a50533be5a2e3a9.pdf while a Financial Times report on the letter can be found at http://www.ft.com/intl/cms/s/0/13cc9614-397f-11e3-a3a4-00144feab7de.html

bank equity to be profitable. Indeed, the most obvious example of state investments in bank equity in recent years, the U.S. Troubled Asset Relief Program (TARP) has been a great success for American taxpayers. In total, the U.S. Treasury disbursed USD 245 billion to invest in bank equity. With almost all the original disbursement repaid, the Treasury has received USD 273 billion back for a return of over 11 percent.[6]

One could also argue that a failure to raise private capital during a period of financial strain may simply represent pressures within the private financial sector to deleverage, making governments the only body with the financial capacity to make large investments in bank equity.

These are important points but, on balance, my view is that the Commission's state aid rules are correct and that Mario Draghi is not. Estimates of the solvency of a bank are always uncertain and dependent on highly subjective asset valuations. There are many examples of banks whose troubles were first revealed in accounts that showed they were solvent but weakly capitalised with losses of larger magnitudes only being revealed later. Even independent stress tests are unlikely to be an exception to the general rule that bad news tends to drip out slowly over time.

For these reasons, point estimates of solvency should be interpreted carefully if a bank fails to receive offers of equity investment at any reasonable cost from private sources. Considerable weight should be given to the view that the private sector has decided that there are further losses to come at this bank and that any equity investment would lose money.

Sub-ordinated bond holders may object to mandatory conversion of their investments into equity in these circumstances. However, if indeed a bank's assets turn out to be consistent with stress test valuations that show solvency, then the converted equity investment that these investors hold will retain its value. If, on the other hand, these valuations turn out to be overly optimistic, then it is only fair that losses are taken by private investors who knowingly invested their money under the risk that they could be wiped out if the bank became insolvent. If the government invests money before subordinated debt is converted, then public money will be first in line to be written off.

Mr. Draghi is correct that precautionary conversion of subordinated debt of this type is inconsistent with the current BRRD draft and with the legal contracts underlying these debt instruments. However, these arguments point towards revising the draft BRRD and towards the use of contingent capital (CoCo) bonds rather than subordinated bonds as a way to build up loss-absorption over and above core equity.

The reality is that very few banks are allowed reach the point where their published accounts show them to be insolvent. Regulators are aware of the ability of bankers to manipulate accounts and the long delays involved in the revelation of bad news. As such, it is generally best if they intervene at the point where a bank is solvent but under-capitalised. With the new SSM regime now in place, stress tests for European banks should be a regular event and recapitalisation requests of the type that will occur next year will continue to be a feature. Contingent bonds that are automatically converted to equity are a far cleaner solution to recapitalisation under these conditions than ad hoc conversions of subordinated bonds. As such, banks and regulators should focus on promoting the sale of contingent capital bonds.

[6] Information on TARP is available at http://www.treasury.gov/initiatives/financial-stability/Pages/default.aspx

4. WHY SHARED FUNDS FOR RECAPITALISATION?

Thus far, I have discussed the case in which banks are re-capitalised by a government in the country in which the bank is based. This has ignored a crucial question: What happens if the government in this country is unable to provide these funds?

There may be a number of reasons why a government may not be able to recapitalise its banks:

- It may be that the banks are so clearly insolvent and the government is going to make such large losses that financial markets anticipate that the government is likely to experience a sovereign default if it proceeds with the recapitalisation. It may still be possible to proceed with the recapitalisation in this case through the use of non-market forms of debt issuance (for example, the promissory notes that the Irish government used to recapitalise Anglo Irish Bank in 2010) but most governments would be reluctant to go down this path.
- It may be unclear whether there will be large losses but if debt levels are already high, financial markets may be unwilling to take a risk on a government that could be heading for default if its investments in bank shares turn out badly.
- The government may be able to fund the recapitalisation and may expect it to provide a full return and markets may view the risk of default as slim but the country will end up violating European rules on public debt. These rules focus on the gross amount of government debt, so even if a country has accumulated assets (in the form of bank shares) that match this debt, it will still end up increasing its "headline" debt figures. Commissioner Rehn has written to finance ministers signalling that once-off accumulations of debt will not trigger escalation of excessive deficit procedures.[7] However, the effect of such debt issuance on headline debt levels may be enough to prevent governments from proceeding with recapitalisation plans.

Given that these circumstances can arise for an individual Member State, what are the arguments for a shared recapitalisation using the ESM as a vehicle? The most obvious rationale – and the one that is clearly put forward in the agreed guidelines of 20 June 2013 relating to the use of the ESM for bank recapitalisation – is the maintenance of financial stability in the euro area.[8]

In particular, there is likely to be a common European public interest in limiting losses for depositors. A situation in which a bank inflicts large losses on depositors because a government does not have the ability to bail out creditors or recapitalise the bank could lead to fears across Europe that banks in any country with weak public finances may be unsafe.

Of course, the obvious response to this argument is that there were large write-downs of deposits in Cyprus earlier this year and this triggered almost no response from depositors in the rest of Europe. My sense is that this response was because people believed that Cyprus represented a "special case" that could not be repeated. In some ways, Cyprus was a special case: The level of insolvency of its banks was high and they had very little non-deposit funding to be bailed in. In addition, the level of publicity given to the involvement of Russian depositors in the Cypriot banks led many people to conclude that there was a political element to the Cypriot bail-in that would not be repeated elsewhere.

---

7 This letter is available here http://ec.europa.eu/commission_2010-_2014/rehn/documents/finmins_public091013_en.pdf

8 The guidelines for the use of ESM for recapitalisation purposes can be found online at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137569.pdf

These points, however, do not rule out situations arising over the next year in which deposits could be at risk because Europe's banks differ widely in the extent to which they may be hiding losses and in their dependence on non-deposit funding. As soon as depositors see one more case in which deposits are bailed in, they may view events in Cyprus as a template rather than as an exception. This could trigger substantial financial instability across Europe.

Furthermore, it would be unwise for euro area leaders to consider repeating the post-bail-in approach taken in Cyprus. The ECB's approach to the Cypriot banking crisis has effectively been opposite of the textbook approach of lending freely to solvent institutions. Large amounts of Eurosystem funding were provided in 2012 and early 2013 to Cypriot banks that the ECB knew were insolvent. After solvency was restored to Bank of Cyprus via deposit write-downs, it appears that the ECB then decided to limit its support for the bank, an approach that can be implemented because capital controls limit the extent to which deposits can be taken out of the bank. Again, this is perhaps viewed across Europe as a one-off event but the imposition of these controls in a second country could provoke significant concerns amongst depositors all across Europe.

For these reasons, I believe there is a common interest in the euro area in using the ESM to recapitalise banks when Member States are incapable of doing so, with the top priority being the avoidance of deposit write-downs. At a minimum, deposits of households and SMEs should be protected as a matter of priority in line with the hierarchy set out in the draft recovery and resolution directive.

The idea of using ESM to recapitalise banks is unpopular in a number of European countries, most notably Germany. It should be remembered, however, that the ESM guidelines call for the EU Commission's state aid rules to be applied to any ESM-backed recapitalisation. While some cases may involve filling in solvency gaps in a way that will not return money, a well-designed policy of bailing in subordinated and senior bonds will be the best way to ensure that, where possible, ESM's investments in banks provide a shared return for European taxpayers as well as maintaining financial stability.

REFERENCES

- Adrian, Tobias and Hyun Song Shin (2010). "Liquidity and Leverage", *Journal of Financial Intermediation*, 19, 418-437.
- Barisitz, Stephan (2013). "Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions," *Focus on European Economic Integration*, Oesterreichische Nationalbank.
- Crockett, Andrew (2000). Marrying the micro- and macro-prudential dimensions of financial stability, Bank for International Settlements.
- Haldane, Andrew (2012). The Dog and the Frisbee. Bank of England. Available at www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf
- Oliver Wyman (2012). Asset Quality Review and Bottom-Up Stress Test. Available at http://www.bde.es/f/webbde/SSICOM/20120928/informe_ow280912e.pdf

NOTES

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Ending uncertainty: Re-capitalisation of banks supervised by the SSM

Sivia MERLER, Guntram B. WOLFF and Giuseppe DALUSIO

NOTE

Abstract

Estimates of the recapitalisation needs of the euro-area banking system vary between 50 billion and more than 600 billion euros. The range shows both the considerable uncertainty about the quality of banks' balance sheets and the central parameters of the upcoming European Central Bank stress testing exercise, such as the treatment of sovereign debt and systemic risk. The ECB should communicate those parameters early to allow for private sector solutions. It should also establish itself as a tough supervisor and not shy away from closing banks. Governments should accept cross-border bank mergers, substantial creditor involvement under clear rules (tough bail-in rules) and the creation of a single resolution mechanism that operates under majority rules to exercise discretion where necessary. The note discusses the current state aid rules, the Bank Recovery and Resolution Directive and further steps in the transition towards a full banking union.

CONTENTS

LIST OF ABBREVIATIONS **21**

EXECUTIVE SUMMARY **23**

INTRODUCTION **25**

1. BANK RECAPITALISATION NEEDS, WHAT TO EXPECT **27**

1.1 Elements of uncertainty in the design 27

1.2 Market Expectations 28

2. BANK RECAPITALISATION: HOW AND WHEN **33**

CONCLUSIONS **38**

REFERENCES **39**

LIST OF ABBREVIATIONS

AQR	Asset Quality Review
BoE	Bank of England
BoJ	Bank of Japan
BRRD	Bank Recovery and Resolution Directive
CBPP	Covered Bond Purchase Programme
CRD IV	Capital Requirements Directive - package IV
CET 1	Common Equity Tier 1
CRR	Capital Requirement Regulation
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
ESAs	Joint Committee of the European Supervisory Authorities
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FED	Federal Reserve

GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
G-SIFI	Global Systemically Important Financial Institution
IMF	International Monetary Fund
LTRO	Long Term Refinancing Operation
MIP	Macroeconomic Imbalances Procedure
MRO	Main refinancing operation
NAIRU	Non-accelerating inflation rate of unemployment
NCA	National Competent Authorities
NPL	Non-Performing Loans
OMT	Outright Monetary Transaction
RWA	Risk Weighted Asset
SMP	Securities Markets Programme
SSM	Single Supervisory Mechanism
SRM	Single Resolutions Mechanism
TFEU	Treaty on the Functioning of the European Union

EXECUTIVE SUMMARY

The European financial system is plagued at present by two major sources of uncertainty. First, there is still mistrust over the quality of banks' balance sheets. Second (and related), major uncertainty remains about the rules that will apply to bank recapitalisation, bank restructuring and bank resolution.

The fact that the European Central Bank is due to become the single supervisor for euro-area banks, and that it will conduct a far-reaching preliminary assessment of banks' balance sheets, has the potential to greatly reduce the first uncertainty, because a centralised assessment will make balance-sheet information more transparent, comparable and credible. The ECB has already communicated the broad structure of the exercise and some important technical elements underpinning it, such as, for example, the 8 % threshold of core tier 1 capital that will be used as the benchmark capital level. However, to date, important parameters remain still undecided and/or have not yet been communicated. These include in particular the treatment of sovereign debt, the magnitude of the stress test and the treatment of systemic risk. In light of the relevance of these variables for the formation of market expectations *ex ante* and for the credibility of the stress tests *ex post*, it will be important for the ECB to be as transparent as possible as early as possible.

The choices that still have to be made about these elements can potentially affect the results of the exercise. Market analysts and academics have been putting forward numerous estimates of the recapitalisation needs that might be identified by the stress tests for the euro-area banking system. The estimates vary widely between 50 billion and up to 650 billion euros. Differences in estimates are explained by the lack of information about the balance sheets of banks, and by the uncertainty over central parameters of the exercise, in particular the way the systemic dimension of the exercise will be approached.

If a recapitalisation need is identified, decisions will need to be taken on how the capital need will be met. In the current situation, the main guiding framework is national decision-making authority. Some harmonisation is introduced via the amended state-aid framework, which is discussed in this paper. This regime however could lead to potentially significant differences between countries and could thereby deepen financial fragmentation. The Bank recovery and resolution directive (BRRD) will improve the situation significantly in terms of harmonisation, but it is important to agree on a Single Resolution Mechanism in time for the ECB exercise.

The discussion on bail-in has gained importance over recent months, and is likely to remain topical also in the context of this exercise. The modified state-aid regime *de facto* introduces bail-in of junior debt as a precondition for accessing public funds for bank recapitalisation. The BRRD will introduce tougher requirements from 2018 (unless the bail-in provisions are anticipated). We argue that the new system should be based on strict and clear rules. However, in some exceptional cases, policy discretion needs to be exercised in order to prevent major systemic fall-outs from bail-ins. Who exercises this discretion, and how they do it, are of central importance. For large bail-ins of senior debt in the transition, the potential systemic implications need to be assessed, but they should not be excluded *ex-ante*.

Finally, there is the question of how remaining recapitalisation costs should be distributed between national taxpayers and taxpayers of other European countries. While during the transition phase to the new steady state, national taxpayers will inevitably have to shoulder most of the burden, we argue that in order to credibly break the vicious circle between

banks and sovereigns, a European insurance scheme for the large risks, combined with a contribution from national taxpayers (skin in the game) is needed in the steady state.

A number of important policy priorities follow:

- To end uncertainty, the ECB should soon transparently communicate the central parameters of the comprehensive assessment, in order to allow for private sector solutions. The risk connected to sovereign debt holding should be assessed in the asset quality review (AQR) by treating it at a discount reflecting the current market value. But sovereign debt should not be part of the forward looking stress test exercise. The resulting better capitalisation should strengthen the lending of banks to corporations and households. The ECB should also say how it will treat and take into account systemic interconnectedness.
- Once the exercise is underway, the ECB should not shy away from forcing non-viable banks into restructuring. We acknowledge that this could lead to some short-term volatility on the financial markets, which could be unavoidable, but this should be weighed against the cost of a lasting weak and dysfunctional banking system and the value of the credibility of the ECB as a supervisor and a monetary authority. The ECB needs to be ready to provide large amounts of liquidity to the remainder of the financial system following the closure of banks.
- Governments should support the ECB in its effort to re-structure and bring the banking system back to health. Most importantly, governments should accept and support cross-border bank mergers where sensible. This means that they should accept losing political influence over their banks. They should also be ready to recapitalise banks where necessary. This will mostly occur from national taxpayer resources but the Eurogroup should agree on cost sharing for bank re-capitalisation needs where it can prevent government insolvency.
- To credibly break the link between banks and sovereigns, bank creditors need to be more involved in the sharing of the burden than during most of the last five years. Toughening and advancing bail-in rules is one element of this strategy. However, for senior debt during the transition period, a systemic risk evaluation should be made before proceeding to the bail-in. The senior creditor bail-in should only occur for banks that are put in "gone concern".
- Decisions on bail-in, bank restructuring and resolution should be based on rules that limit discretion and prevent different approaches in different countries. However, there is always an element of policy discretion because the situation and implications are different depending on the case and cannot be fully made automatic. It is of crucial importance that the policy discretion is exercised by a European resolution authority. Relying only on national authorities can lead to major differences and applications in different countries, thereby undermining financial integration and reinforcing the re-nationalisation of finance that has been seen in the last few years. This is not only sub-optimal but also undermines monetary integration. The co-legislators should therefore adopt the BRRD, and agree on a workable single resolution mechanism and on a roadmap to a proper Fund.

INTRODUCTION

The European Council's June 2012 commitment to break the vicious circle between banks and sovereigns by creating a banking union is one of the most important steps taken towards a more integrated euro area. Since then, the co-legislators have agreed on the first element of banking union, the creation of a single supervisory mechanism (SSM). Discussions on the single resolution mechanism (SRM) are still ongoing at the time of writing and the bank recovery and resolution directive (BRRD) is still in *trialogue*. A central aspect of the political discussion concerns the rules governing the recapitalisation of banks and the important transitional arrangements on the way towards banking union. This note focuses on the question of recapitalisation of banks to be supervised by the SSM.

The European economy is currently plagued by two major sources of uncertainty about the financial system and banks in particular. First, there is still uncertainty about the information the quality of banks' balance sheets. The fact that supervisors are to date still national means that outside investors cannot be fully sure that risk models in banks etc. are harmonised in different countries, and they may also have doubts about the quality of different national supervisors. The fact that the ECB becomes the single supervisor and will conduct a far-reaching initial assessment of banks' balance sheets will greatly reduce this uncertainty.[1]

The second major uncertainty concerns the rules that will apply to bank recapitalisation, bank restructuring and bank resolution. The European approach towards banking issues in general – and bank recapitalisation specifically – has changed considerably since 2008, jumping from one extreme to the other. Initially, the prevailing view in Europe was that private sector participation needed to be avoided at all costs.[2] The ECB itself was adamantly against forcing losses on the private creditors of Irish banks, where admittedly the potential savings to the taxpayer were rather subdued[3]. This opposition was mainly rooted on the concern – justified or not – that forcing losses on private investors would have had potentially disruptive consequences for the stability of the financial system of the countries concerned, and of the euro area as a whole.[4]

The general approach changed – although slowly – when it became evident that the strategy of total bailouts was costly and could also have major systemic consequences. The channels are well known by now: high costs associated to bank recapitalisation cast doubts on the sustainability of public finances, initiating a "vicious circle" [5] between sovereigns' and banks' misfortunes, which has been one of the characteristic features of this crisis. Faced with the high cost of public bank rescues, European policymakers started to talk more openly about the possibility of private sector participation. This started to be seen as a way to both reduce the cost for the taxpayer and to foster the right incentives, by allocating responsibilities to those that took risks in the first place. The episode of Cyprus marked a jump to the extreme, leading to considerable confusion about the applicable framework for bank recapitalisation. Since then, all in all, the EU has been on the path of shifting from a framework in which private participation was abhorred to one where it will become the

---

[1] See Constâncio (2013) on the way the SSM will harmonize such differences.

[2] This is what Bruegel scholar Nicolas Véron has called the « Sanio doctrine » referring to the first large bail-out of the crisis that happened in Germany on the insistence of the Bafin chef with reference to the systemic dimension of the concerned bank and the Pfandbrief market.

[3] Pisani-Ferry, Sapir and Wolff (2013) estimate the number for Ireland to be around 5-10bn euros.

[4] See, for example, Asmussen (2012), The Irish case from an ECB perspective, 12 April 2012,

[5] Gerlach, Schulz, Wolff (2010) empirically demonstrate that larger banking sectors and less capitalized banking sectors can potentially constitute a significant burden on tax payers and are therefore positively correlated with sovereign risk, in particular when risk aversion is increasing.

norm, but the transition is tricky and the timing is challenging especially in relation to the ECB's upcoming comprehensive assessment of banks.

Against this background, this note starts by discussing estimates of potential recapitalisation needs that could result from the ECB's upcoming assessment of banks. This highlights that important choices, which will influence the outcome of the exercise, have not yet been made. It also highlights the fact that the ECB assessment will be *de facto* an assessment of the banking system and not just individual banks – which is necessary to restore trust but which is delicate, in view of the potentially substantial recapitalisation needs that it could imply. We then review the currently discussed rules on bank recapitalisation and note that there is still considerable uncertainty, which should be removed before the ECB takes over as supervisor.

1. BANK RECAPITALISATION NEEDS, WHAT TO EXPECT

1.1 Elements of uncertainty in the design

The European Central Bank (ECB) will assume its new supervisory tasks in November 2014. Prior to that, the ECB together with national competent authorities (NCA) will conduct a comprehensive assessment of the banking system, which is to be concluded in October 2014. This exercise will involve all banks that will in the future be directly supervised by the ECB, i.e. around 130 banks in 18 euro area countries, accounting approximately for 85 % of total euro area bank assets. The comprehensive assessment is to be undertaken by the ECB based on the transitional arrangements laid out in Article 33.4 of the SSM regulation[6]; national authorities as well as the concerned credit institutions shall supply the necessary information as requested. According to the ECB, the assessment consists of three elements[7]

- A supervisory risk assessment, addressing key risks in the banks' balance sheets, including liquidity, leverage and funding.
- An asset quality review, examining the asset side of banks' balance sheets as of 31 December 2013. All asset classes, including non-performing loans, restructured loans and sovereign exposures, will be covered.
- A stress test, building on and complementing the asset quality review by providing a forward-looking view of banks' shock-absorption capacity under stress.

The ECB will set capital thresholds as a benchmark for the outcomes of the exercise amounting to 8 % Common Equity Tier 1. The threshold is decomposed to 4.5 %, which is the ratio that will be legally mandatory as of 1st January 2014 according to CRDIV/CRR, a capital conservation buffer of 2.5 %, and an add-on of 1 % to take into account the systemic relevance of banks. The capital ratios make reference to the new regime that will phase in with the CRD IV Directive. The 4.5 % is the minimum CET1 capital ratio required under CRD IV (up from 2 %) whereas the capital conservation buffer is a new prudential tool introduced by Basel III and implemented by the CRD IV, which sets it at 2.5 % of Risk Weighted Assets (RWAs). The capital conservation buffer will however only start to phase in gradually as of 2016. CRD IV includes also a mandatory systemic risk buffer of between 1 and 3.5 % CET 1 of RWAs for banks that are identified by the relevant authority as globally systemically important (based on the G-20 agreed G-SIFI criteria). Moreover, CRD IV also gives the supervisor an option to set a buffer on "other" systemically important institutions, including domestically important institutions and EU important institutions. The decision by the ECB to introduce an additional systemic buffer echoes a choice previously done by the FED[8] in its recent stress tests[9].

---

6 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0063:0089:EN:PDF

7 ECB Note, Comprehensive Assessment October 2013, http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

8 See Comprehensive Capital Analysis and Review 2014 Summary Instructions and Guidance, 1 November 2013; http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131101a2.pdf

And 2014 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule - November 1, 2013 http://www.federalreserve.gov/bankinforeg/bcreg20131101a1.pdf

9 CRD IV establishes five new capital buffers: the capital conservation buffer, the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer. On top of all these own funds requirements, supervisors may add extra capital to cover for other risks following a supervisory review and institutions may also decide to hold an additional amount of capital on their own. See

These being the cornerstones of the exercise, two elements create uncertainty. A first element of doubt is the **definition of capital.** There are in fact two elements that play a role in a stress test: (i) the size of capital ratios to be met and (ii) the strictness of the definition of capital (i.e. what instrument can and cannot be counted as Core Equity Tier 1). For given capital ratios, a tighter definition of CET1 makes it more difficult for banks to meet the requirement. The element of uncertainty in the context of the ECB exercise stems from the fact that the latter will be taking place at the same time of the phase in of the new requirements foreseen in the EU Capital Regulation and Directives, which change the definition of capital by making it stricter.[10] Currently used instruments that do not meet the new requirements will have to be phased out. Both Basel III and CRR foresee long transition periods.[11] This means that banks will start adjusting next year to the new definition of capital, whereas the ECB exercise will use balance sheet data as of end 2013, i.e. before the beginning of the transition. The definition of instrument that will counted as Tier 1 in the stress test is therefore important and it has not yet been entirely clarified by the ECB.[12]

A second non-negligible element of uncertainty concerns the **post-stress-test outcomes.** As to date, in fact, it has neither been communicated what would happen with banks falling below the 4.5 % threshold in the comprehensive assessment, nor it is clear how toughly the ECB would handle banks above 4.5 % but below 8 %.[13]

1.2 Market Expectations

Researchers and bank analysts have expressed their hope in the exercise as a central element of strategy to restore trust in Europe's banking system. One big difference of the current exercise compared to previous EBA exercises is indeed that the ECB will actually become the competent supervisor. It will therefore have far reaching powers and it will also be able to make sure that banks' internal risk models will be harmonised. If so, this may contribute substantially to restoring trust in Europe's banking system.

Currently, market based valuations of banks in Europe suggests that investors still do not trust entirely the quality of banks' balance sheets. The Figure below shows that the market to book value of major banks in 5 selected euro area countries is below 1, which indicates that stocks are either systematically undervalued or that the market suspect balance sheets still hide significant potential losses.

European Commission - MEMO/13/690 of 16/07/2013
http://europa.eu/rapid/press-release_MEMO-13-690_en.htm

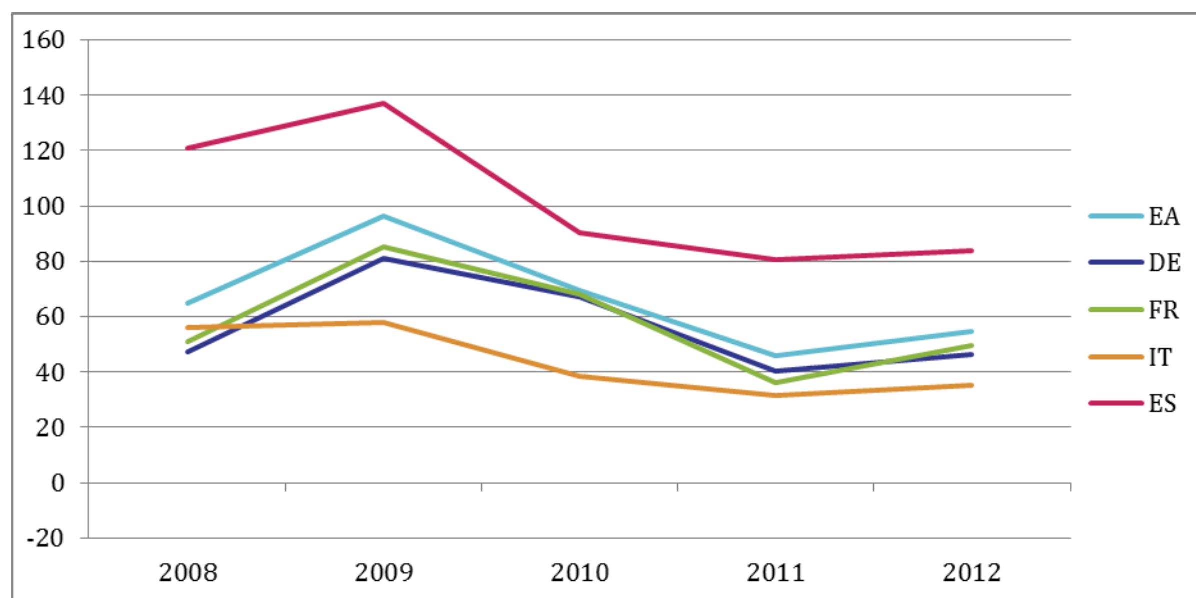
[10] The CRR follows Basel III and sets 13 strict criteria which any instrument would have to meet to qualify as CET1. The 14 criteria are listed in Article 28(5) of Regulation (EU) No 575/2013 - http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF

[11] The transition period is established to ensure that before the new capital requirements apply in full, banks are given the proper time to adapt so as to avoid negative consequences on their activity of lending to the economy. In particular the phase out of capital instruments that will not meet the new and stricter eligibility criteria is supposed to last 8 years from 2014.

[12] The guidelines just published state that *"the capital definition of 1 January 2014 will apply for the asset quality review, whereas the definition that is valid at the end of the horizon will be used for the stress test".* Being the horizon of a stress test normally around 3 years, the "definition valid at the end of the horizon" – which would be applied on balance sheet data of 2013 – could include part of the phase in to the new requirements.

[13] Current legislation only foresees the 4.5 % threshold for existing bank balance sheets. Once the transition phase for capital conversion buffers is over, the law would also require banks that do not hold the full 2.5 % capital conversion buffer, to refrain from certain practices such as payments of dividends and the like. However, these rules are formally not applicable in 2014.

Figure 1: Price / Book ratio in per cent



Note: the data are computed as the average of the largest 5 banks in each respective country.
Source: SNL Financials and Bruegel computations.

Concerns may be justified in light of the generalised rise in non-performing loans on the balance sheet of European banks, especially in the South. The absence of harmonisation in the definition of NPLs implies that numbers are not entirely comparable across countries (Barisitz, 2013) and adds another element of opacity that affects investors' confidence. The IMF in the GFSR estimated potential losses stemming from corporate lending for several countries coming to much diversified conclusions. The importance of the ECB's exercise – which will use a uniform definition of NPL – is therefore immediately evident.

Bank analysts report different numbers on the capital shortfalls in Europe's banking system. The table below reports a selection of different estimates. The numbers generally vary between EUR 100bn and EUR 300bn even though some estimates are significantly higher. The wide range of estimates can be explained by differences in methodologies, in particular as regards assumptions on the size of stress and the systemic interconnectedness of the banks on the one hand, but on the other hand they also show the considerable uncertainty as regards the quality of banks' balance sheets. Concerning the geographical distribution of needs, market analysts seem to agree that the surprises are more likely to come from those countries whose banks have not been subject to a thorough review, e.g. in the context of EU/IMF programmes.

Table 1: Estimates of capital shortfalls

Source[14]	Estimation, EUR Billions	Publication date
Credit Suisse	50	16/10/2013
Goldman Sachs	75	31/10/2013
Standard & Poor's	95	08/11/2013
PricewaterhouseCoopers	280	28/11/2013
VLAB	652	23/11/2013

On the right side, the capitalisation of euro area banks has certainly improved in recent years. According to the ECB itself, "euro area banks have raised around EUR 225 billion of fresh capital and a further EUR 275 billion has been injected by governments, equivalent in total to more than 5 per cent of euro area GDP[15]" since the beginning of the crisis. Core Tier 1 capital has increased substantially and the median now amounts to a healthy 12 %[16]. Non-risk weighted average tangible equity in the 9 global systemically important banks of the euro area stands at 3 %.[17]

However, an assessment of the recapitalisation needs of banks ultimately requires deep supervisory knowledge and involves a number of important choices in the stress tests. Potential recapitalisation needs depend on future growth, on the future developments of non-performing loans and other factors that determine the performance of banks' assets. A particularly relevant issue concerns the systemic dimension of the stress with which the system will be confronted in the stress tests. By the definition of the sample, many of the banks that will be tested are systemic for the countries where they are incorporated and the euro area as a whole. In its note laying out some of the key principles of the upcoming comprehensive assessment, the ECB emphasises that an ad-on of 1 % of Tier 1 Capital will be requested to take into account the systemic relevance of the banks concerned. The ECB also makes clear that the comprehensive assessment will not only concern the banks individually but that due to the magnitude of the exercise, it should rather be seen an assessment of the whole banking system.

A particularly relevant question is thus how systemic risk is taken into account. It is important to understand that systemic risk can give rise to non-linear effects on capital

[14] Credit Suisse Securities Research & Analytics, European Economics Research, *Banking Union – The Year Ahead: Part I;* https://doc.research-and-analytics.csfb.com/docView?language=ENG&format=PDF&document_id=1023963451&source_id=em&serialid=fHARcZ2KSnlcH5aR9BZvRUWNrLM%2FF4H2tSPjwktHWjY%3D

Declaration of Frank Gill, S&P's Director of European Sovereign Ratings as reported by Reuters News; http://www.reuters.com/article/2013/11/08/eurozone-banks-idUSL5N0IT1L120131108

Goldman Sachs Global Economics, Commodities and Strategy Research, European Economics Analysis: 13/38 - *Will weak bank lending endanger the gradual recovery?*; https://webid2.gs.com/cgi-bin/external/login.cgi?From=aHR0cHM6Ly8zNjAuZ3MuY29tL3Jlc2VhcmNoL3BvcnRhbC8/c3Q9MSZhY3Rpb249YWN0aW9uLmJpbmFyeSZkPTE1OTEyMjA5JmZuPS9kb2N1bWVudC5wZGYmYT1jMjQyMmZjMmFhNDY0MzQyYTZhYzdlNmU4MTUwOTdhYQ==

PricewaterhouseCoopers Report - Basel III and beyond - *Deleverage take two: making sense of the revised Basel III leverage ratio* as reported by Reuters News. http://www.reuters.com/article/2013/11/28/banks-capital-pwc-idUSL5N0JD1VQ20131128

[15] ECB Note, Comprehensive Assessment October 2013, http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

[16] Constanzio (2013), Banking Union and the Future of Banking, Speech, December 2013, http://www.ecb.europa.eu/press/key/date/2013/html/sp131202.en.html

[17] Sapir and Wolff (2013), based on FDIC statistics.

shortfalls. While at small scale shocks, required capital buffers increase gradually, at larger shocks, some banks may suddenly require much larger capital increases as spillovers magnify the shock. On the other hand, it is also possible that at some capital levels, systemic interconnectedness abruptly goes down[18].

The New York University's Stern V-Lab publishes estimates of systemic risk of major banks around the world.[19] The estimates are based on publicly available information and include correlations of market price as well as currently reported capital levels. The central factors driving the estimates are the fact that leverage is measured at market values and that tail-risks get correlated. The estimated capital shortfall is then based on a drop in the aggregate market value of 40 %. The estimates are therefore capturing true systemically relevant episodes but are not necessarily comparable with the outcome of the ECB's exercise. Applying this methodology would result in a number of EUR 652.62 Billion for the euro area[20]. Using the same methodology, Dor (2013) estimates the capital shortfall for the euro area banking system to be 597.48 Billion[21]. The capital shortfalls differ significantly across countries. Such a tough approach may be exaggerated for next year's exercise as the size of the asset market shock would resemble the one experience at the beginning of the crisis, an event very unlikely to repeat itself in the next years. Yet, in the medium-run a sufficient capitalisation of the banking system to withstand such a shock is certainly desirable.

A second relevant dimension concerns the treatment of sovereign bonds on the books of banks. The issue of sovereign holdings is certainly a thorn in the side of both the ECB and European regulators, in light of the perverse dynamics observed during the crisis and the increasing exposure of banks in some countries to sovereign debt. As far as the ECB exercise is concerned, the published guidelines refers to the fact that sovereign bond holdings will be part of the in depth assessment conducted in the Asset Quality Review (AQR) but there is no mention on whether and how they will be treated in the subsequent stress test, nor is it clarified how sovereign debt will be valued. In the AQR, it is advisable to treat sovereign debt at current market value and not at book value as lower market values do weigh on the banks' balance sheets and may therefore curtail lending to corporations and households. In the medium-run, single exposure rules or risk weights should be introduced for sovereign debt as a further way of breaking the link between banks and sovereigns but such rules cannot be applied immediately (Sapir and Wolff 2013). One should therefore not include sovereign debt in the stress tests as this could lead to negative short-term dynamics.

Ultimately, the capital needs can only credibly be assessed with detailed information on banks' balance sheets and on their systemic interconnectedness. Even more importantly, not all policy decisions have been made to perform the assessment of the capital shortfalls. The most important policy choices concern GDP projections, the treatment of sovereign debt as well as the extent to which systemic risk is taken into account in the tests. The European Central Bank has therefore clearly communicated that no intermediate results

---

[18] See for example, Schweitzer, Frank, « Mechanisms of systemic risk » http://www.sg.ethz.ch/media/talk_slides/zif-schweitzer-presentation.pdf for an easy introduction. Also Huang et al (2010), « Systemic Risk contributions », http://www.federalreserve.gov/pubs/feds/2011/201108/201108pap.pdf

[19] Global MES model for Systemic Risk Analysis by NYU Stern - http://vlab.stern.nyu.edu/analysis/RISK.WORLDFIN-MR.GMES

[20] This number refers to EA17 countries minus Estonia and Luxembourg, for which data are not reported. Last data update: 2013-11-30.

[21] This number refers to EA17 minus Estonia, Luxembourg, Slovenia, Slovakia, Malta and Ireland. Last data update: 2013-09-27.

can be published.[22] The fact that capital levels have increased in the last years does certainly not preclude the potential for further recapitalisation needs being detected.

To establish its credibility as a supervisor, the ECB should not only be tough in its assessment. It should also not shy away from forcing banks to raise new capital and in *ultima ratio* forcing banks in restructuring and resolution. The result may be temporary volatility on the financial market, which should be weighed against the cost of a lasting weak and dysfunctional banking system as well as the credibility of the ECB as a supervisor and also as a monetary authority. In the period of possible financial instability, the ECB should stand ready to provide large amounts of liquidity to the banking system. Governments should be supportive of this policy action, even if the liquidity provision would result in a rise in Target2 balances.

Against this background, the next section discusses principles and practices of bank recapitalisation. Particular emphasis is put on the currently existing rules, which are the state aid rules, on the Bank Recovery and Resolution Directive, which is currently in *trialogue* as well as principles that should govern the SRM.

[22] Asmussen (2013) « We will not publish any preliminary or intermediate results and I am quite surprised about the noise you hear these days in all directions about the possible outcome of the exercise. If we knew that "banks in the periphery will not face severe problems" or if we knew that "the recapitalisation needs will be a double digit bn figure" we could spare the effort in conducting this exercise. All these statements are mere speculation. » Speech at the joint conference "The Single Resolution Mechanism and the Limits of Bank-Regulation" Humboldt Universität/Financial Risk and Stability Net-work in Berlin, 8 November 2013, http://www.ecb.europa.eu/press/key/date/2013/html/sp131108_1.en.html

2. BANK RECAPITALISATION: HOW AND WHEN

The comprehensive assessment of Europe's banking system taking place next year will start the phase of single bank supervision in Europe. The exercise is of fundamental importance for the ECB, as it will be the building block of its reputation as supervisor. Some market participants seem to have doubts about the fact that the exercise can be a game-changer. A recent investor survey run by Morgan Stanley revealed that the majority of investors interviewed did not see the AQR/stress tests as likely to have a meaningful impact on boosting lending. To avoid episodes like Dexia – which jeopardised the reputation of EBA's stress tests in 2011 – ensuring credibility is crucial and the statements of ECB's official suggest it will be biting. ECB President Draghi in a recent interview with Bloomberg[23] stated that if banks *"do have to fail, they have to fail. There is no doubt about that"*. This consideration has raised animated discussions at the political level across Europe, about how to deal with the shortfalls that will possibly be discovered. More specifically, a key point in the debate surrounding the ECB's exercise concerns the optimal degree of private versus public contribution to the recapitalisation, in the case of banks that were not able or willing to raise all (or part) of the needed capital on the market.

A number of issues deserve careful consideration when deciding about the how and when of bank recapitalisation.

(1) The first issue concerns who should decide on whether a bank needs to raise capital. There is a difference between legal requirements on the one hand and what the results of the comprehensive assessment could document, which stems ultimately from the supervisory choices underlying the design of the exercise. This also closely relates to the issue of when banks are put in resolution and when it should be instead recapitalised.

(2) The second dimension concerns the question of raising of capital in the private markets versus public recapitalisation.

(3) The third (and related) question is under which circumstances European funds should be used and under which conditions national funds should be relied on.

A first fundamental question is when should a bank be resolved rather than recapitalised and who should decide this. As regards this issue, the situation is currently unclear. Under existing legislation, a bank can be forced to raise capital when it is falling below the 4.5 % threshold defined by the CRDIV/CRR. In case the capital threshold of 4.5 % is met, the ECB has still, as any supervisor, the possibility to ask the bank to increase its capital. The decision on whether a bank should be put into resolution or recapitalised necessarily involves some degree of discretion on the side of the supervisors. But there are technical issues that should be taken into account as well. In particular, it would be at present very difficult for the ECB to put a bank into "gone concern", i.e. force the bank to actually restructure, even assuming that it wanted to, if the bank's current capital ratio exceeds 4.5 %. In case resolution was the avenue chosen, the ECB would have to work closely with national resolution and supervisory authorities in such instances.

Unfortunately, in the absence of a single resolution – as the SRM is in the early stage of negotiations and the BRRD has yet to be agreed upon – there is currently no harmonisation of the procedures for resolving credit institutions at Union level. This means that under current legislation the ECB would have to operate with numerous national resolution

[23] *Draghi Says ECB Won't Hesitate to Fail Banks in Stress Tests*, By Stefan Riecher & Jeff Black, Bloomberg News, Oct 23, 2013, http://www.bloomberg.com/news/2013-10-23/draghi-says-ecb-won-t-hesitate-to-fail-banks-in-stress-tests.html

authorities, which each would operate under different legal rules and political logics. This is likely to lead to massively different re-capitalisation and restructuring practices across the union. This would not only constitute a very difficult situation for the ECB, but it would also likely lead to a further re-nationalisation of banking and fragmentation of the financial system[24].

A second (and possibly more) relevant question in the context of the ECB assessment is what to do with a banks that were to fail the stress test – i.e. were found to have a capital shortfall – but were not to be put in resolution. In such circumstances, the ECB will as the relevant supervisor ask the bank to raise its capital levels.

If a bank cannot or does not want to raise private capital, under current legislation, state aid rules would determine how public resources would be used. In July 2013, the European Commission issued a new Communication that amends the rules for State Aid to banks[25]. The new regime includes a number of fundamental changes to the regime previously in place, which will have bearings in the context of the ECB's exercise.

First, ex-ante evaluation is strengthened. The Communication clarifies in particular that State intervention (in the form of recapitalisations and impaired asset measures including asset guarantees) will be authorised only if the Member State concerned has previously demonstrated that all measures to limit such aid to the minimum necessary have been exploited to the maximum extent. To that end, the "Member States are invited to submit a capital raising plan, before or as part of the submission of a restructuring plan". This means that as a general rule, a restructuring plan will have to be notified to the Commission and a final State aid approval will have to be obtained before recapitalisation is undertaken. An exception is foreseen, but only in cases where the competent supervisory authority expressly confirms that the rescue aid is required.

Second, a bail-in framework is de facto introduced as the Communication states that the restructuring plan must cater for "adequate burden-sharing". More specifically, "before granting any kind of restructuring aid […] to a bank all capital generating measures including the conversion of junior debt should be exhausted, provided that fundamental rights are respected and financial stability is not put at risk". A pecking order is also specified, with losses being first absorbed by equity and then by contributions from hybrid capital holders and subordinated debt holders. The contribution from senior debt holders will instead not be required as a mandatory component of burden-sharing under State aid rules. The Communication also draws a distinction between cases of banks found to be below the minimum regulatory capital requirements or not. In cases of banks falling below the minimum regulatory capital requirements, "subordinated debt must be converted or written down, in principle before State aid is granted. State aid must not be granted before equity, hybrid capital and subordinated debt have fully contributed to offset any losses". In cases of banks whose capital ratio remains above the EU regulatory minimum, The Communication points out that "the bank should normally be able to restore the capital position on its own, in particular through capital raising measures" but if there were no other possibilities, "then subordinated debt must be converted into equity, in principle before State aid is granted".

The new State Aid rules therefore subordinate the possibility to use public funds for the recapitalisation of a bank to the previous implementation of an "appropriate" amount of bail-in. These rules extend the idea of bail-in outside the resolution context, to the case of

[24] See for example Sapir and Wolff (2013), The neglected side of banking union: reshaping Europe's financial system, Bruegel Policy Contribution to informal ECOFIN.

[25] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:216:0001:0015:EN:PDF

recapitalisation of banks that are not in resolution and it will be applicable in the context of the ECB exercise. Banks that are not able to raise all the needed capital on the market would therefore need to bail-in their subordinated debt-holders before having the option to access public money.

The modification of the state aid rule works as a bridge towards the fully harmonised framework that will be introduced with the Bank Recovery and Resolution Directive (BRRD), which has been endorsed by the Council and is currently in *trialogue* with the European Parliament. On more than 300 pages, the BRRD provides a number of important provisions, which can rightly be considered a game changer in European banking. They also go a significant step forward in terms of creating a harmonised approach to bank resolution as well as to the bank resolution of the large banks to be supervised by the ECB directly. In particular, the BRRD foresees:

- An asset separation tool
- Bail-in of investor capital, which is mandatory up to 8 % of the bank's non-risk-weighted assets, before using any public sector money.[26]
- That banks issue debt that are subject to bail-in
- Establishes a resolution fund financed by the industry
- Requiring banks to provide resolution plans

It is the declared aim of the EU heads of state and government to not only have the BRRD in place by the time of the ECB's comprehensive assessment but also to have agreed on a single resolution mechanism. It is of crucial importance that Europe has agreed on the BRRD and the SRM by that time[27].

The second question concerns the extent to which private and public money should be used for bank recapitalisation. In principle, banks that were to be found undercapitalised with respect to the benchmark set by the ECB, will be asked to raise capital on the market. This is what banks would normally do and it should be seen as the benchmark also for next year's exercise. However, a number of specific factors can render the issue more complicated next year. First, the different estimates of potential capital shortfalls reported in the previous Section show that the numbers could be quite big. This could give rise to a situation in which some of these banks do not manage to raise all (or some) of the required capital on the market[28]. In such instances, the use of some public resources may be desirable in order to prevent major fire sales of assets. Those public resources could, however, only be used following clear and strict rules, including the bail-in of junior creditors according to state aid rules. Depending on the provisions agreed upon in the BRRD, even the bail-in of senior creditors may be contemplated. The debate here centres on the date at which the bail-in tool should be made operational. The BRRD currently sees the tool to be starting only in 2018 and the main argument advanced for this date is to allow banks time to adapt and prepare. The counterargument would be that the solution to significant past problems can only hardly be imposed on taxpayers, that have already

---

[26] "A contribution to loss absorption and recapitalisation equal to an amount not less than 8 % of the total liabilities including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 30, has been made by shareholders and the holders of other instruments of ownership, the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise" – Article 38 (3cab) of the Council proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms. http://blogs.r.ftdata.co.uk/brusselsblog/files/2013/06/BRR.pdf

[27] The BRRD foresees a phase in period for the bail-in provisions, which were expected to kick in from 2018, although some countries have recently been pushing for anticipation to 2015.

[28] Banks are important investors into other banks, and having possibly several big European banks on the market for capital at the same time could already per se reduce the number of potential investors.

significantly contributed and that it would therefore be preferable to impose them on current bank creditors.

Bail-in can be an effective tool in reducing the cost of rescuing a bank, but its application on a systemic scale can also have negative consequences. The risk is that it introduces negative confidence effect that would induce investor to rush out of an otherwise solvent bank (or even banking system) with evident financial stability risks. ECB President Mario Draghi expressed concerns about such an outcome in a letter sent to the Commission. On that occasion he called for flexibility in the case of those banks that will be found to need more capital without falling below the minimum regulatory requirement. However, in such a situation the usages of public capital is not entirely convincing as the capital levels are anyway above the legal requirement. On the other hand, there is a risk that not all banks manage to raise the entire amount they need on the market, based on the fact that several very big banks could possibly be going to the market for capital as a result of the stress test result and the fact that amount needed could be sizable. A solution to this dilemma may be to agree on longer transition periods during which banks would raise capital in the market.

More problematic is however the case where the capital level is below the legal minimum but where there is a going concern. Here, the use of public capital is much more straightforwardly regulated and the central question is then how much to dilute current shareholders of banks. The State aid regulation does cater for exceptions to the bail-in requirements in cases where implementing such measures would "endanger financial stability or lead to disproportionate results" but the circumstances are not defined. This has the advantage of leaving flexibility to cope with unforeseen situations. At the same time, flexibility introduces yet another element of uncertainty from the point of view of the investors that the framework was supposed to reassure and it increases the risk that flexibility will result into public re-capitalisations even in cases where no financial stability risk exists. The bail-in of senior debt should not be excluded ex-ante. The experience with two middle-sized Danish banks, Amagerbanken and Fjordbank Mors, shows that bail-ins can be handled without systemic implications even though the situation is not fully comparable.[29] However, senior bond holder involvement can have systemic implications, which would need to be carefully assessed before the decision to bail-in.

Overall, we acknowledge that the framework should be based on very clear and binding rules which minimise tax payer involvement. However, some flexibility may be necessary in very exceptional cases. The governance of exercising this flexibility is of absolutely crucial importance. To exercise flexibility, it is important to clearly define the authority that will exercise the discretion. The BRRD framework is clearly insufficient for exercising this flexibility as national authorities would still play a dominant role. This could lead to vastly different applications of the rules causing significant distortions in the European banking market and increasing substantially the policy uncertainty to bankers. It is therefore of central importance to finish the work on the Single Resolution Mechanism. It is not possible to take meaningful bank resolution decisions in a short time period based on unanimity voting mechanisms. It is therefore necessary to revert to normal or qualified majority voting. This means that national authorities can be overruled, even where there are fiscal implications. Further steps on ensuring the appropriate legitimacy of this process are necessary.

The third important policy dimension concerns the use of national or European public resources for bank recapitalisation. This discussion should be seen in the light of the

[29] For details, see Darvas (2013), To bail-in or not to bail-in, that is the question for Cyprus, Bruegel Blog 14 March. http://www.bruegel.org/nc/blog/detail/article/1043-to-bail-in-or-not-to-bail-in-that-is-the-question-now-for-cyprus/

potentially very large risks identified above. More generally, banking crisis can have very large fiscal implications.[30] To permanently and credibly break the vicious circle between banks and sovereigns, a credible insurance for large risks is necessary. The build-up of a resolution fund, paid from contributions of the banks covered is an important step. In the steady state in which the common resolution fund would be funded by the large banks, the organisation of this fund only makes sense at a European level as individual countries often do not have a sufficient number of large banks to provide a meaningful number to diversify risks. However, to be fully credible, such a fund would need to have a credit line to the European tax-payer, which could, for example, be based on the ESM. In the steady state, it will also be important to keep national tax-payers on the hook. As long as numerous national policies influence the likelihood of bank failures, the fact that national tax payers keep a skin in the game along-side the common insurance is justified.

For the transition, the main principle should be that the European insurance should be only used for large risks, which endanger national public solvency. For small public recapitalisation needs, national budgets can take care of the matter. For somewhat larger risks, a programme similar to the Spanish programme is advisable in order to avoid the risk of a country's government to be priced out of the market. In some cases of very large capital needs, direct bank recapitalisation from the ESM, combined with national tax-payer contribution, to take care of the legacy problems is advisable. This can be motivated not only by the fact that government solvency problems should be prevented. Equally important is the fact that some of banking problems are not the responsibility of faulty national supervision but have been done for euro area financial stability concerns[31]. In such circumstances, the case for burden sharing is strong. It is impossible to agree ex ante on precise thresholds at which direct bank recapitalisation should be done. Certainly, when banking rescue costs are high a debt sustainability analysis should be undertaken as this can already materially affect government solvency. There may also be instances, where government solvency is in any case endangered undermining the logic of direct bank recapitalisation. In the transition, policy discretion will remain a defining element of providing support. It is important that the policy system clearly signals its intention to collaborate to find the best European solution, ideally through a European resolution authority that will take such decisions with qualified majority voting. We therefore go further than the ECOFIN Council conclusion of November 15 and acknowledge the need for direct bank recap under specific circumstances.[32]

[30] Pisani-Ferry and Wolff (2012), The fiscal implications of banking union, Bruegel Policy Brief to informal ECOFIN; http://www.bruegel.org/publications/publication-detail/publication/748-the-fiscal-implications-of-a-banking-union/

[31] See Asmussen (2013), reference above.

[32] Council statement on EU banks' asset quality reviews and stress tests, including on backstop arrangements – Economic and Financial Affairs - Council meeting Brussels, 15 November 2013, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/139613.pdf

CONCLUSIONS

The euro area has embarked on a process of creating a banking union, which is of critical importance to the stability of the common currency area. After the creation of the single supervisory mechanism, the debate now focuses on bank recapitalisation. This note has focussed on the matter in view of the upcoming comprehensive assessment of banks' health by the ECB.

Considerable uncertainty prevails for investors in European banks. The uncertainty concerns the quality of banks' assets, the valuation of assets by policy makers as well as the rules under which losses will be handled. Reducing all three uncertainties is of paramount importance for improving funding conditions throughout the euro area. Policy makers should therefore finalise their work on the BRRD and the SRM ahead of the finalisation of the ECB's comprehensive assessment. The ECB should define clearly the rules under which the assessment will be done. This includes, *inter-alia*, the definition of the stress test as well as the treatment and valuation of sovereign debt. Finally, governments should be prepared to re-capitalise banks where necessary and there should be a political commitment to direct bank recapitalisation if it can avoid government insolvency.

REFERENCES

- Asmussen, J. (2013), Speech at the joint conference "The Single Resolution Mechanism and the Limits of Bank-Regulation" Humboldt Universität/Financial Risk and Stability Net-work, Berlin, 8 November 2013 - http://www.ecb.europa.eu/press/key/date/2013/html/sp131108_1.en.html
- Asmussen, J. (2012), Speech at the Institute of International and European Affairs, Dublin, 12 April 2012 - http://www.ecb.europa.eu/press/key/date/2012/html/sp120412.en.html
- Barisitz,S. (2013) - *Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions*, National Bank of Austria - http://www.oenb.at/de/img/feei_2013_q1_studies_barisitz_tcm14-253775.pdf
- Constâncio, V. (2013) Vice-President of the ECB, Speech at the IIEA Conference on "The Future of Banking in Europe", Dublin, 2 December 2013 http://www.ecb.europa.eu/press/key/date/2013/html/sp131202.en.html
- Dor, E. (2013) – "*The recapitalization needs of European banks if a new financial crisis occurs*", IESEG School of Management, Working paper number 2013-ECO-19.- http://www.ieseg.fr/wp-content/uploads/2013-ECO-19_Dor.pdf
- Gerlach, Schulz, Wolff (2010) - *Banking and sovereign risk in the euro area*, Deutsche Bundesbank - http://econstor.eu/bitstream/10419/32799/1/627499228.pdf
- Pisani-Ferry, Sapir and Wolff (2013), *EU-IMF assistance to euro area countries: an early assessment*, Bruegel Blueprint Series - http://www.bruegel.org/publications/publication-detail/publication/779-eu-imf-assistance-to-euro-area-countries-an-early-assessment/
- Pisani-Ferry and Wolff (2012), *The fiscal implications of banking union*, Bruegel Policy Brief to informal ECOFIN - http://www.bruegel.org/publications/publication-detail/publication/748-the-fiscal-implications-of-a-banking-union/
- Sapir and Wolff (2013), *The neglected side of banking union : reshaping Europe's financial system*, Bruegel Policy Contribution to informal ECOFIN - http://www.bruegel.org/publications/publication-detail/publication/792-the-neglected-side-of-banking-union-reshaping-europes-financial-system/

NOTES

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The asset quality review and capital needs: Why re-capitalise banks with public money?

Daniel GROS

NOTE

Abstract

It is generally assumed that any capital needs discovered by the Asset Quality Review the ECB is scheduled to finish by the end of 2014 should be filled by public funding (=fiscal backstop). However, this assumption is wrong. Banks which do not have enough capital should be asked to obtain it from the market; or be restructured using the procedures and rules recently agreed. DG COMP should be particularly vigilant to ensure that no further state aid flows an already oversized European banking system.

The case for a public backstop was strong when the entire euro area banking system was under stress. But this is no longer the case. Banks with a viable business model can find capital, those without should be closed because any public sector recapitalisation would likely mean throwing good money after bad.

CONTENTS

LIST OF ABBREVIATIONS **43**

EXECUTIVE SUMMARY **44**

INTRODUCTION **45**

1. ASSET QUALITY REVIEW VERSUS BUSINESS MODEL REVIEW **46**

2. WHY USE PUBLIC CAPITAL FOR RECAPITALISATION? **48**

2.1. On the ‘need’ for public sector recapitalisation 48

2.2. The real conundrum: throw good money after bad? 49

3. BANK LENDING IN THE EURO AREA: A QUESTIOIN OF QUANTITY OR QUALITY? **51**

4. CONCLUSION **52**

REFERENCES **53**

LIST OF ABBREVIATIONS

AQR Asset Quality Review

EBA European Banking Authority

ECB European Central Bank

EFSF European Financial Stability Facility

ELA Emergency Liquidity Assistance

EMU Economic and Monetary Union

NCB National Central Bank

SSM Single Supervisory Mechanism

EXECUTIVE SUMMARY

There are three aggregate numbers which describe the problem the Single Supervisory Mechanism (SSM) is inheriting: The 130 banks under its direct supervision hold assets worth 250 % of euro area GDP, their capital is equivalent to only 4 % of assets' value and they made zero profits, in the aggregate, over the last four years.

This is clearly not a 'normal' sector of the economy. The aggregate numbers hide of course huge national and sectoral differences; aggregate numbers have, however, some immediate implications.

The huge amount of assets implies that any problem with their value could raise massive risk, which could materialise quickly in losses, very large both relative to the bank's capital and relative to GDP. The cases of Spain and Ireland show what can happen if large banking systems make large losses.

Furthermore, given that these banks (which are coming under the Asset Quality Review, AQR) hold already about 1 000 billion euro in capital, any substantial recapitalisation of the sector requires funds in the order of hundreds of billions of euro.

But the aim of the AQR is not to change the status quo of a large and thinly capitalised banking system, but only to uncover whether some banks have overvalued assets on their balance sheets.

Any recapitalisation need which the AQR uncovers could be covered by the market, which can discriminate better between banks which are viable in the long run and those which are not. Those banks unable to obtain market funding should be restructured gradually under the rules recently agreed.

The continuing tendency of national authorities to help their banks is evident from the recent decision of the Spanish authorities to allow their banks to recognise 'deferred tax assets' as capital. The revaluation of the share of Italian banks held in the National Central Bank also increases the regulatory capital of some Italian banks (albeit by a rather small amount). In both cases the motives of the national authorities might have been understandable and both measures have been made fully compatible with EU norms. But both episodes show the continuing influence of national authorities on bank capitalisation.

INTRODUCTION

When the Heads of State and Government agreed in principle on the creation of a 'Banking Union' in the summer of 2012, the one step which was immediately agreed and quickly implemented was the decision to give the ECB supervisory powers. The main reason for this was that it had become clear during the crisis that national supervisors had become champions of their own banks. National supervisors had not always recognised serious problems at home and had developed a tendency to ring fence assets of 'their' banks (i.e. banks headquartered or even only with a legal seat in their countries).

The first phenomenon had created the widespread impression that the balance sheets of the major banks which now come under the direct supervision of the ECB might harbour significant amounts of assets which might not be properly valued. It was thus natural to allow the ECB conduct its own 'Asset Quality Review' to make sure that the banks it is now directly supervising are properly capitalised.

It is widely expected that the AQR, which the ECB will be conducting in the course of 2014 will uncover the need to recapitalise some banks. This had led to much discussion concerning the potential magnitude of the capital shortfall and the sources of funds for the re-capitalisation of those banks in need of additional capital. This contribution will deal only with the latter aspect.

The evaluation of the capital needs of a bank cannot be done only on the basis of a review of the quality of its assets. In the long run a bank can only survive if it has a viable business model. A forthcoming CEPS publication will go in great detail in the different business models pursued by the many different types of banks which operate in the 28 member countries of the EU. (Every sector and every national supervisor argues naturally that its sector or its banking system is totally safe and that the real problems are elsewhere.) But the broader issues raised by the diversity within the European banking sector cannot be addressed in this short contribution.

1. ASSET QUALITY REVIEW VERSUS BUSINESS MODEL REVIEW

The name 'Asset Quality Review' suggests a simple underlying problem: some assets are overvalued on the balance sheets of the banks. The ECB will organise a proper evaluation of the value of all assets in the banks' balance sheets and if it estimates that the 'true' value of some assets is lower than what provided in the book, the bank in question will be asked to increase its capital in order to cover these accounting losses. That seems to be the end of the story.

In reality, however, the problem is in many cases much more severe. Indeed, one should also consider that on average the banks under review have not made any profits over the last years. Many banks might not only have overvalued assets on their balance sheets, but they might also lose money on their current operations. If this is the case the problem can no longer be cured by a once off injection of capital, but only by a deep restructuring of the bank itself. Moreover, it simply does not make sense to put new capital into banks which for the foreseeable future cannot return (operating) profits.

Gros (2013) has shown that there might be large parts of the euro area's banking system which have a structural profitability problem. The difficulties in Southern Europe are well known, although they differ fundamentally from country to country. In Spain banks have over the years issued hundreds of billions of 30-year mortgages whose interest rates are indexed to interbank rates (Euribor), with a small spread (often less than 100 basis points) fixed for the life time of the mortgage. This seemed profitable at a time when Spanish banks were able to refinance themselves at a spread much lower than 100 basis points. But today Spanish banks, especially those most heavily engaged in domestic mortgage lending have to pay much more than 100 basis points spread over inter-bank rates on their own cost of funding. Many local Spanish banks can thus stay afloat only because they refinance a large share of their mortgage book via the ECB. But reliance on cheap central bank (re)financing does not represent a viable business model.

German banks have deposited hundreds of billions of excess liquidity at the ECB. The quality of these assets is 100 % (i.e. zero risk), but the return is zero. This does not make a profitable business model since the funding costs of German banks are not zero given the expensive domestic retail network necessary to collect the savings deposits, which form backbone of their financing.

There will of course be wide variations across individual banks and sectors. But it is clear that in an environment of low growth, low interest rates but high risk premia many banks must struggle to survive.

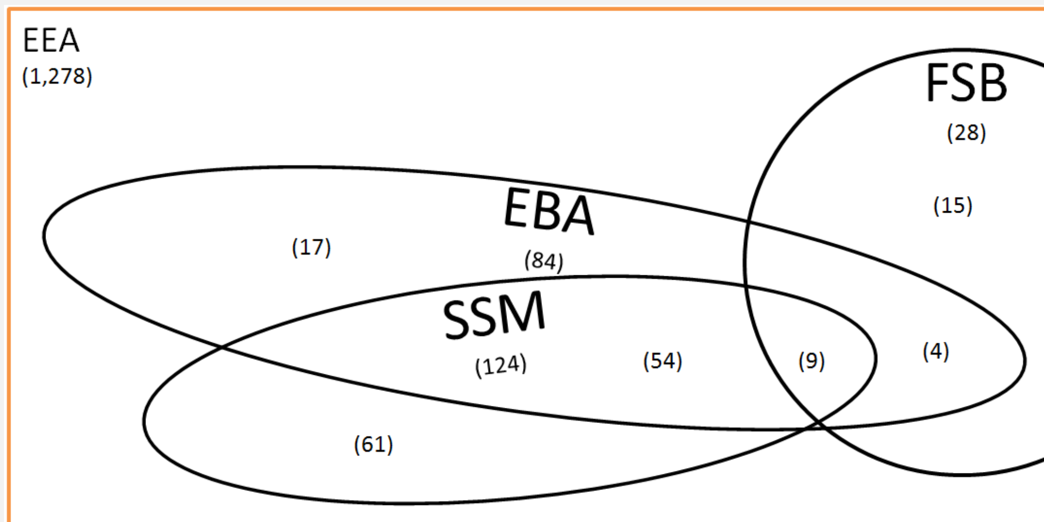
On the one hand, instead of simply reviewing the quality of the assets of the banks under its direct supervision, the ECB should also review their longer terms viability, i.e. their business models. ECB representatives have said that they intend to look at the viability of business models as well. Yet, it remains to be seen whether they will be able to do so since the AQR is undertaken in cooperation with the national supervisors and no national authority is likely to admit that its national 'champion' does not have a viable long-term business model.

On the other hand, it should not be the task of a public sector institution to decide which banking business models are viable. This should normally be done by the capital market. But the authorities might have no choice if the bank itself declares that it is not able to raise the capital the supervisors regards as necessary for financial stability.

Box 1: European banking overlapping circles

The group of 130 banks subject to the direct supervision of the ECB (and now under the AQR) should not be seen in isolation, but in the context of a very complex structure with many overlapping circles as shown in Figure 1 given the many levels which concur in banking supervision and regulation in Europe. In ascending order of magnitude there is the euro area, the EU and the EEA. In terms of banks under special scrutiny there is the group of 130 banks directly under the ECB and now subject to the AQR. Then there is the sample of 84 banks which the EBA covers more closely. And finally there are, in Europe, 14 banks which are looked over by the (Financial Stability Board) FSB because they are of potential global significance (9 of these will also be under the direct supervision of the ECB.

Figure 1: Banks and banking supervision and regulation



Source: Ayadi and De Groen (2014).

For example, the EBA will launch another of its periodic stress tests next year. Many of the about 90 banks which fall under the stress test of the EBA will also be tested by the ECB at the same time. As the chart shows there are also over 50 banks coming under the EBA stress tests, which do not fall under the AQR. If the EBA stress tests and the AQR (cum stress test) of the ECB are of similar quality one must presume that there might be an additional need for re-capitalisation coming to light from the EBA stress test at the same time as the AQR.

2. WHY USE PUBLIC CAPITAL FOR RECAPITALISATION?

Most discussions about the AQR assume as given that any recapitalisation need should be taken up by public funds. In the next section, it is argued that this is not a proper assumption.

2.1. On the 'need' for public sector recapitalisation

From a theoretical point of view, if the market for bank capital is working normally there should be no need for a public sector recapitalisation.

A properly working market for bank capital does not mean that capital is necessarily cheap (or expensive). On the contrary, given the dearth of profits in the sector, it is quite likely that capital would be very costly; i.e. the present owners might have to issue a lot of new shares to obtain new capital. Deciding about the price of capital for any sector of the economy is exactly what the capital markets are supposed to do – whether or not the present owners of the capital like this verdict or not. The present owner will oppose any recapitalisation exactly at the time when it is most needed because such need is likely to emerge for banks with problems and hence for which capital will be naturally very expensive (or equivalently where the market value of the bank is very low). Under these circumstances any recapitalisation via the capital market will dilute the own control rights of the present owners (see also Bini Smaghi (2013)).

The most visible expression of the scepticisms of investors concerning the European banking sector is the fact that (for the banks which are quoted) the market value is usually much lower than the book value. Before the crisis the opposite was true: the market value was higher than the book value as investors then, ex post mistakenly, believe that bank profits would increase forever.

The so called market/book ratio has recently improved considerably, but it remains in the aggregate significantly below one (and it is of course much lower for the problem banks which might be most in need of capital).

The present owners of bank capital have thus a strong incentive to argue that the market for bank capital is not working properly.

Hence the question key question is: What is the evidence that the market for bank capital is closed?

Reliable data on the amounts of capital banks are raising is scarce. Commercial information services provide statements like these:

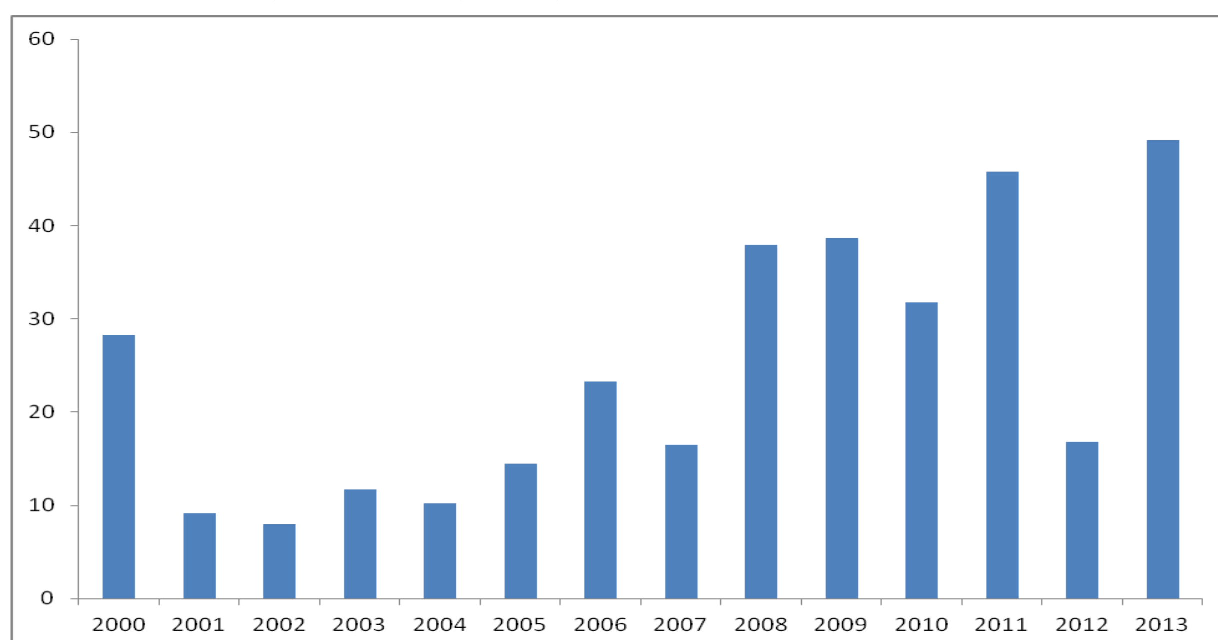
"*… analysts at information provider SNL Financial estimate that European lenders have raised a total of €415.6 billion of equity since the start of 2009.*"[1]

If one takes these estimates as correct and spreads the 400 billion euro over 4 and half years (since 2009), about 100 billion per year (including some crisis years) is being raised by banks. This would suggest that it should not be impossible to force banks to raise substantial amounts directly on capital markets to cover any shortfall the AQR might ascertain.

[1] As reported in http://www.efinancialnews.com/story/2013-10-16/the-bank-capital-that-could-stop-a-train-wreck?ea9c8a2de0ee111045601ab04d673622

The ECB provides statistical series on quoted shares issued by MFIs. This is a more restrictive definition than overall equity issuance since it includes only quoted share (and many of the SSM banks are not quoted). Under this restrictive definition the numbers are considerably smaller and more variable as Figure 2 below shows. According to the chart, at present, banks are issuing new quoted share at a rate of 40 billion per annum, but this does not seem to be the limit that the market can bear given that issuance was already higher than 60 billion in 2011, when market conditions were much less favourable than today. Given that banks under review will have one year before the AQR delivers its outcome, it could be possible to fill capital holes, in viable banks, with private capital.

Figure 2: Quoted shares issues, other financial institutions, cumulated over 12 months in billion euros



Source: Own elaboration on ECB data.

All in all it thus appears that the need for public sector funding to backstop any capital needs the AQR might unearth is much exaggerated.

It is often argued that the public sector backstop is crucial for 'confidence'. However, in reality, confidence is in first place based on fundamentals, at least outside panic mood during acute crises. In this same line, the OECD publication on euro area banks indicates that 'Despite actions to strengthen banks and build a banking union, confidence in the euro area banking system remains week, and is likely to remain so until underlying concerns over low capitalisation of some banks are addressed.'[2]

2.2. The real conundrum: throw good money after bad?

The concrete issue facing the authorities (not only the ECB, but also the Commission, and the national authorities) is what to do in case of a bank for which the market is really not willing to provide the necessary capital at any price. The qualifier at any price is crucial here because as long as there is a price at which investors are willing to put fresh capital into an ailing bank there should be no need for public funding. It is of course possible that

[2] See: OECD, Focus: Strengthening euro area banks, 10 January 2013; http://www.oecd.org/eco/economicoutlookanalysisandforecasts/strengtheningeuroareabanks.htm

market failures occur and that the evaluation by the market of the value of any particular bank is mistaken. It might be too low (or too high), but this does not constitute a reason to help present owners of capital to preserve their control by putting public funding into the bank.

The more fundamental issue is then whether one could leave banks without a clear business model (the ones with a clearly viable business model will not have problems to access the market) to the market mechanism.

This should be the case of most sectors of the economy, but for banking. A bank without a viable business model does not shrink gradually and then disappears. Its share price might decline towards zero, but its retail customers will be blissfully unaware of the difficulties, and other creditors will continue to provide financing because they expect that in the end the (national) authorities will intervene before the bank fails by either providing emergency funding or by arranging a merger with another institution.[3] When this expectation is not fulfilled the complacency often turns into panic and very costly bank run ensues. The process leading up to the bankruptcy of Lehman in the fall of 2008 showed this mechanism in action.

This is indeed the rational behind the asset quality review but also for an assessment of the business model. Depositors would be aware of the real conditions of the bank and creditors' moral hazard would be eliminated.

---

3 It is now official policy to 'bail in' bank creditors. But the new rules on inflicting losses on creditors of failing banks will enter into force only in 2018.

3. BANK LENDING IN THE EURO AREA: A QUESTIOIN OF QUANTITY OR QUALITY?

Keeping a weak banking system afloat has high economic costs. The argument for keeping banks afloat is that a quick restructuring would curtail the availability of credit and be bad for growth. But against these short run considerations one has to keep in mind that banks with too little capital, or those without a viable business model, tend to keep extending credit to their existing customers even if their creditworthiness is low, and to restrict lending to new companies or projects. This misallocation of capital hampers any recovery and reduces longer terms growth prospects. Others have referred to this situation as ‘zombie banks’.

The one country where this long run effect can be seen most clearly is Italy (see Gros 2011). Italian banks have over the last decade continued to lend to domestic enterprises, especially SMEs while GDP has not grown. The productivity of investment in Italy has thus been close to zero, even before the crisis. The crisis, with the ensuring fall in GDP has of course exacerbated this trend and has exposed the low returns on investment as many SMEs are failing, creating large losses for the banks. In other words, the real problem might not be too little credit but its allocation: credit flowing to the wrong enterprises and sectors and not flowing where is more productive. Just recapitalising banks will not change this underlying problem.

Italy represents an extreme case of a low productivity of investment, but it is evident that there were important other cases of mis-allocation of capital in many other countries (e.g. in the housing sector in Spain and Ireland, US subprime securities by German banks). The problem for Europe might thus appear in the short run to keep credit flowing, but the more important problem in the long run is to change the allocation of capital. This will not be achieved if all failing banks are just kept afloat by recapitalisation.

4. CONCLUSION

The raw numbers are stark: The 130 banks under the direct supervision of the ECB and now under review have about 25 000 billion euros of assets and only about 1000 billion euro of capital (about 4 % of assets). This is a very leveraged, and thus potentially unstable, sector. Any losses uncovered by the AQR can at most remedy immediate needs for more capital at some problematic banks, but cannot change the chronic undercapitalisation of the entire sector. Hundreds of billions would be needed to strengthen the entire sector.

Moreover, the set of so-called SSM banks has in the aggregate not made any profit since 2008. This seems to be a sector which has consumed capital for years. This implies that a recapitalisation per se cannot change the chronic capital shortage of this sector.

This note argues that the market for bank capital is working, and open for banks with a viable business model. Hence a priori there is no case for a public sector recapitalisation of weak banks. During a generalised banking crisis one could argue that markets cannot provide sufficient capital for troubled banks. However, this is no longer the case. Banks which are still found having insufficient capital after a year-long process during which they had ample opportunities to go to the market should be closed down or taken over.

The present owner will oppose any recapitalisation exactly when it is most needed because a recapitalisation need is only likely to emerge for banks with problems, i.e. banks for which capital will be naturally very expensive. But under these circumstances any recapitalisation via the capital market it will dilute the own control rights of the present owners.

REFERENCES

- Ayadi Rym and W.P. De Groen (2014), "Monitoring banking business models in Europe", Forthcoming CEPS Publications.
- Alcidi Cinzia, Alessandro Giovannini and Daniel Gros (2012), "Central Banks in Times of Crisis: The FED versus the ECB", available at http://www.europarl.europa.eu/document/activities/cont/201207/20120702ATT48168/20120702ATT48168EN.pdf.
- Benink, Harald and Harry Huizinga (2013), "The urgent need to recapitalise Europe's banks", Voxeu.org, 5 June 2013; http://www.voxeu.org/article/urgent-need-recapitalise-europe-s-banks
- Bini Smaghi, Lorenzo (2013) "Bank capital is Europe's big problem" Financial Times, A List, May 30, 2013; http://blogs.ft.com/the-a-list/2013/05/30/bank-capital-is-europes-big-problem/#axzz2m2OgIMQt
- Gros, Daniel (2011) "What is holding Italy back?", 9 November 2011; http://www.voxeu.org/article/what-holding-italy-back
- Gros, Daniel (2013) "What's wrong with Europe's banks?, CEPS Commentary; http://www.ceps.be/book/what%E2%80%99s-wrong-europe%E2%80%99s-banks
- Micossi, Stefano, Ginevra Bruzzone and Jacopo Caramassi (2013) "The New European framework for Managing Banking Crises", CEPS Policy Brief N. 304, November 2013.
- OECD (2013) "Focus: Strengthening euro area banks", 10 January 2013; http://www.oecd.org/eco/economicoutlookanalysisandforecasts/strengtheningeuroareabanks.htm
- Valiante, Diego (2012), Last Call for a Banking Union in the Euro Area, *Applied Economics Quarterly,* Vol. 58, N. 2.

NOTES

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Re-capitalisation of banks

Sylvester C.W. EIJFFINGER

NOTE

Abstract

The ECB comprehensive assessment of banks' balance sheets is an important step in anticipation of the Single Supervisory Mechanism. It is expected that the outcome will suggest that some banks will need to be re-capitalised. We argue that the assessment should be done by the ECB behind closed doors. The scrutiny by financial markets should be based on the results of the comprehensive assessment. However, we believe that the plan for this assessment, the methodology, the scenarios and the capital thresholds should be communicated in advance. We are also concerned by the fact that the bail-in tool is to be implemented only in 2018. The important issues of how to deal with capital shortfalls and the implementation of a backstop mechanism should be addressed before the results of the comprehensive assessment are communicated.

CONTENTS

BACKGROUND 57

1. THE ROLE OF THE ECB 58

2. COMPREHENSIVE ASSESSMENT 60

3. BAIL-IN 62

4. CONCLUSION 64

REFERENCES 65

BACKGROUND

In the formation of a Banking Union, 2014 will prove to be a milestone. The ECB will carry on a balance sheet assessment of the largest EU banks, involving about 130 banks which represent about 85 % EU total banking sector assets. This ECB audit is intended to assess the health and resilience of the EU banking sector before the ECB takes up in November 2014 its role of single supervisor on the basis of the Single Supervisory Mechanism (SSM) regulation.

The ECB assessment may unveil (further) capital shortfalls for some of the banks under scrutiny. This briefing paper discusses how this re-capitalisation should be carried out. We start by emphasizing the implications of transparency when assessing the health of financial institutions. Subsequently we discuss the steps to be taken in case bank re-capitalisation is required. We argue that the re-capitalisation and resolution procedures for troubled banks should be laid out at an early stage to enhance transparency. This would also allow financial markets to adequately price the risks associated to the management of assets and liabilities of financial institutions.

1. THE ROLE OF THE ECB

In the on-going process towards a Banking Union, in the fall of 2014 the ECB will take up its new role as single banking supervisor. Figure 1, taken from our September Briefing Paper, [1] shows the distribution of tasks – current and planned - delegated to the ECB by the SSM regulation. The Figure illustrates that the ECB is directly responsible for monetary policy and micro-prudential supervision (under SSM). The dotted line stresses that the ECB is also connected to macro-prudential supervision. While macro-prudential supervision falls under the responsibility of an independent body, the European Systemic Risk Board (ESRB), it is related to the ECB as the ESRB is hosted by the ECB and chaired by ECB president. To the right of the Figure we see the Single Resolution Mechanism (SRM), also discussed in a previous briefing paper.[2] The dashed line suggests that the organisational design of SRM and the relations between the SSM, the SRM and the ECB have not been fully settled yet.[3] Finally, we have put the Deposit Guarantee System as well in this Figure. We outlined our vision on a common Deposit Guarantee System in our briefing paper of July 2013[4], arguing that much progress is unlikely to happen in the near future. Nonetheless we chose to keep the DGS in the Figure as we believe that it is a key ingredient of a fully-fledged Banking Union.

In order to take up its role of single banking supervisor, the ECB must first assess which banks have to be re-capitalised and to what extent as well as to test the resilience and health of the banks to be supervised. To the purpose, the ECB will undertake a comprehensive assessment (see also next section).

The widespread view is that some large EU banks will need additional capital.[5] The ECB is well equipped to perform the comprehensive assessment, but the complexity of this task should not be underestimated. For example, in 2011 Dexia bank passed a stress test designed by European regulators only to see it collapse subsequently.

Our view is that the comprehensive assessment of EU banks' balance sheets - i.e. supervisory risk assessment, asset quality review and a stress test - is best carried out behind closed doors. The ECB is a trustable and accountable institution. Moreover, transparency may prove to be costly in the light of the large, and potentially unknown, risks stemming from the instability of financial markets as well as explicit or hidden pressure from outsiders. It is clear that such an approach is only feasible and justifiable if the comprehensive assessment follows a clear plan outlined in advance on the various steps to be implemented.

---

[1] Eijffinger, Sylvester C.W. (2013), *The various roles of the ECB in the new EMU Architecture,* Briefing Paper for the Monetary Dialogue of September 2013. http://www.europarl.europa.eu/document/activities/cont/201309/20130923ATT71742/20130923ATT71742EN.pdf

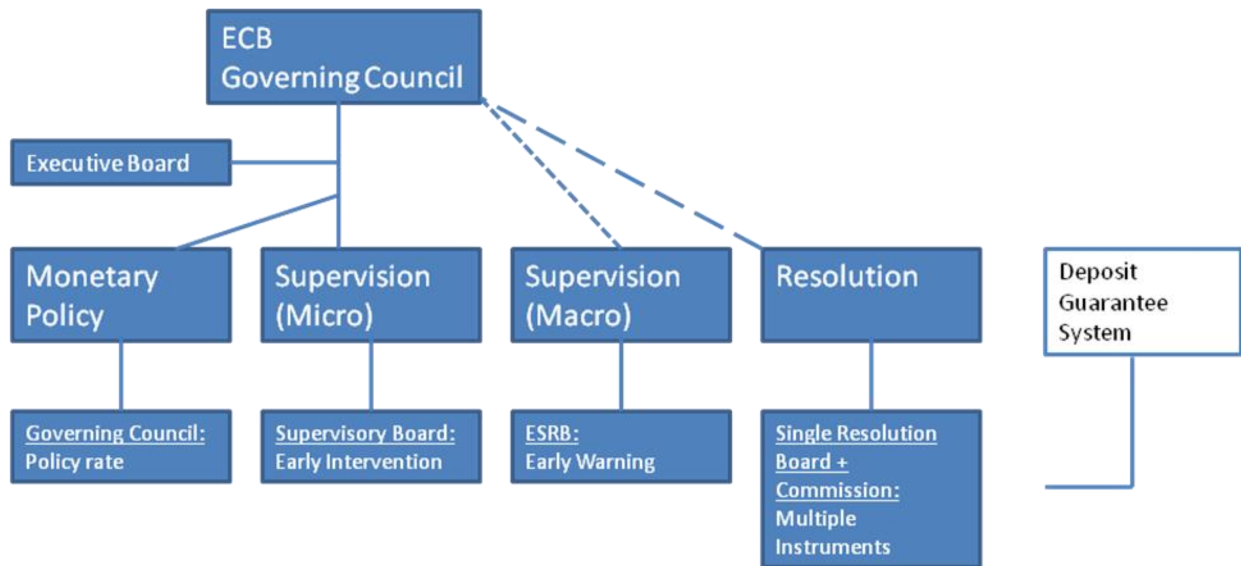
[2] Eijffinger, Sylvester C.W. (2013), *Single Resolution Mechanism.* Briefing Paper for the Monetary Dialogue of February 2013.

[3] In a recent press release, the ECB stated that *'the ECB seeks representation in all plenary and executive meetings of the Single Resolution Board as an observer*', http://www.ecb.europa.eu/press/pr/date/2013/html/pr131108.en.html

[4] Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013.

[5] OECD (2013), Focus: Strengthening euro area banks, 10 January 2013 http://www.oecd.org/eco/economicoutlookanalysisandforecasts/strengtheningeuroareabanks.htm

Figure 1: Distribution of tasks: current, future, proposed and hypothetical



Source: Eijffinger, Sylvester C.W. (2013), The *various roles of the ECB in the new EMU architecture*, Briefing Paper for the Monetary Dialogue of September 2013.

2. COMPREHENSIVE ASSESSMENT

The comprehensive assessment is likely to strengthen the confidence in the EU banking system.[6] If investors trust the ECB comprehensive assessment confidence will rise, with beneficial effects in terms of financing costs and health of banks' balance sheets.

The experience with the *Supervisory Capital Assessment Program (SCAP)* - the banks' stress tests conducted by the Fed in 2009 to determine if the largest U.S. financial organizations had sufficient capital buffers to withstand the recession - showed that even in difficult market conditions banks can raise capital if a trustable central bank is behind the exercise. Most banks which were deemed to raise additional capital were able to do so through private investors.[7]

A necessary condition for the comprehensive assessment to succeed is to have in place a financial backstop as the capital shortfalls must be resolved quickly, so as to avoid the risks of bank runs. The pecking order for the financial backstop should foresee the bailing-in of creditors, national interventions and, lastly, the European Stability Mechanism (ESM). Strict and severe conditions for the use of backstop mechanisms should provide incentives to private sector solutions for banks' capital shortfalls. I the US, after the SCAP, less than 3% of the capital shortfalls were addressed by the US government.

The comprehensive assessment itself comprises three elements: a supervisory risk assessment, an Asset Quality Review and a stress test (Figure 2).

The scope of the supervisory risk assessment is to determine the intrinsic risk profile of the bank. By addressing key risks in the balance sheet of banks, using backward and forward looking information, the ECB and the national competent authorities want to assess the position of each individual bank relative to its peers and its vulnerability to exogenous factors. This assessment tool will be used in the future SSM as well. [8]

The scope of the Asset Quality Review is to examine the asset side of individual banks' balance sheets. This examination will take a broad view, cover all asset classes (including non-performing loans, restructured loans, sovereign exposures) and deal with on and off-balance sheet positions.

The scope of the stress test is to examine how well banks can absorb shocks. The ECB and the European Banking Authority (EBA) will perform the next EU-wide stress testing in close cooperation. The details on methodology have not been communicated yet. Details on the methodology of the stress test(s) are key to ensure financial market participants about the quality of the exercise.

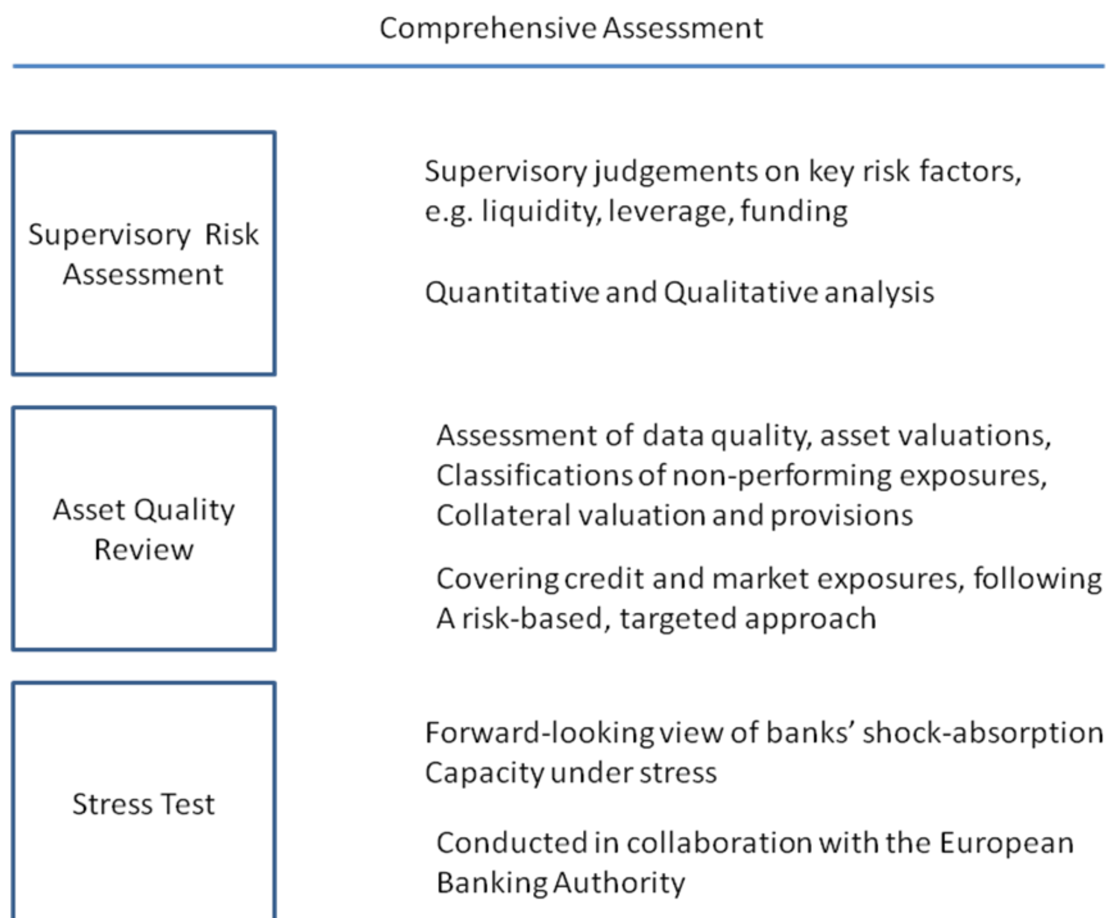
---

[6] European Central Bank (2013), *Note Comprehensive Assessment October 2013* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

[7] De Nederlandsche bank (2013), *Overzicht financiele stabiliteit, najaar 2013.*

[8] European Central Bank (2013), *Note Comprehensive Assessment October 2013* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

Figure 2: Overview of the Comprehensive Assessment



Source: European Central Bank (2013), Note Comprehensive Assessment October 2013.

3. BAIL-IN

As mentioned in the previous section, the ESM or any other form of EU burden sharing should only be addressed after the bail-in of private creditors and after the intervention by the national government. A *credible* bail-in regime is key to break the adverse loop between governments' deficits and health of banks' balance sheets.

Concerning banks' capital requirements, the ECB has communicated that the 8 % threshold of core tier 1 capital will be used as the benchmark capital level. In case of capital shortfalls, the bail-in is to be implemented from January 1st 2018 onwards. While the new EU resolution framework provides the appropriate toolbox, some, including ECB President Mario Draghi, have suggested that an earlier implementation would be better to have it available right from the start of the SRM.[9] The comprehensive assessment is likely to uncover capital shortfalls in some EU banks which may be also to be bailed-in. It would therefore be beneficial to know in advance the implementation design of bail-in tools. The ECB points out in its opinion on the current proposal for the SRM and Single Bank Resolution fund, that between 2015 and 2018 "*there will be uncertainty to whether senior debt can be bailed in since Member States are free to decide whether they should anticipate the introduction of a bail-in framework.*"[10] Such uncertainty should be eliminated as soon as possible, ideally before the ECB comprehensive assessment is completed.

The ECB also notes that the cost of bail-in is already priced in to a large extent and, therefore, the impact of an earlier implementation should be minimal. [11] An agreement on bail-in procedures would contribute to legal certainty and to the consistency of resolution mechanisms.

In our July MoD briefing paper we outlined our view bail-in tools. [12] Figure 3 from that paper shows our preferred hierarchy for bank resolution tools: Equity holders should be bailed-in first, followed by debt holders, with a distinction between junior and senior debt holders; finally, deposit holders could be considered as long as there is full protection of the deposits below the deposit insurance threshold (currently EUR 100.000).

---

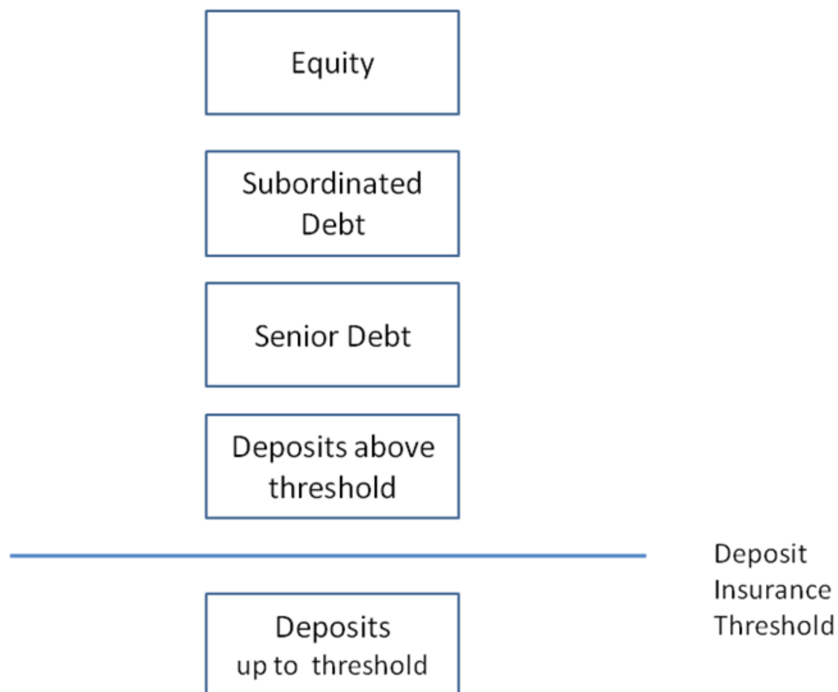
[9] Draghi, Mario (2013), *The future of Europe,* Opening Speech at the european Banking Congress, Frankfurt am Main 22 November 2013 http://www.ecb.europa.eu/press/key/date/2013/html/sp131122.en.html

[10] European Central Bank (2013), Opinion of the European Central Bank of November 6 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76) http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html

[11] European Central Bank (2013), Opinion of the European Central Bank of November 6 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76) http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html

[12] Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013, http://www.europarl.europa.eu/document/activities/cont/201307/20130705ATT69284/20130705ATT69284EN.pdf

Figure 3: Bail-in Order



Source: European Central Bank (2013), Note Comprehensive Assessment October 2013.

Clear procedures on how to recapitalise troubled banks before bail-in tools are implemented are not yet available, which is unsatisfactory. EU banks' capital shortfalls could be very large, in the order EUR 100 billion or more according to some estimates. Resolution may therefore be a massive undertaking. And even if everything goes smoothly, some banks may need further government support, i.e. tax-payer money. An early communication strategy is therefore key.

4. CONCLUSION

In this briefing paper we have argued that the comprehensive assessment by the ECB is best carried out behind closed doors. Excessive transparency *during the assessment process* may be counterproductive. The ECB is a trustable and accountable institution and scrutiny of financial market participants, while important, should be based on the *results of the comprehensive assessment*.

However, the assessment methodology should be communicated well in advance, which is not still the case.

The crucial aspect, however, is how to deal with the restructuring of banks, after the comprehensive assessment. It is clear that some banks will need to be re-capitalised. Bank re-capitalisation in the U.S. through the *Supervisory Capital Assessment Program (SCAP)* in 2009 is often quoted as an example of successful exercise carried on in a difficult context. Capital short-falls in the EU could be more troublesome, requiring significant contributions from bail-in tools. Currently, it is envisaged that bail-in procedures will only be implemented in 2018. An earlier implementation is desirable as well as a clear communication on how troubled banks are going to be dealt with, so as to reduce financial market uncertainty.

The comprehensive assessment of EU banking system and the setting up of resolution mechanisms for troubled banks are important steps in anticipation of the new ECB supervisory tasks in the context of the SSM. The comprehensive assessment itself should therefore be performed rigorously. The best way to achieve this is to let the ECB do its job without excessive interference.

REFERENCES

- Asmussen, Jörg (2013), *Building Banking Union,* Speech at the Atlantic Council, London 9 July 2013; http://www.ecb.europa.eu/press/key/date/2013/html/sp130709.en.html
- De Nederlandsche bank (2013), *Overzicht financiele stabiliteit, najaar 2013.*
- Draghi, Mario (2013), *The future of Europe,* Opening Speech at the European Banking Congress, Frankfurt am Main 22 November 2013; http://www.ecb.europa.eu/press/key/date/2013/html/sp131122.en.html
- Eijffinger, Sylvester C.W. (2013), *Single Resolution Mechanism*, Briefing Paper for the Monetary Dialogue of February 2013; http://www.europarl.europa.eu/document/activities/cont/201302/20130214ATT61105/20130214ATT61105EN.pdf
- Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013; http://www.europarl.europa.eu/document/activities/cont/201307/20130705ATT69284/20130705ATT69284EN.pdf
- Eijffinger, Sylvester C.W. (2013), *The various roles of the ECB in the new EMU architecture*, Briefing Paper for the Monetary Dialogue of September 2013; http://www.europarl.europa.eu/document/activities/cont/201309/20130923ATT71742/20130923ATT71742EN.pdf
- European Central Bank (2013), *Note Comprehensive Assessment October 2013;* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf
- European Central Bank (2013), *8 November 2013 – ECB publishes its opinion on the Single Resolution Mechanism (SRM);* http://www.ecb.europa.eu/press/pr/date/2013/html/pr131108.en.html
- European Central Bank (2013), Opinion of the European Central Bank of 6 November 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76); http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html
- OECD (2013), Focus: Strengthening euro area banks, 10 January 2013; http://www.oecd.org/eco/economicoutlookanalysisandforecasts/strengtheningeuroareabanks.htm

NOTES

EUROPEAN PARLIAMENT

CATALOGUE QA-04-14-081-EN-C

Re-capitalisation of banks supervised by the SSM   Monetary Dialogue December 2013   Compilation of Notes

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A
ECONOMIC AND SCIENTIFIC POLICY

Role

Policy departments are research units that provide specialised advice to committees, inter-parliamentary delegations and other parliamentary bodies.

Policy Areas

- Economic and Monetary Affairs
- Employment and Social Affairs
- Environment, Public Health and Food Safety
- Industry, Research and Energy
- Internal Market and Consumer Protection

Documents

Visit the European Parliament website: **http://www.europarl.europa.eu/studies**

PHOTO CREDIT: iStock International Inc.

ISBN 978-92-823-5367-7
doi:10.2861/52146