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European banking sector

Sector’s development and regulatory, resolution and crisis management framework for banks

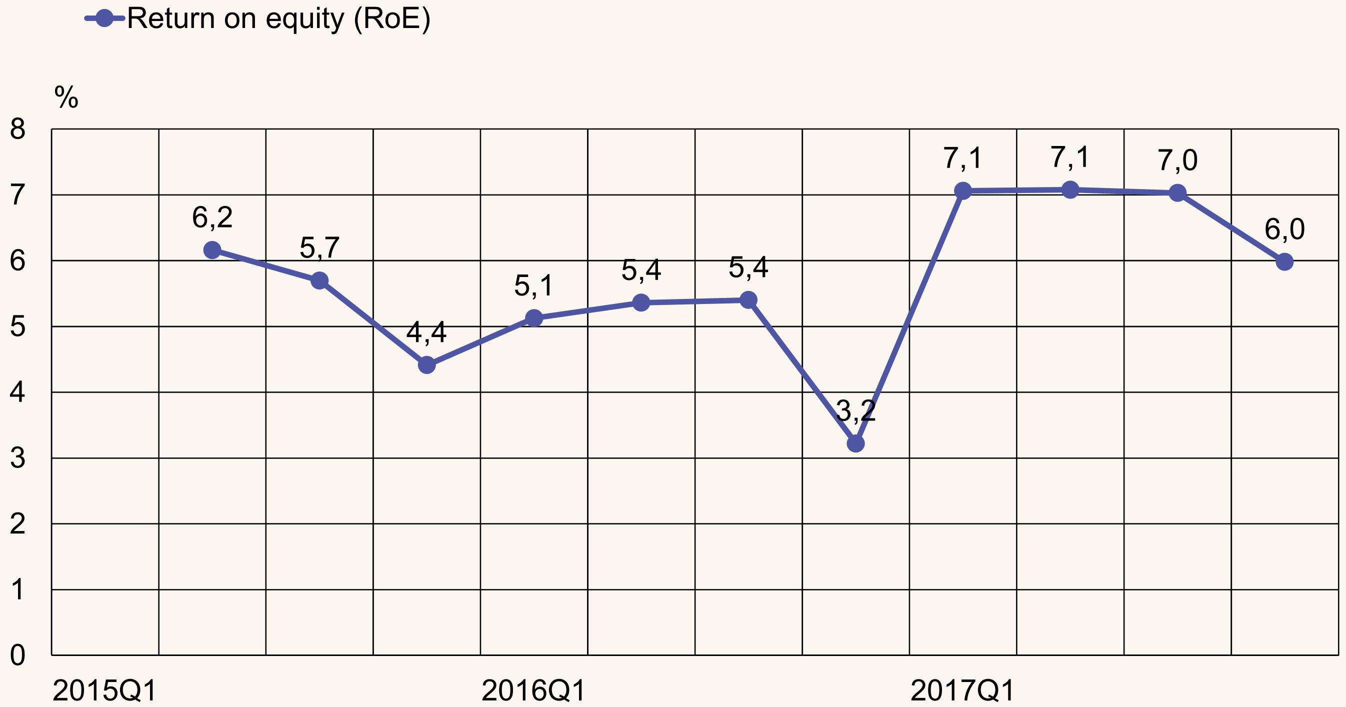
Outline of the presentation

- Development of the European banking sector’s financial standing
  - Profitability
  - Non-performing loans
  - Costs
  - Capital situation
- Main features of the European Economic and Monetary Union
- European Banking Union
  - Single Supervision
  - Single Resolution Authority
  - Deposit Insurance Scheme
- Macroprudential policy in the EU

The financial standing and development of euro area banks

The profitability of large euro area banks is gradually improving

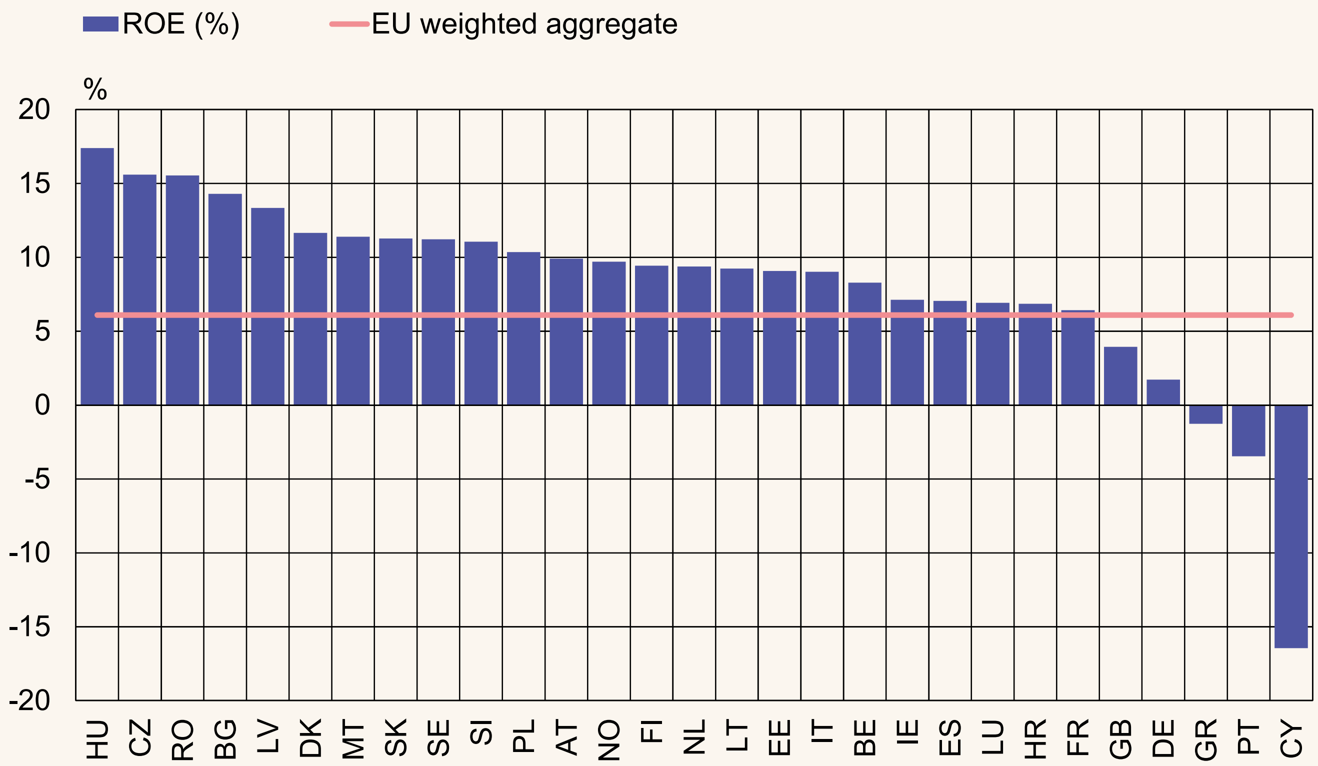
Return on equity (RoE) of significant euro area banking institutions



Source: SSM.

34308@ROE (eng)

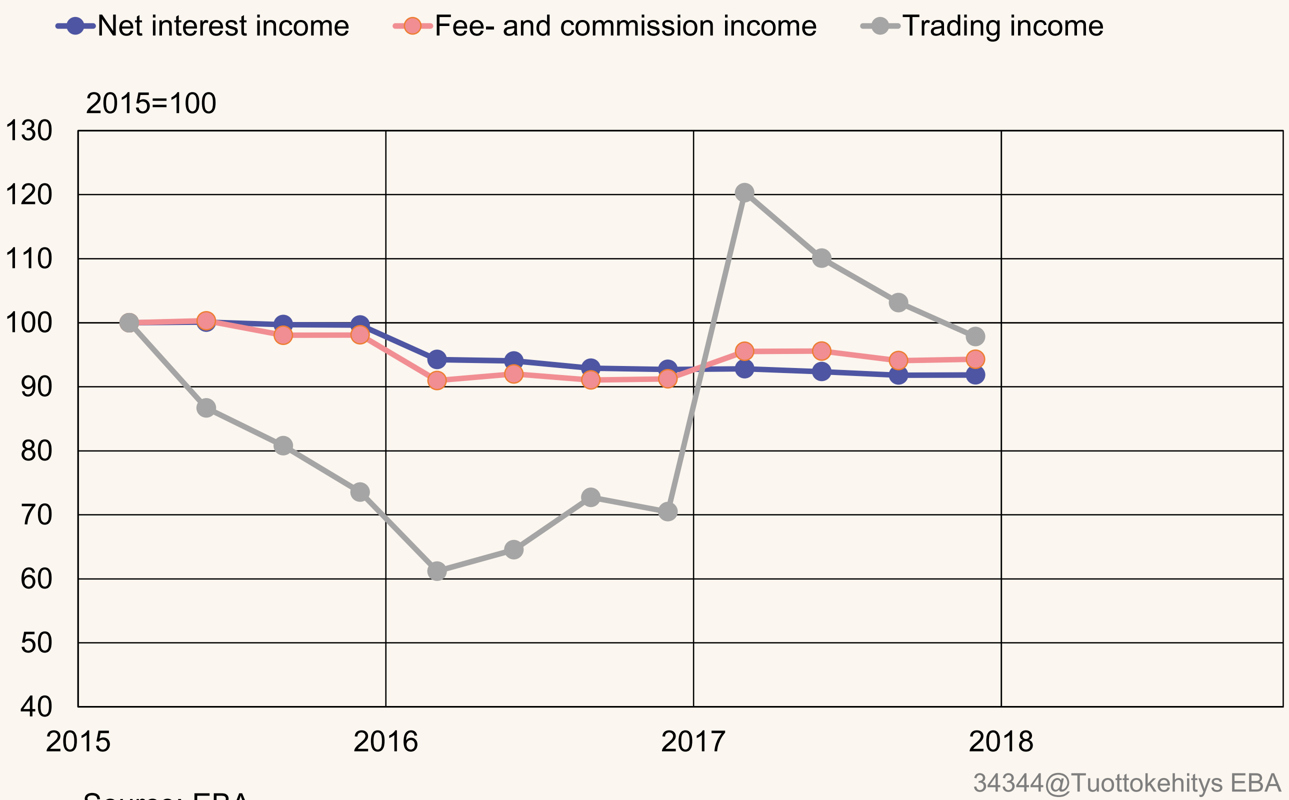
Despite improvement in aggregate return-on-equity (ROE), banks' profitability varies significantly across countries



Source: EBA.

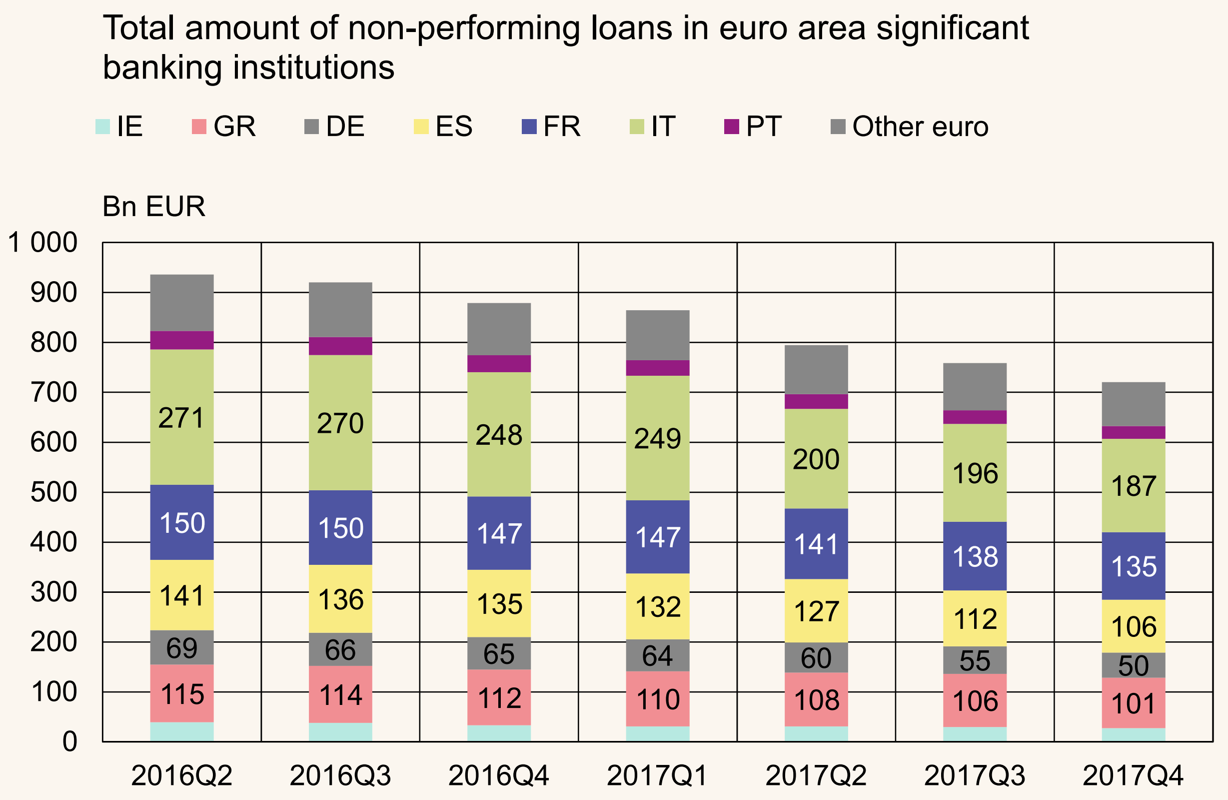
34344@ROE per country

Euro area banks' core banking revenues still under pressure as the low-interest rate environment prevails



Source: EBA.

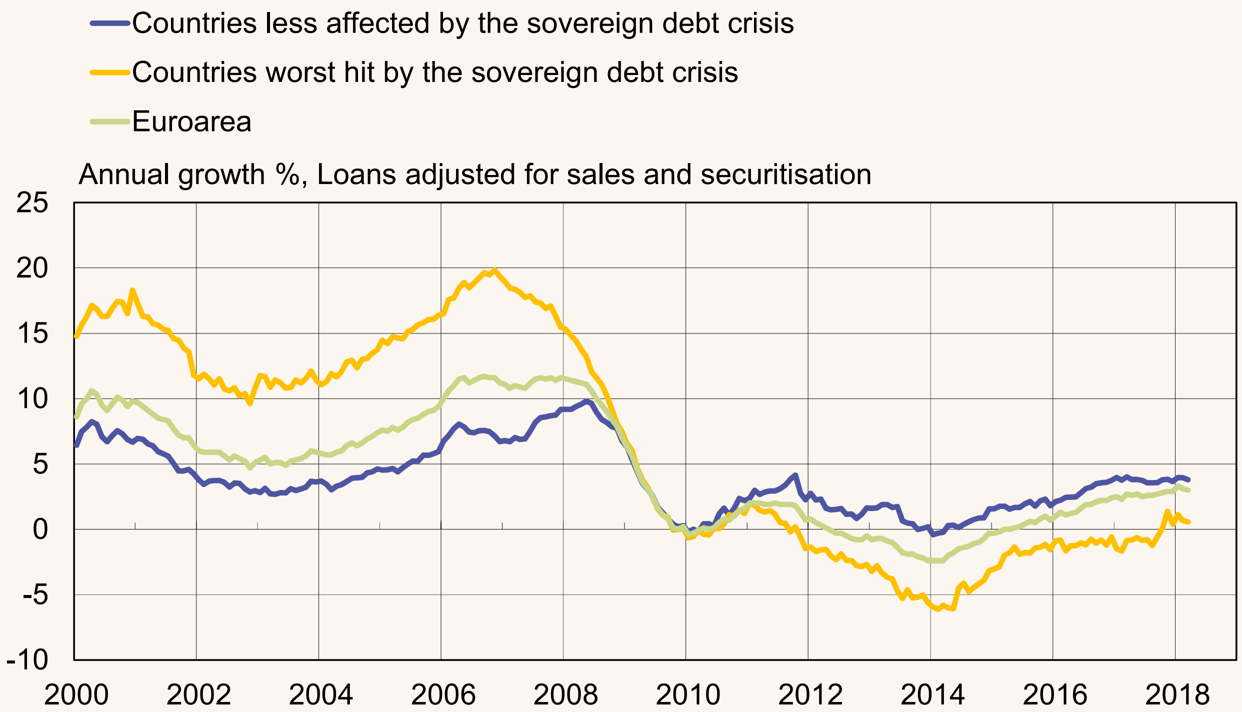
Euro area banks continued to improve the overall quality of their loan portfolio



Source: SSM.

32410@NPL per country (en)

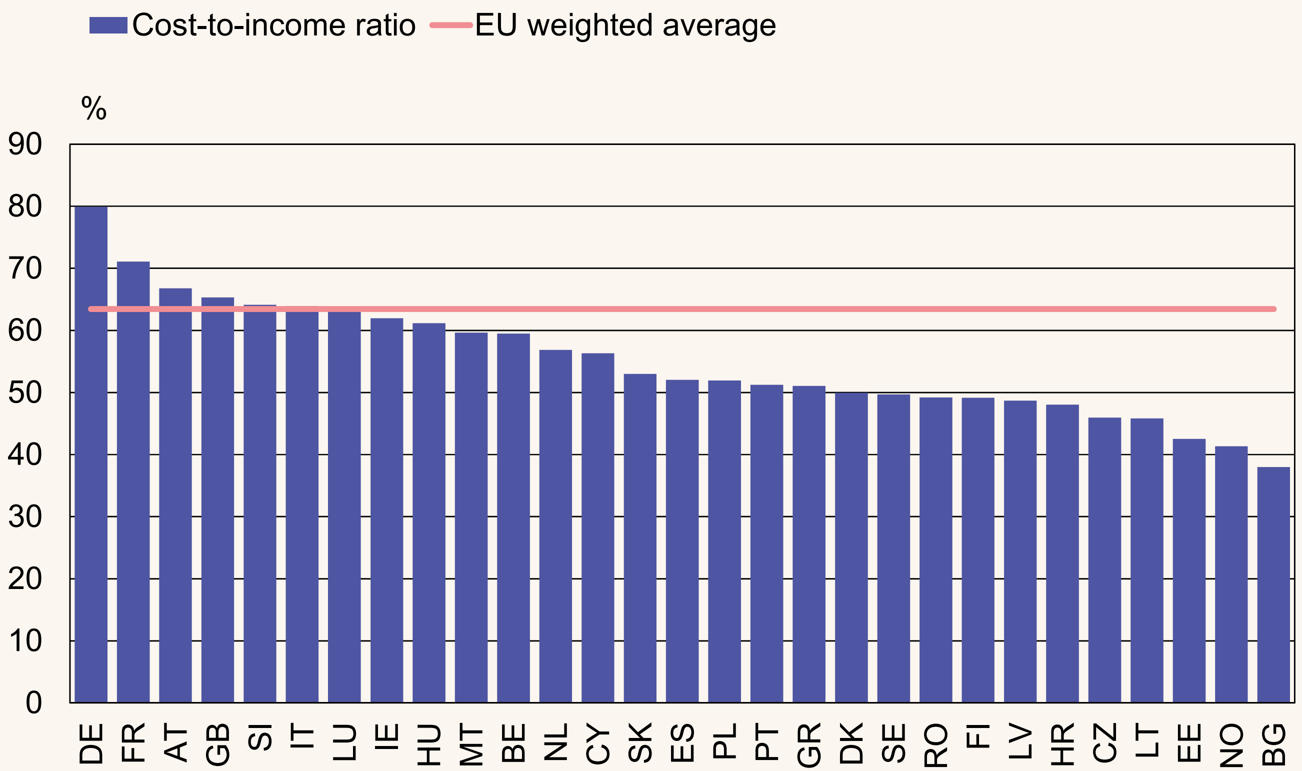
Despite improving economy and decreasing credit risks, loan growth remains modest in the euro area



* DE, FR, NL, BE, AT and FI
** GR, IT, IE, ES and PT
Source: ECB.
25840@Private sector (UUSISARJA)

Announced cost reductions yet to feed through to actual costs

Cost-to-income ratio in European banks

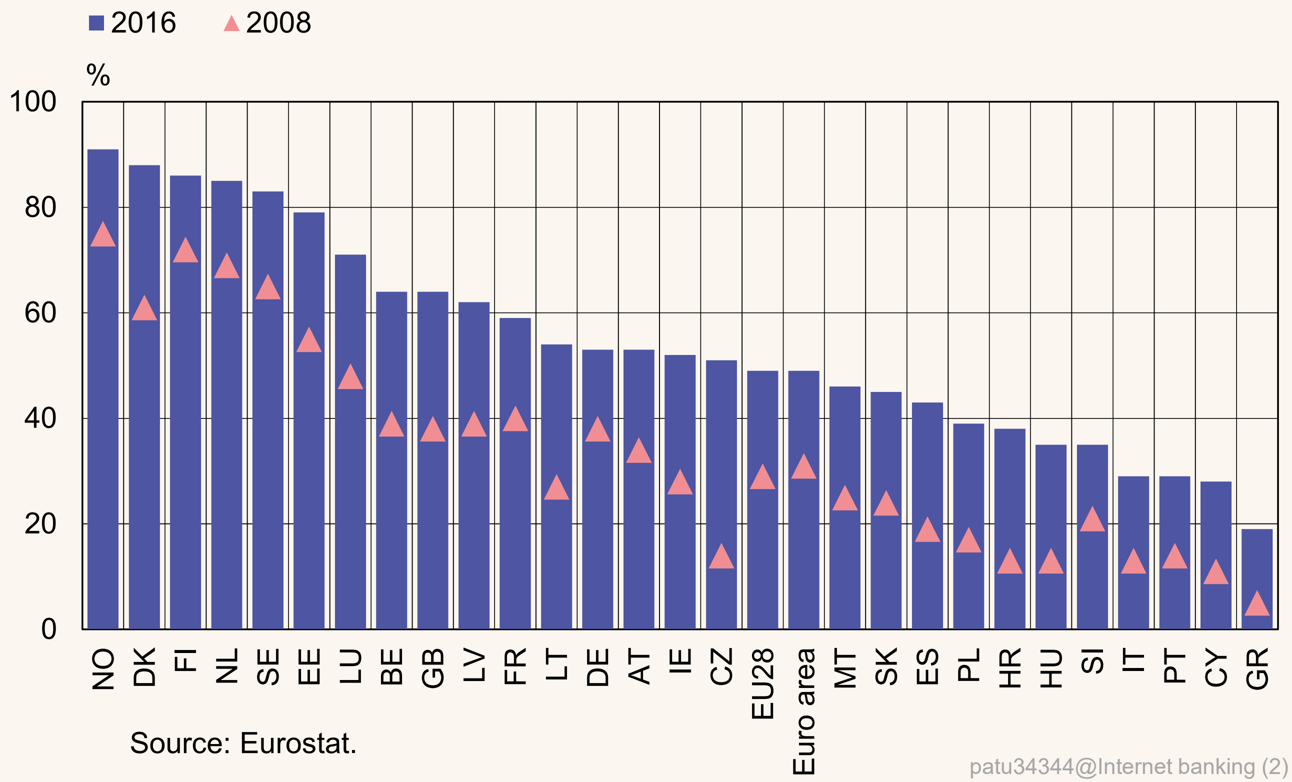


Source: EBA.

34344@Cost-to-income

The level of overall state of digitalization in European countries varies significantly

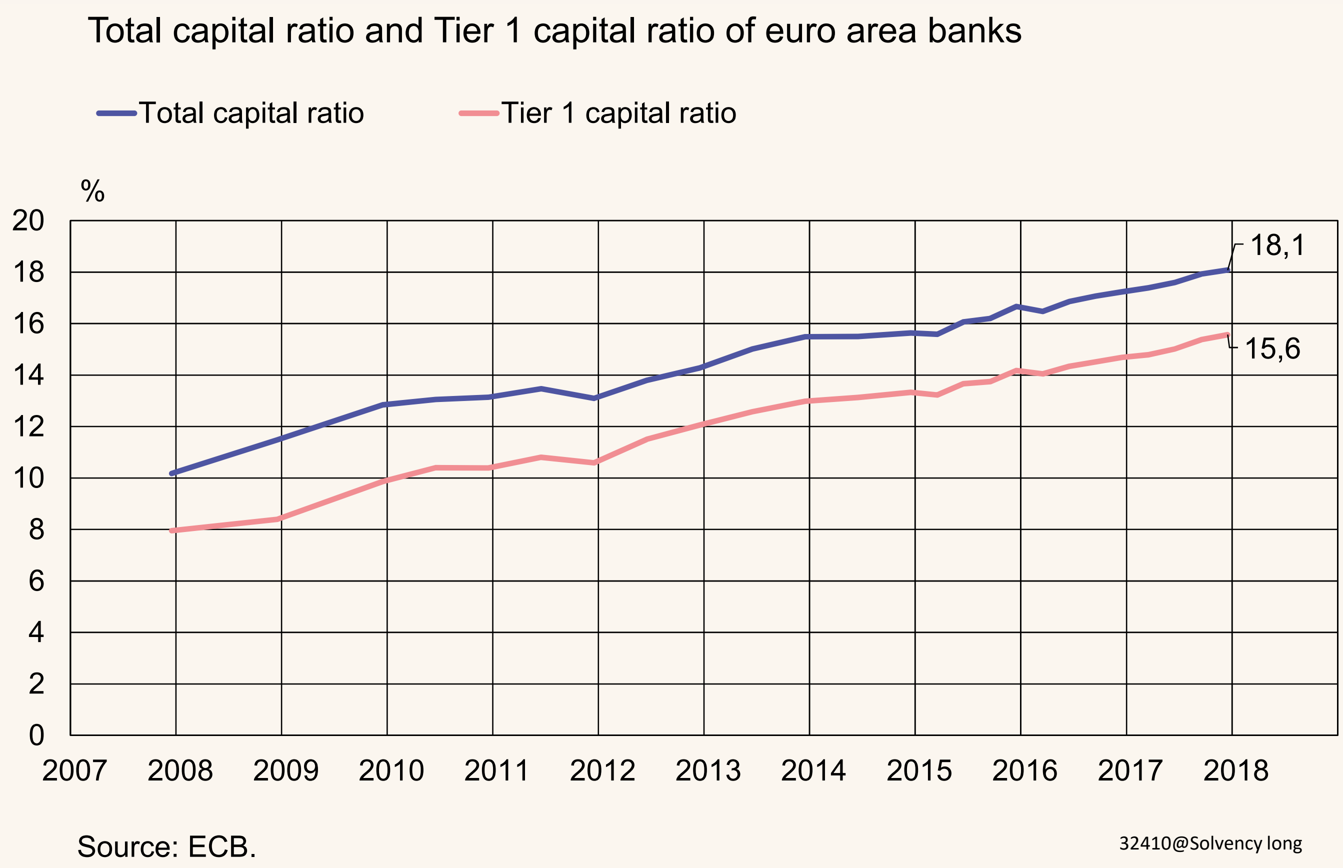
Use of internet banking in selected European countries



Source: Eurostat.

patu34344@Internet banking (2)

Euro area banks have continued to strengthen their capital ratios



European Economic and Monetary Union (EMU) - Completing the joint Banking Union

EMU-related problems emerged during the financial and sovereign debt crises

Differences in the resilience of economies

- Differing developments in euro area economies in 1999–2007 led to large differences in vulnerabilities
- Several euro area countries had weak capacity to adjust to external shocks (exchange rate not an option)

Sovereign-bank loop

- Banks enjoyed (were believed to enjoy) implicit government guarantee, but were at the same time lenders of last resort
- Sovereign debt default leads to bank failures; large bank bailouts lead to sovereign distress

Developing the Economic and Monetary Union - the main building blocks and the current topics under discussion

Completion of the Banking Union

- European Deposit Insurance Scheme
- Prudential treatment of sovereign debt
- Common backstop for the Single Resolution Fund

Capital Markets Union

- Integrated capital markets
- ”Risk-free” assets - ”Safe assets”

Fiscal Union

- European Monetary Fund
- European Governance

Pillars of the European Banking Union

Banking Union

Single Supervisory Mechanism (SSM)

- Efficient, effective supra-national supervision with the ECB at the centre
- Clear separation of monetary policy and supervision

Single Resolution Mechanism (SRM)

- Centralised resolution decisions for systemic banks
- Bail-in principle
- Industry responsibility (resolution fund)

European Deposit Insurance Scheme (EDIS)

- Proposal by European Commission
- Gradual transition to Single Deposit Insurance

Single Rulebook (all EU)

Regulatory and supervisory environment in European banking

- European Banking Authority (EBA) works to ensure effective and consistent prudential regulation and supervision across the European banking sector
- The main tasks include work on European Single Rulebook in banking, promoting convergence of supervisory practices and assessment of risks and vulnerabilities in the EU banking sector

- The Single Supervisory Mechanism (SSM) comprises the ECB and the national competent authorities of participating Member States
- Responsible for the prudential supervision of all credit institutions in the Euro Member States
- Directly supervises 118 significant institutions

- Brexit creates uncertainties as future regulatory environment in the UK is unclear

The SSM has strived for supervisory level playing field in Europe since November 2014

The Single Supervisory Mechanism (SSM) is based on the cooperation between national supervisors and the European Central Bank

Benefits	✓ Similar treatment for all credit institutions ✓ More harmonised, intrusive supervision ✓ Higher standards for the quality and amount of capital
Challenges	✓ Ongoing improvement of supervisory processes ✓ Harmonising National Options & Discretions ✓ Increasing delegation in decision-making

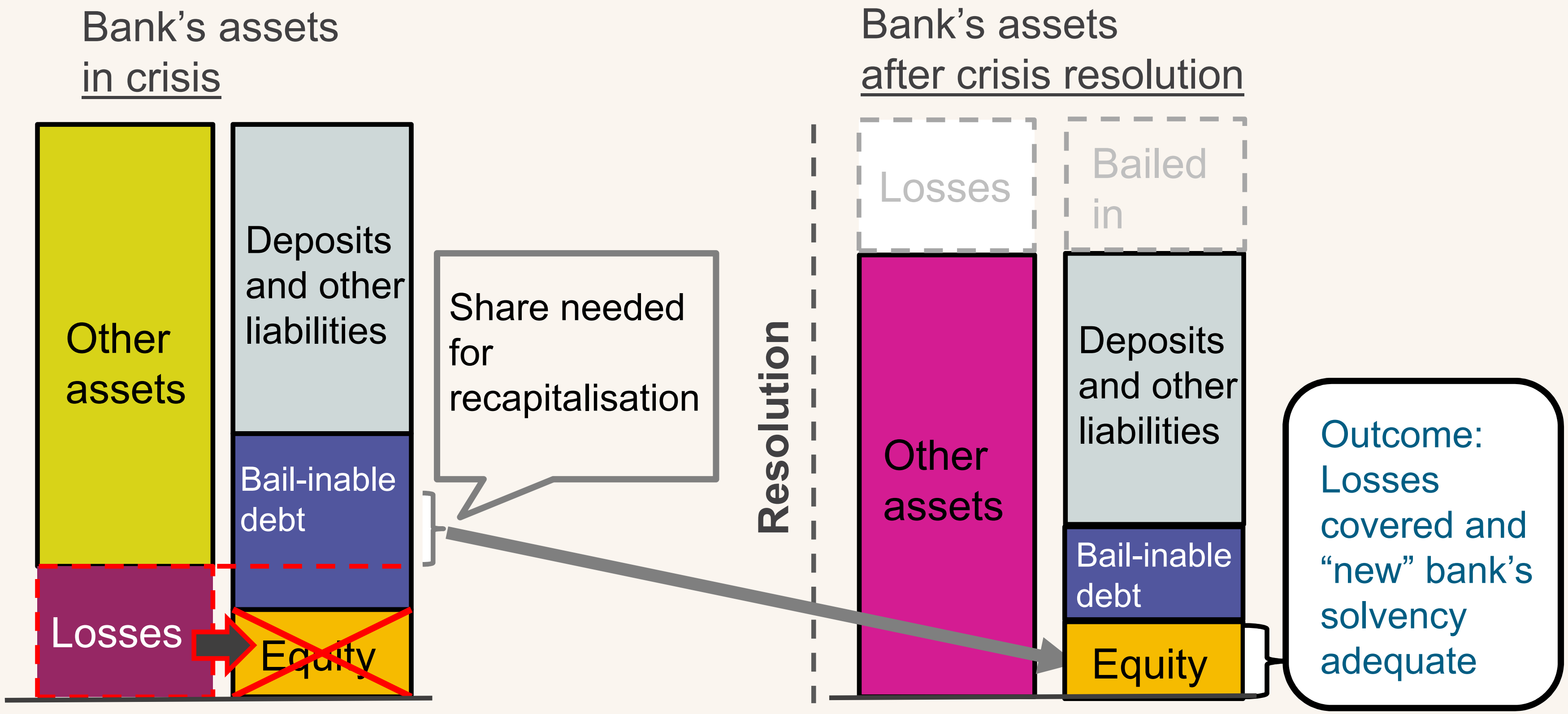
Supervisory focus areas in 2018 will address identified key risks

Business models and profitability drivers	• Sustainability of business models • Assessing interest rate risk implications for banks
Credit risk	• Asset quality and non-performing loans • Exposure concentrations • Collateral management and valuation
Risk management	• Credit, market and counterparty credit risk • Preparedness for IFRS9 and other regulatory changes
Activities comprising multiple risk dimensions	• Brexit preparations • Stress tests for significant institutions

Single Resolution Mechanism (SRM) takes care of banks' resolution

- The financial crisis that unfolded in 2008 showed that authorities lacked the tools and preparation to wind down banks in an orderly manner
  - Need to end "too-big-to-fail"
- Consists of Single Resolution Board and National Resolution Authorities
- Responsible for banks supervised by the ECB and cross-border banks
  - National Authorities take care of less-significant banks
- Cross-border resolution established via the Bank Recovery and Resolution Directive (BRRD) and SRM Directive
- Objective: To ensure an orderly resolution of failing banks with bail-in
- Resolution authorities:
  - Prepare resolution plans for banks
  - Address resolution and apply crisis resolution tools if needed
  - Cooperate with other authorities (SSM and national authorities)
- Single Resolution Fund (SRF)
  - Funded by private banks

Successful crisis resolution with bail-in



From investors' perspective resolution may signify that the value of investment is impaired, investments are transformed into equity or moved into bridge bank or to asset management company.

Macroprudential policy in the EU

What do we mean by macroprudential policy?

- “Taking away the punch bowl when the party is at its best.”

- Preventing and mitigating the crisis in a forward looking manner – ex ante policy
  - Different from crisis management and resolution

- Scope of macroprudential policy covers the whole financial system
  - But starts from the banking sector

Macroprudential policy – legal background

- In Europe, the report of the de Larosière group (2009) highlighted the need for macroprudential supervision → European Systemic Risk Board (ESRB) (2011-)

- Macroprudential policy implemented in EU law through Capital requirements directive (CRD) and regulation (CRR) (2014-)
  - Partly based on standards developed by the Basel Committee on Banking Supervision (Basel III)

- Macroprudential framework still in its infancy

Macroprudential policy objectives

- The **ultimate objective** of macro-prudential policy is to contribute to the safeguard of the stability of the financial system as a whole,
  - including by **strengthening the resilience** of the financial system and
  - **decreasing the build up of systemic risks**,

thereby ensuring a sustainable contribution of the financial sector to economic growth
(European Systemic Risk Board, Recommendation 3/2011)

- The ultimate objective needs to be operationalized through **intermediate objectives**

Intermediate objectives of macroprudential policy: European approach

Prevent and mitigate systemic risks arising from:

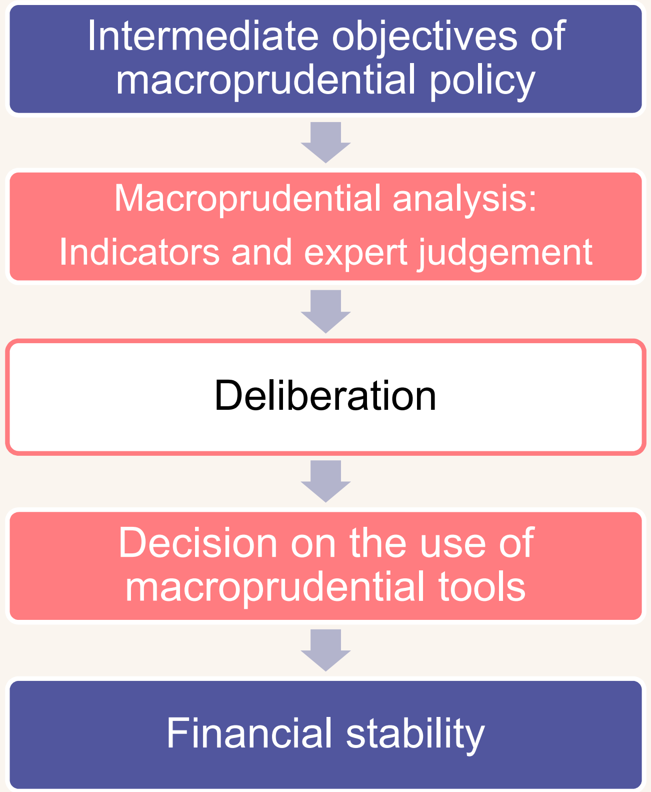
- excessive credit growth and leverage
- excessive maturity mismatch and market illiquidity
- direct and indirect exposure concentrations
- misaligned incentives and moral hazard

Strengthen the resilience of financial infrastructures

(European Systemic Risk Board, Recommendation 1/2013)

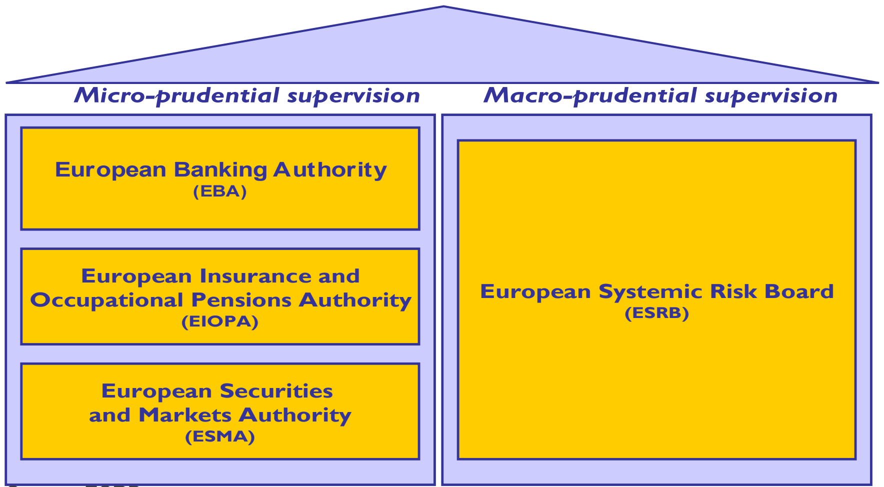
Macroprudential policy in practice

- Analysis:
  - Indicators such as Basel gap, credit growth …
  - Quantitative and qualitative data and evidence
  - Identification of risks
  - Assessment of the impact of potential policy measures
  - Expert judgement
- Selection and calibration of policy instruments based on the analyses
- Instruments:
  - Countercyclical capital buffer
  - Systemic risk buffer
  - Buffers for systemically important institutions at global and national level (G-SII / O-SII buffers)
  - Borrower based tools (loan-to-value, loan-to-income…)
  - Risk weights



Macroprudential policy: Cross-border institutions within the SSM/European Union

- The role of the European Central Bank (ECB) in macroprudential policy within the Single Supervisory Mechanism (SSM)
  - Option to react to national macroprudential measures based on EU law (before final decisions)
  - Option to apply more stringent measures
- European Systemic Risk Board (ESRB)
  - Risk discussions
  - Warnings and recommendation
- Reciprocity
  - Mandatory/voluntary recognition of national macroprudential measures by other countries
- Nordic-Baltic cooperation



Source: ESRB

Macroprudential policy and the future

- Much has already been done and achieved
  - New framework which did not exist before the crisis
  - Increasing awareness of system-wide risks

- But the financial system is evolving rapidly
  - Digitalization
  - Fintech / new competitors (for instance, Alibaba, Google, Amazon, Apple)

- In the future, there is an increasing need to
  - Extend the scope of macroprudential policy beyond banking
  - Address cross-border transmission of systemic risks
  - Further develop the analytical framework for the policy impact assessment

Thank you!