



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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Member of the ECB Supervisory Board

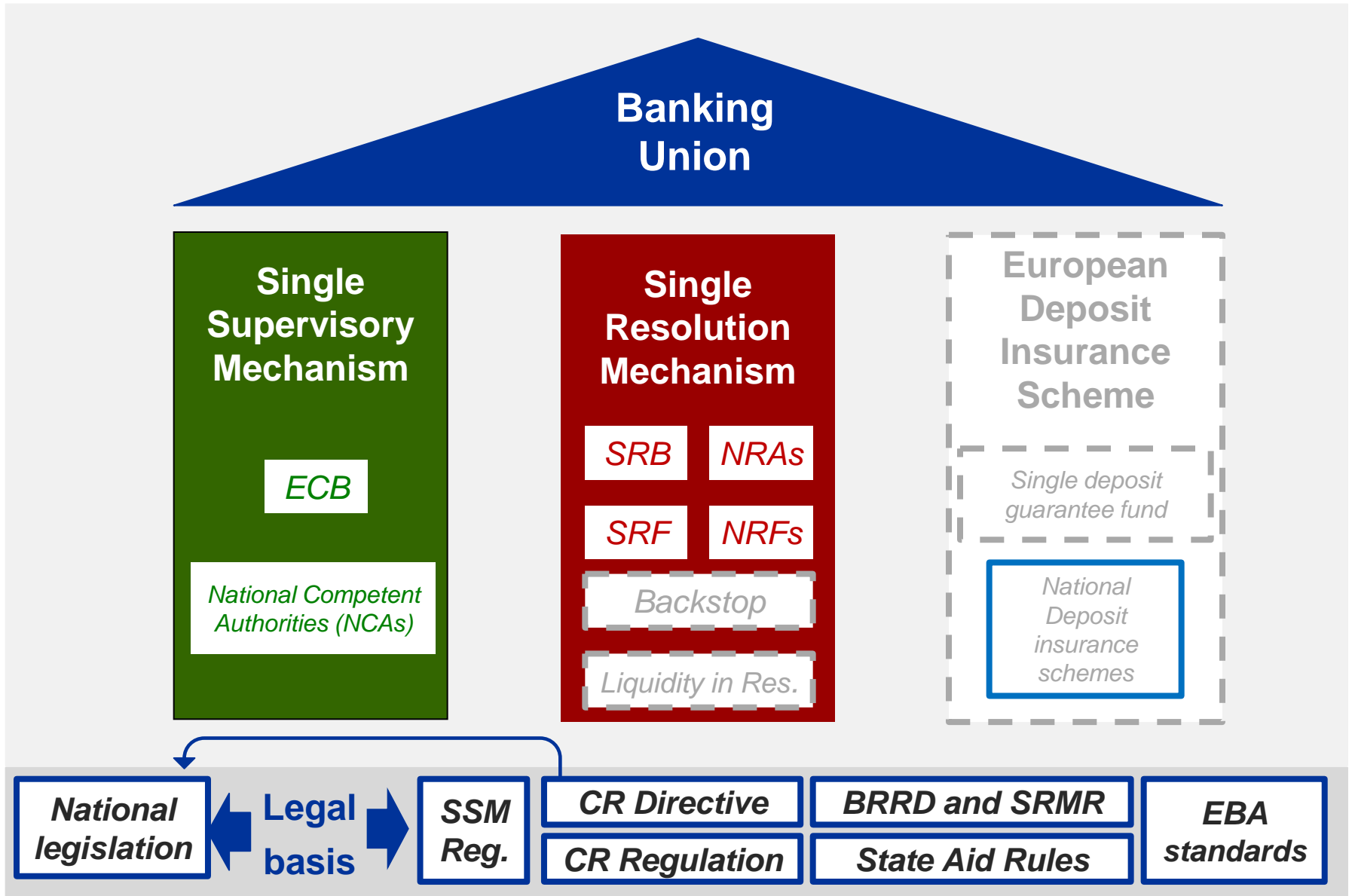
How real is Europe's banking union?

Peterson Institute for International Economics
Washington D.C., 19 April 2018

* I am grateful to Francisco Ramon-Ballester for preparing a first draft of this presentation

Five years on, what questions can be asked?

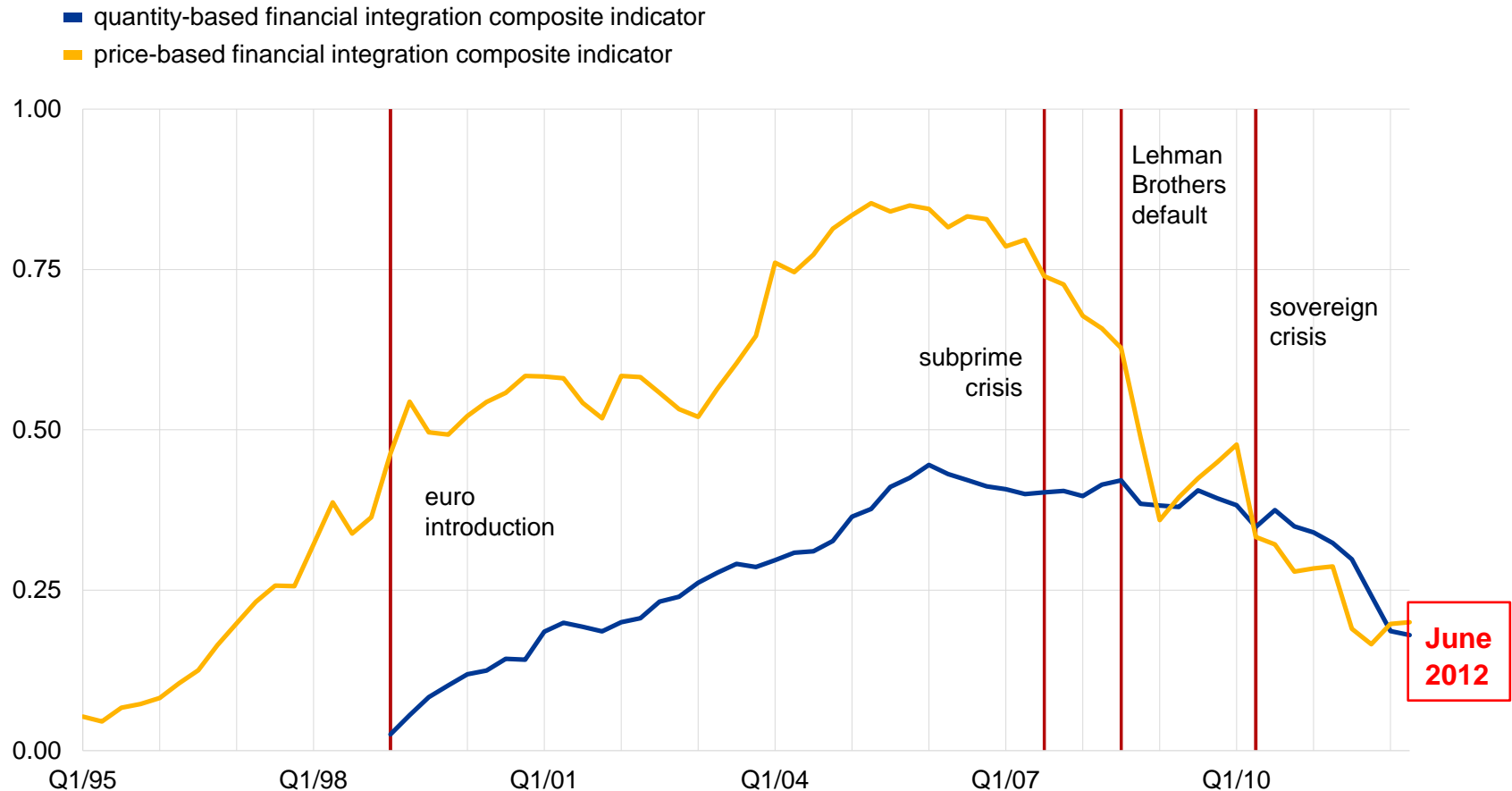
1. Where did we start from
2. What could reasonably be expected
3. Actions taken (institution building, strategies and priorities adopted)
4. Where do we stand today
5. What's next (challenges, roadblocks, potentials, ...)



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1. Financial integration

ECB indicators of financial integration (price and quantity-based)

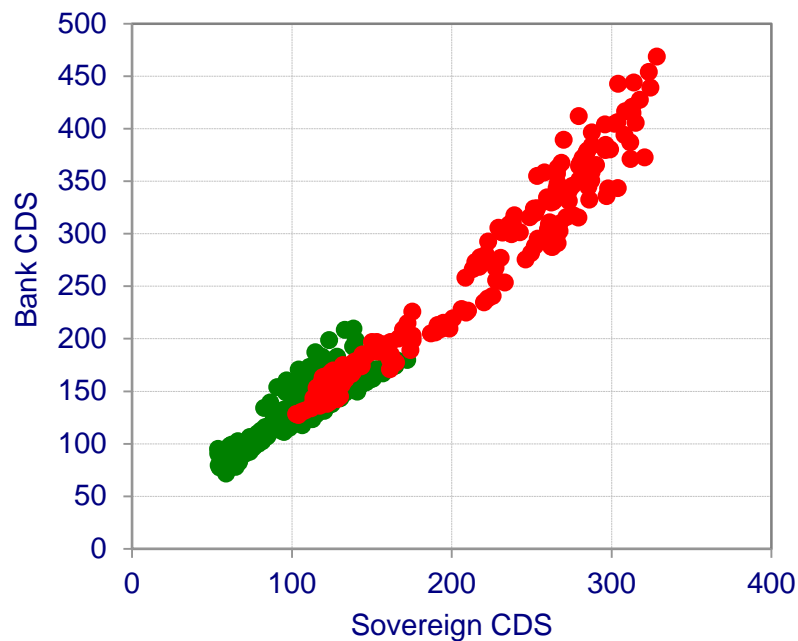


Source: ECB Financial Integration Report, various issues. Sources: ECB and ECB calculations. Notes: The price-based composite indicator aggregates ten indicators covering the period from the first quarter of 1995 to the fourth quarter of 2016, and the quantity-based composite indicator aggregates five indicators available from the first quarter of 1999 to the third quarter of 2016. The indicators are bounded between zero (full fragmentation) and one (full integration). Increases in the indicators signal greater financial integration. For a detailed description of the indicators and their input data, see the statistical annex of the Financial Integration Report.

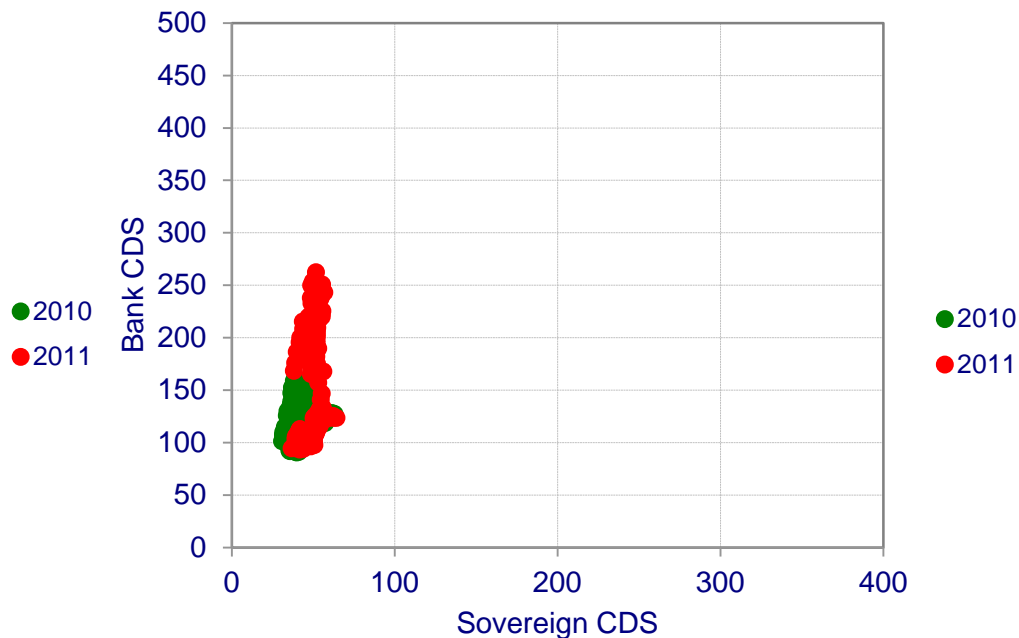
1. “Doom loop” between banks and sovereigns

Correlation between bank and sovereign CDS spreads: 2010-2011
(bps)

Euro area



United States

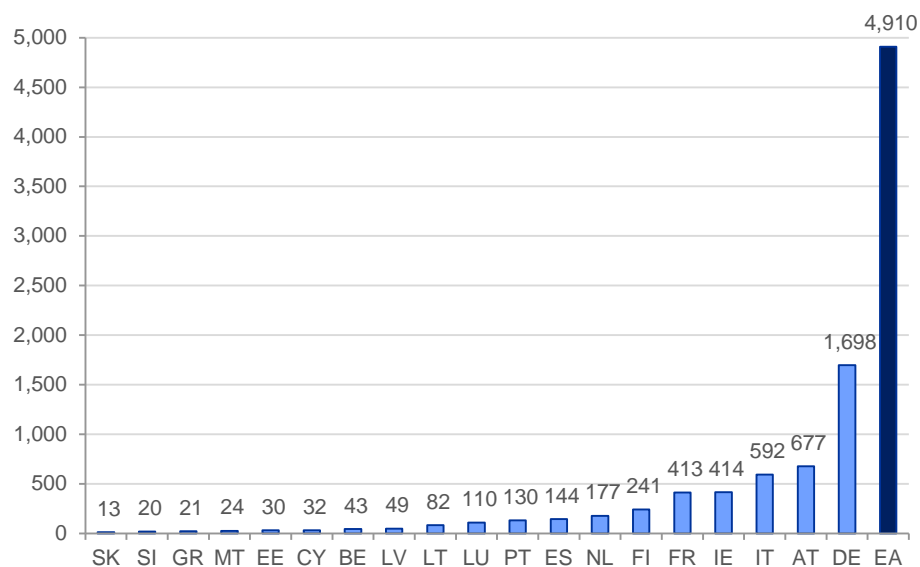


Source: Thomson Reuters Datastream, ECB calculations

1. Overbanking, home bias (2014)

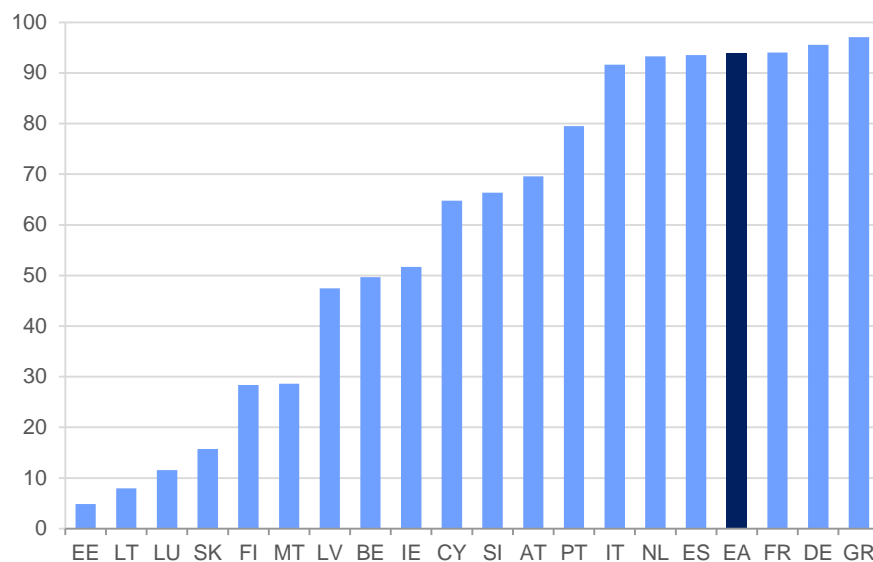
The euro area banking sector at the start of the SSM

Number of banks
(2014Q4)



Source: ECB list of financial institutions and Latvijas Banka; ECB Report on Financial Structures. Note: numbers show the total number of credit institutions which were legally incorporated in the reporting country in end-2014.

Share of bank assets held by domestic banks
(%, 2014Q4)

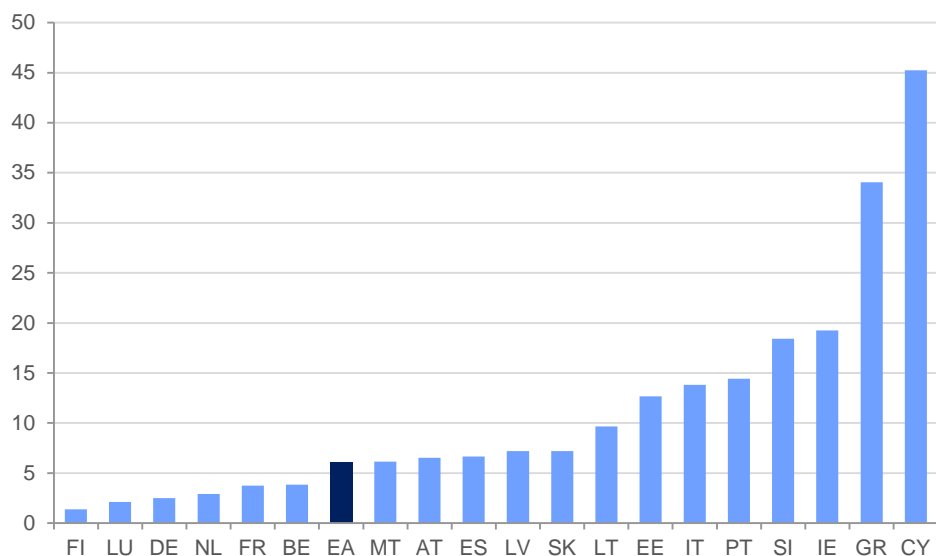


Source: ECB Consolidated Banking Data.

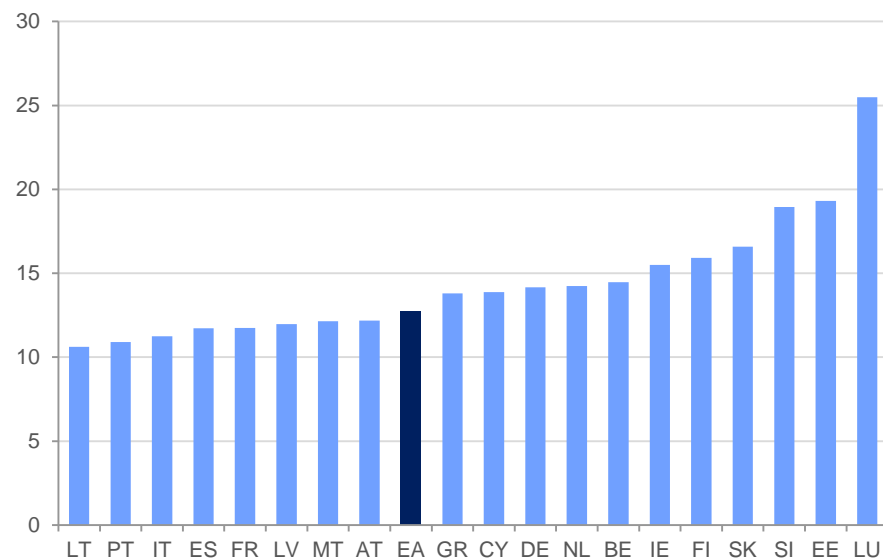
1. Capital adequacy and asset quality (2014)

The euro area banking sector at the start of the SSM

Gross non-performing exposures
(% of total debt instruments, 2014Q4)



Common equity Tier 1 ratio
(%), 2014Q4

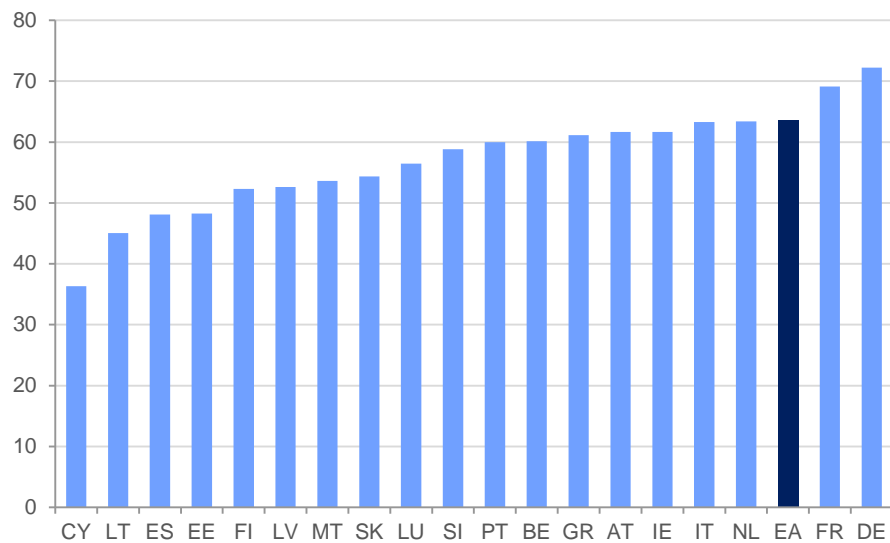


Source: ECB Consolidated Banking Data. Data excludes subsidiaries and branches of foreign banks

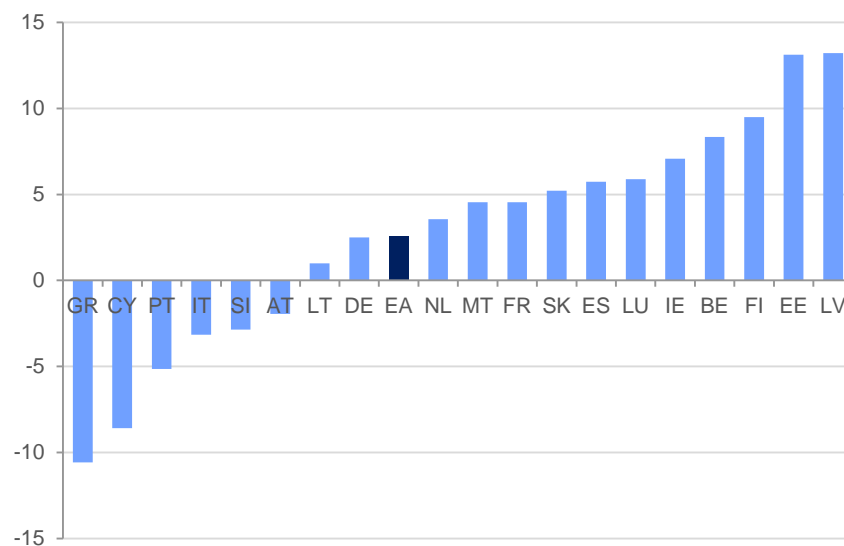
1. Profitability and cost efficiency (2014)

The euro area banking sector at the start of the SSM

Cost to income ratio
(%, 2014Q4)



Return on equity
(%, 2014Q4)



Source: ECB Consolidated Banking Data. Data excludes subsidiaries and branches of foreign banks

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2. Achievements that could be expected (personal views)

- risk reduction
 - risk sharing
 - weaken the 'doom loop'
 - macroprudential policy
- banking integration
 - level-playing field
 - higher supervisory standards (less capture, more independence, transparency, scrutiny)

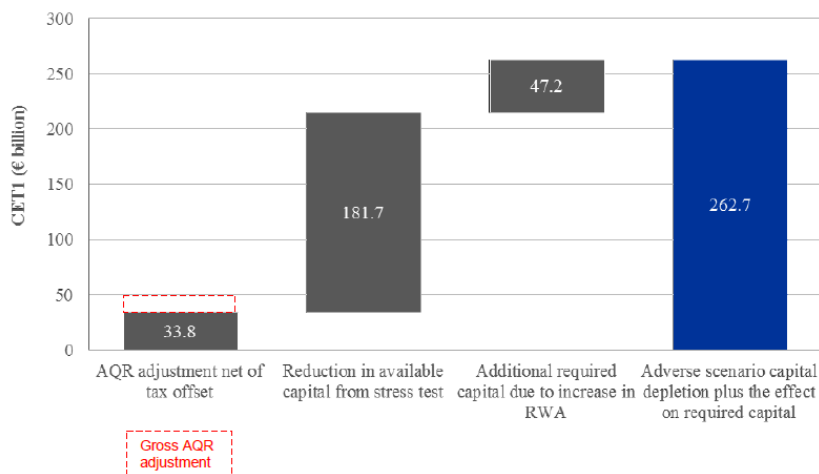
Financial Stability

1. Where did we start from
2. Achievements that could reasonably be expected
3. Actions taken (institution building, strategies and priorities adopted)
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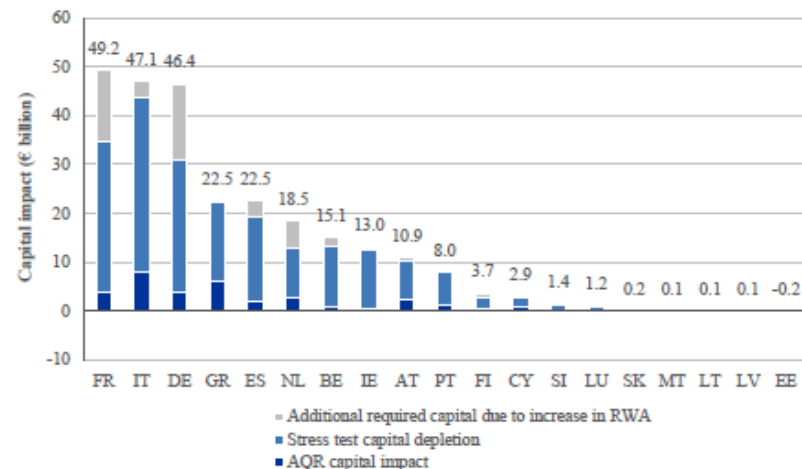
3. The “comprehensive assessment” (2014)

- Asset Quality Review cum Stress Test (pass-fail)
- €25 billion capital shortfall across 25 banks
- Gross impact on asset values by €48 billion, €37 billion of which did not generate a capital shortfall; hence overall impact of €62 billion.
- €136 billion in new NPLs identified in the AQR
- 4% reduction of median CET1 ratio over 130 banks
- €263 billion capital depletion under the adverse scenario
- Comprehensive assessment was a focused exercise covering only certain areas of banks’ risk

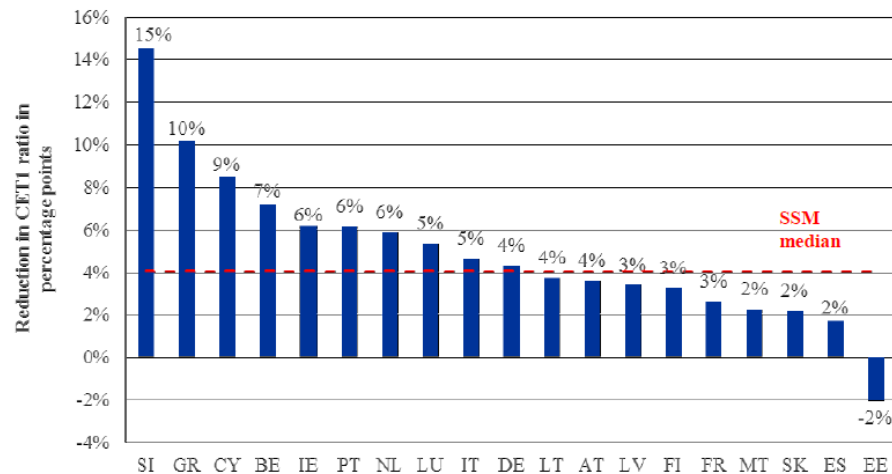
Comprehensive assessment adverse scenario capital depletion SSM level, (€ BN)



Comprehensive assessment projected adverse scenario impact on capital by country of participating bank



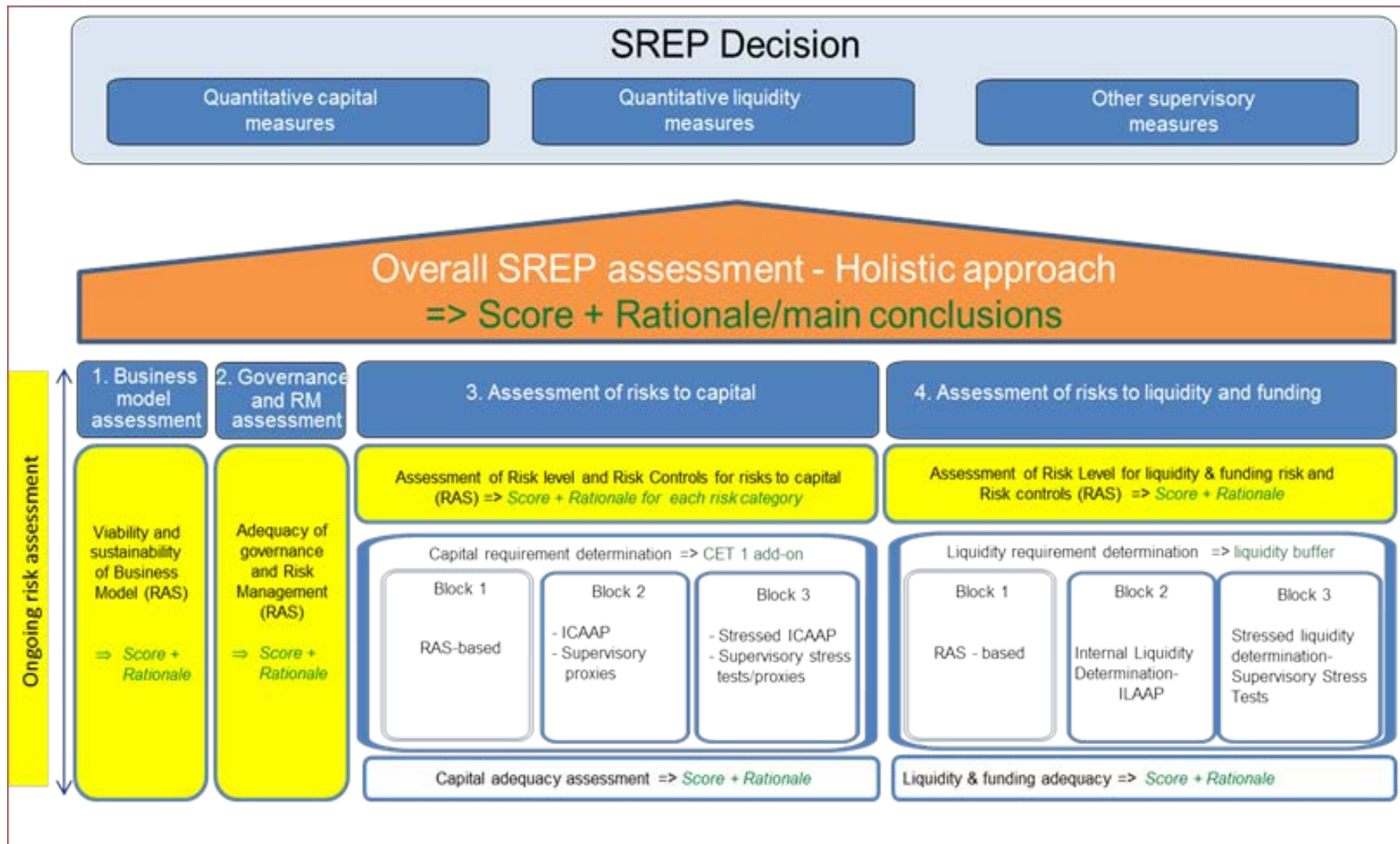
Comprehensive assessment impact on CET1 ratio under the adverse scenario Median by country of participating bank, %



Source: ECB Comprehensive Assessment, final results press conference, 26 October 2014 and ECB aggregate report on the comprehensive assessment, October 2014

3. Supervisory Review and Evaluation Process (SREP)

Banks' risk assessments and quantification of prudential requirements undertaken through a single methodology



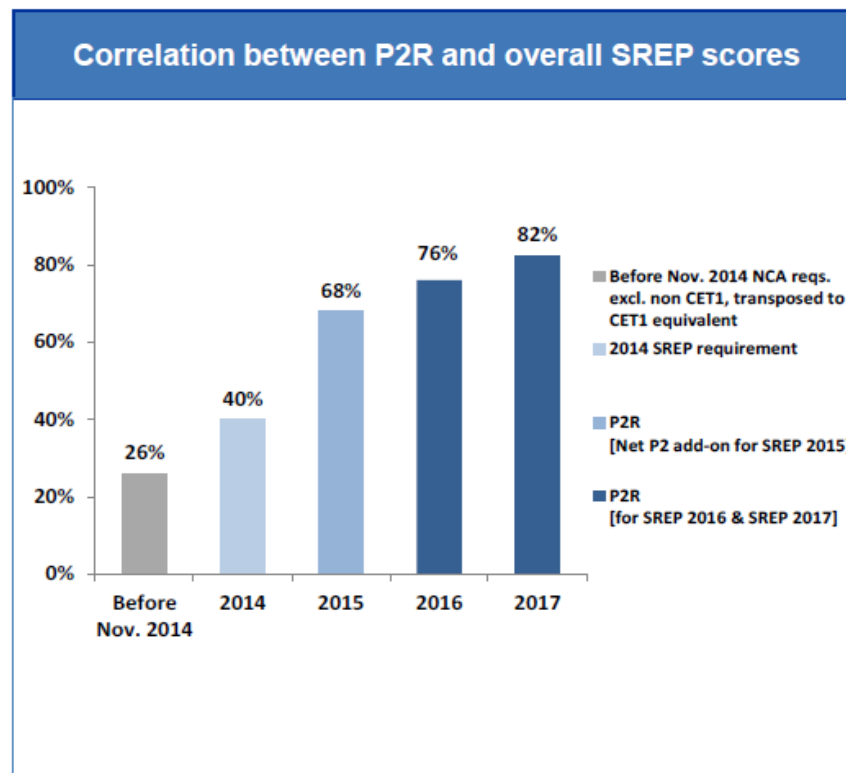
3. NPL Action Plan

- **Guidance (2017) focused on qualitative aspects**
 - ✓ banks asked to develop internal structures and quantified action plans
- **Addendum (2018) with expectations regarding provisioning of NPLs**
 - ✓ aims to avoid the piling-up of new NPLs by fostering timely provisioning practices as a starting point for the supervisory dialogue
 - ✓ addendum is complementary to any future EU legislation based on the European Commission's proposal to address NPLs under mandatory prudential requirements (i.e. 'Pillar 1' rules in the CRR).
- **Application is monitored through the normal supervisory process by the Joint Supervisory Teams**
- **Guidance applies also to legacy NPLs. Need for further provisioning expectations on legacy NPLs is being assessed**

3. Enhancing the level-playing field

Initiatives to foster supervisory harmonisation and convergence

- ✓ SREP
- ✓ Harmonising options and discretions
- ✓ Guide to fit and proper assessments
- ✓ On-site inspection methodology
- ✓ Internal capital and liquidity assessment (ICAAP and ILAAP)
- ✓ Recovery planning
- ✓ Involvement in EBA and global supervisory fora



Based on banks with a final SREP 2017 decision as of 30 November 2017

Note:
Correlation cannot reach 100% due to the facts that risks can also be addressed by other measures e.g. qualitative measures

Source: SSM SREP Methodology Booklet, 2017 edition

3. Supervision of less significant institutions (LSIs)

Indirect supervision and joint standards

*LSIs are supervised indirectly by the ECB. The ECB promotes a **common supervisory culture** across the SSM via the development of joint supervisory standards (JSS) with the National Competent Authorities (NCAs).*

- ✓ **JSS on: Crisis Management for LSIs, Fintech, Recovery Planning, On-site Methodologies, BMA, Car Finance**
- ✓ Guidance on notifications, Guidelines on options & national discretions for LSIs

Methodology and analysis

The ECB develops with the NCAs methodologies to apply the general SSM approach in a way that is consistent but proportionate, and takes account of the specificities of LSIs

- ✓ **RAS methodology, SREP for LSIs, methodology to define high-priority LSIs, IFRS 9 implementation, Early Warning Model**

Supervisory cooperation with NCAs

*The ECB conducts general oversight by **collecting and processing information from the NCAs**.*

- ✓ **LSI Crisis Management Cooperation Framework (CMCF)**
- ✓ Reports on supervisory priorities (forward looking), Report on LSI Supervision (backward looking)

Common procedures: SSM gatekeeper role

*The **ECB is responsible for the granting and withdrawal of authorisations, and approval of acquisitions of qualifying holdings for SIs and LSIs. As such, the ECB fulfils a **gatekeeper role**, preventing banks from being acquired by unsuitable acquirers, and ensuring that new banks comply with the relevant requirements.***

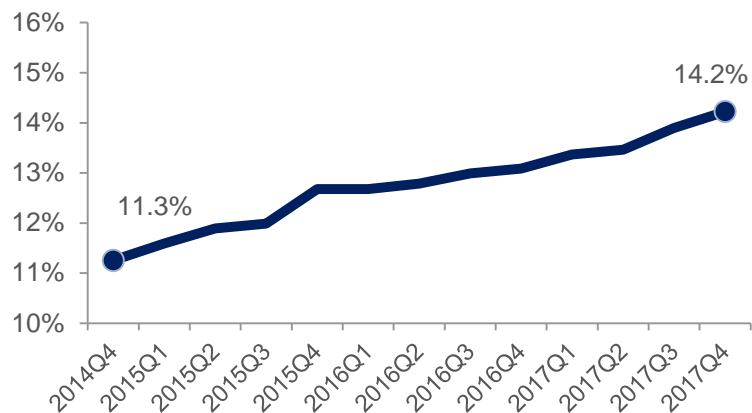
2. Crisis management and resolution

- Single Resolution Mechanism active since 2015, based on BRRD
- Single Resolution Fund built up incrementally with private funded, available under stringent conditions
- SRM in charge of resolution planning and of setting MREL targets
- Close cooperation between SSM and SRM based on an MoU; intense exchange of information, advice and expertise
- In crisis management cases, close cooperation between SSM, SRM and EU Commission

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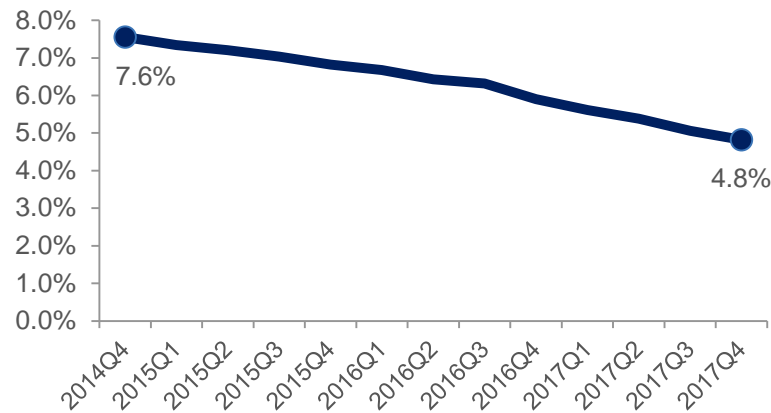
4. Progress achieved in prudential standards and asset quality

Evolution of fully loaded CET1 ratio



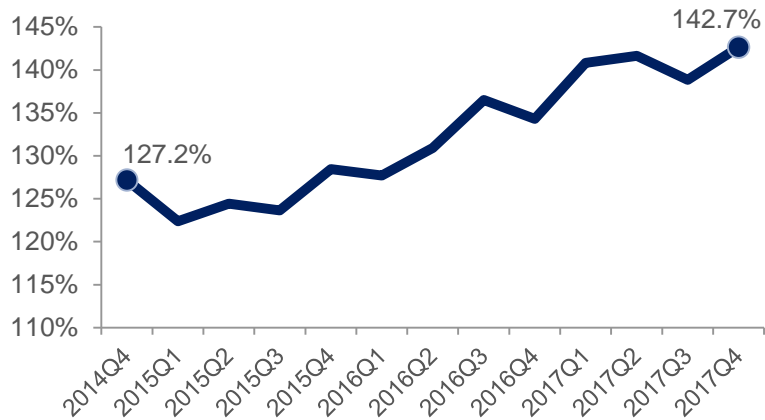
Source: COREP, ECB calculations.

Non-performing loans ratio



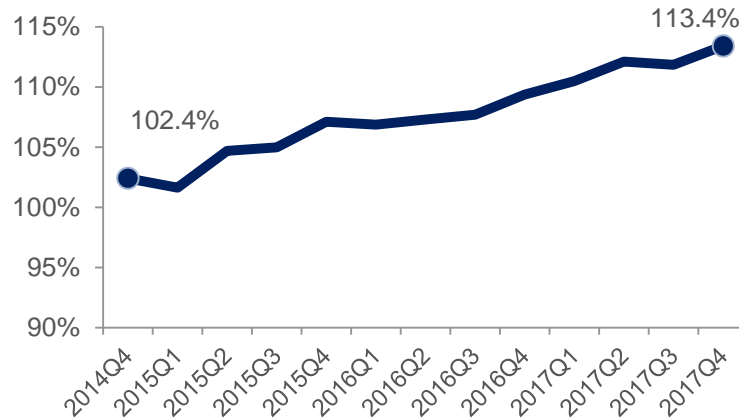
Source: FINREP, ECB calculations.

Liquidity coverage ratio



Source: COREP, STE data, ECB calculations.

Net stable funding ratio

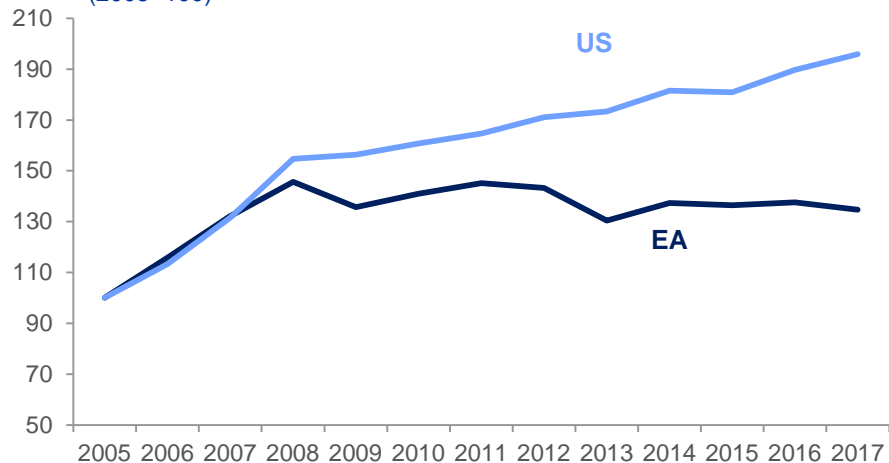


Source: STE data, ECB calculations.

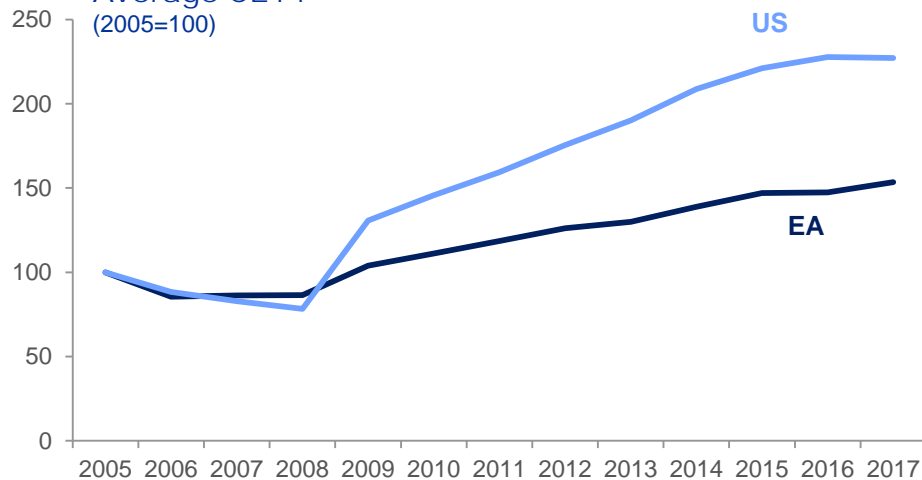
Notes: All averages are weighted by the denominator. The analysis is based on a sample of 98 significant institutions (SIs) that reported RWA and total assets in all time periods.

4. Benchmarking with the US

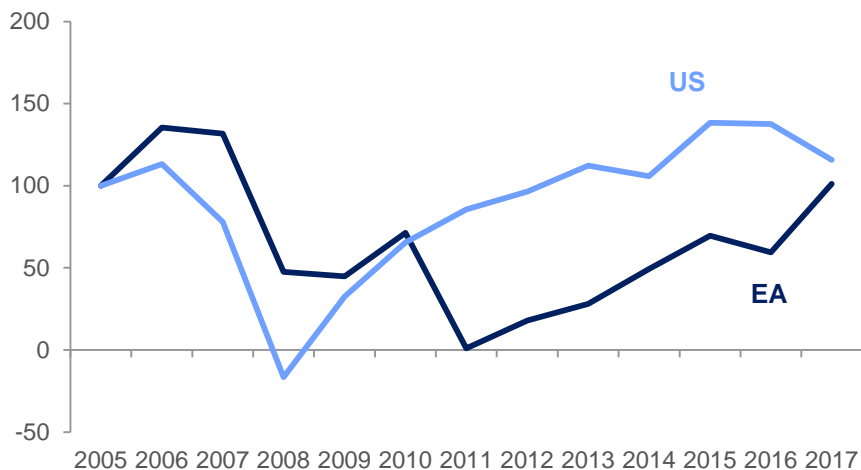
Total Assets
(2005=100)



Average CET1
(2005=100)



Aggregate Profits
(2005=100)



Average Return on Equity
(2005=100)



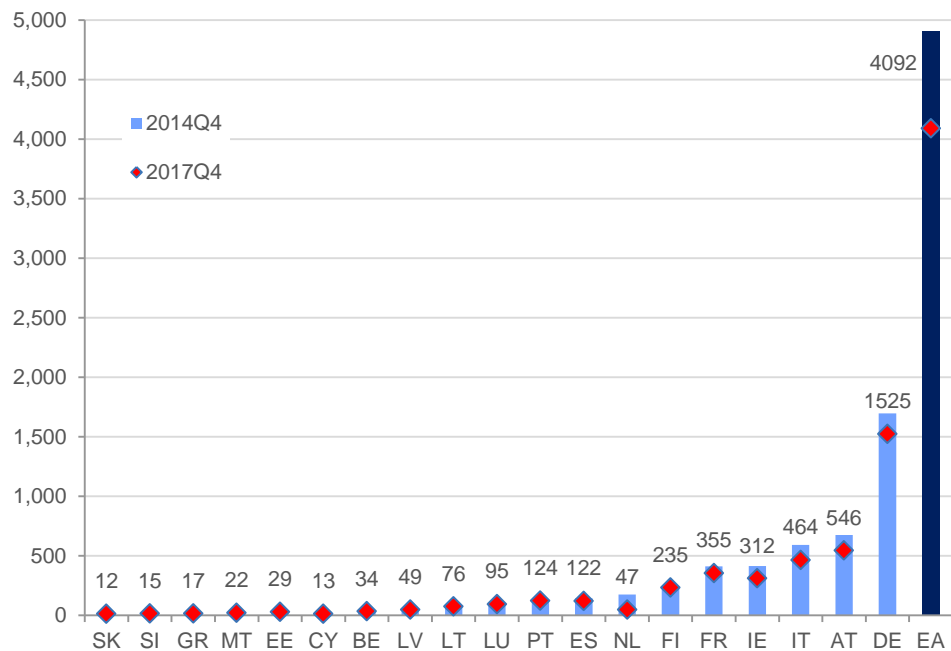
Source: SNL

Notes: Based on a sample of 37 euro area and 41 US banks. For CET1 ratios, some figures have been extrapolated due to data gaps

4. Overbanking, home bias (2014 and today)

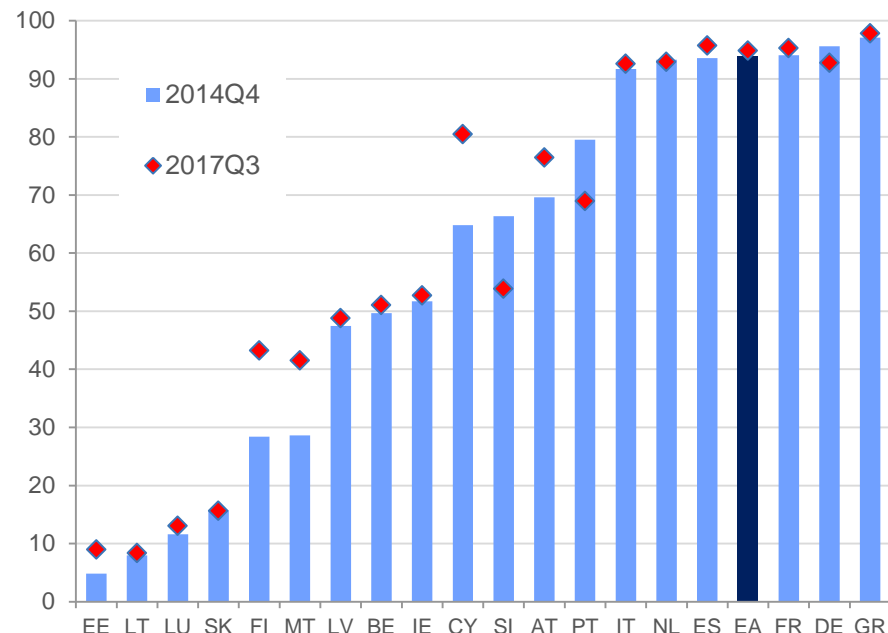
The euro area banking sector at present

Number of banks



Source: ECB list of financial institutions and Latvijas Banka; ECB Report on Financial Structures. Note: numbers show the total number of credit institutions which were legally incorporated in the reporting country in end-2017.

Share of bank assets held by domestic banks (% , 2014Q4)

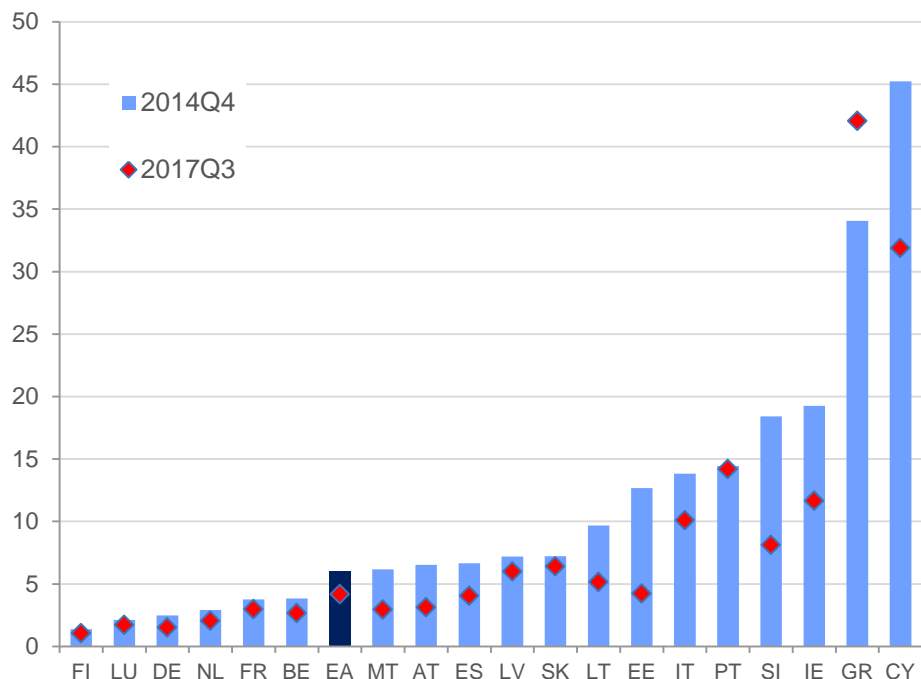


Source: ECB Consolidated Banking Data.

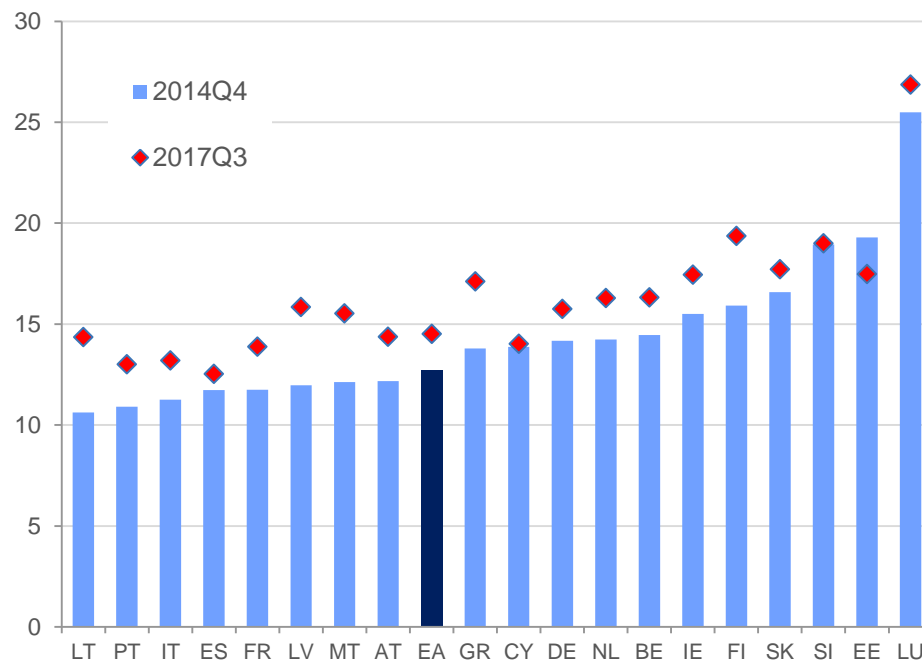
4. Capital adequacy and asset quality (2014 and today)

The euro area banking sector at present

Gross non-performing exposures
(% of total debt instruments)



Common equity Tier 1 ratio (%)

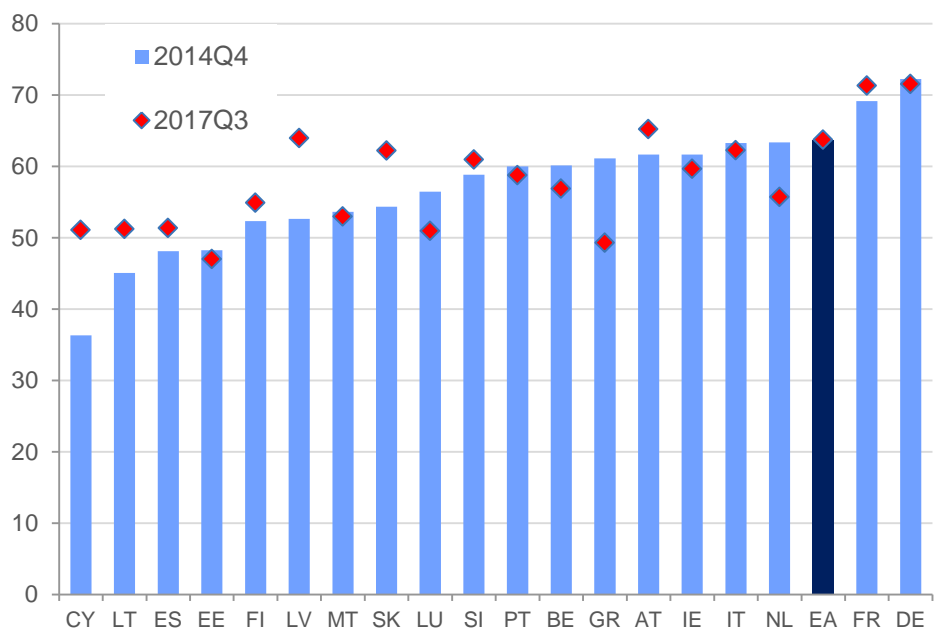


Source: ECB Consolidated Banking Data. Data excludes subsidiaries and branches of foreign banks

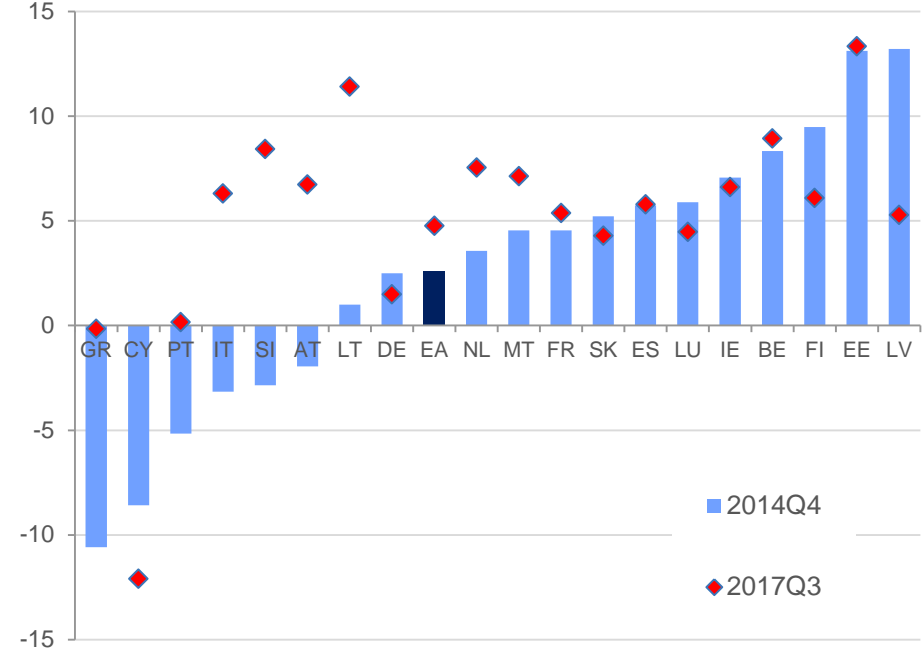
4. Profitability and cost efficiency (2014 and today)

The euro area banking sector at present

Cost to income ratio (%)



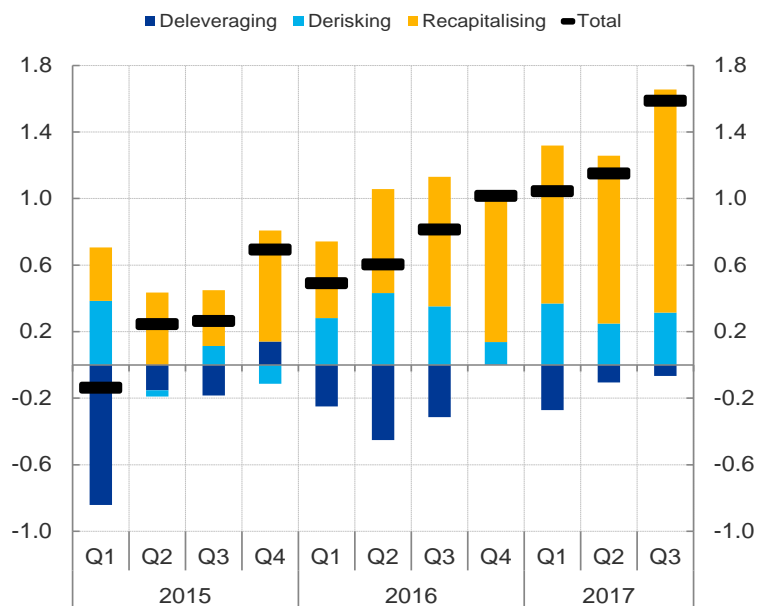
Return on equity (%)



Source: ECB Consolidated Banking Data. Data excludes subsidiaries and branches of foreign banks

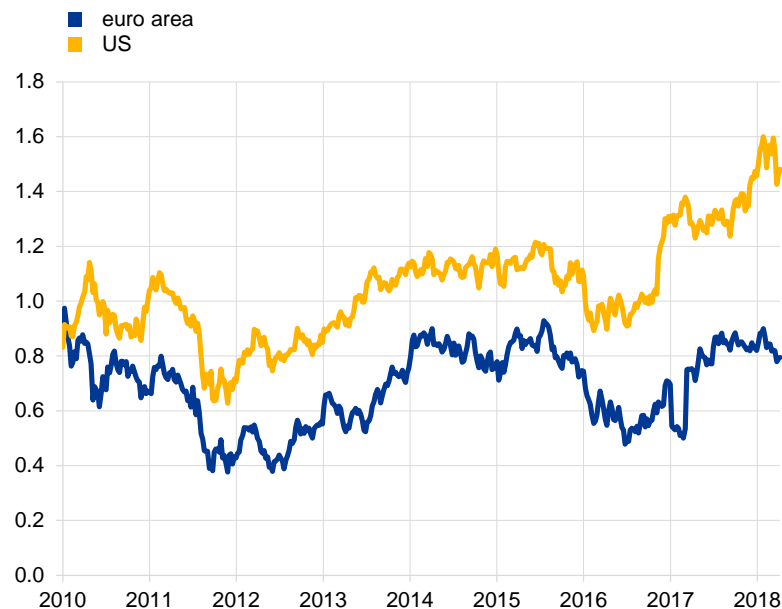
4. Sources of capital and price-to-book ratios

Factors contributing to the change in CET1 capital ratios in the euro area
(cumulated changes since 2014Q4, percentage point contributions)



Sources: ECB and ECB calculations. Notes: Based on data for a balanced panel of 199 institutions under the supervision of the ECB. Sample means weighted by total assets. Deleveraging refers to changes in total assets. Derisking refers to changes in average risk weights. Recapitalising refers to changes in the amount of bank capital. Latest observation: 2017 Q3.

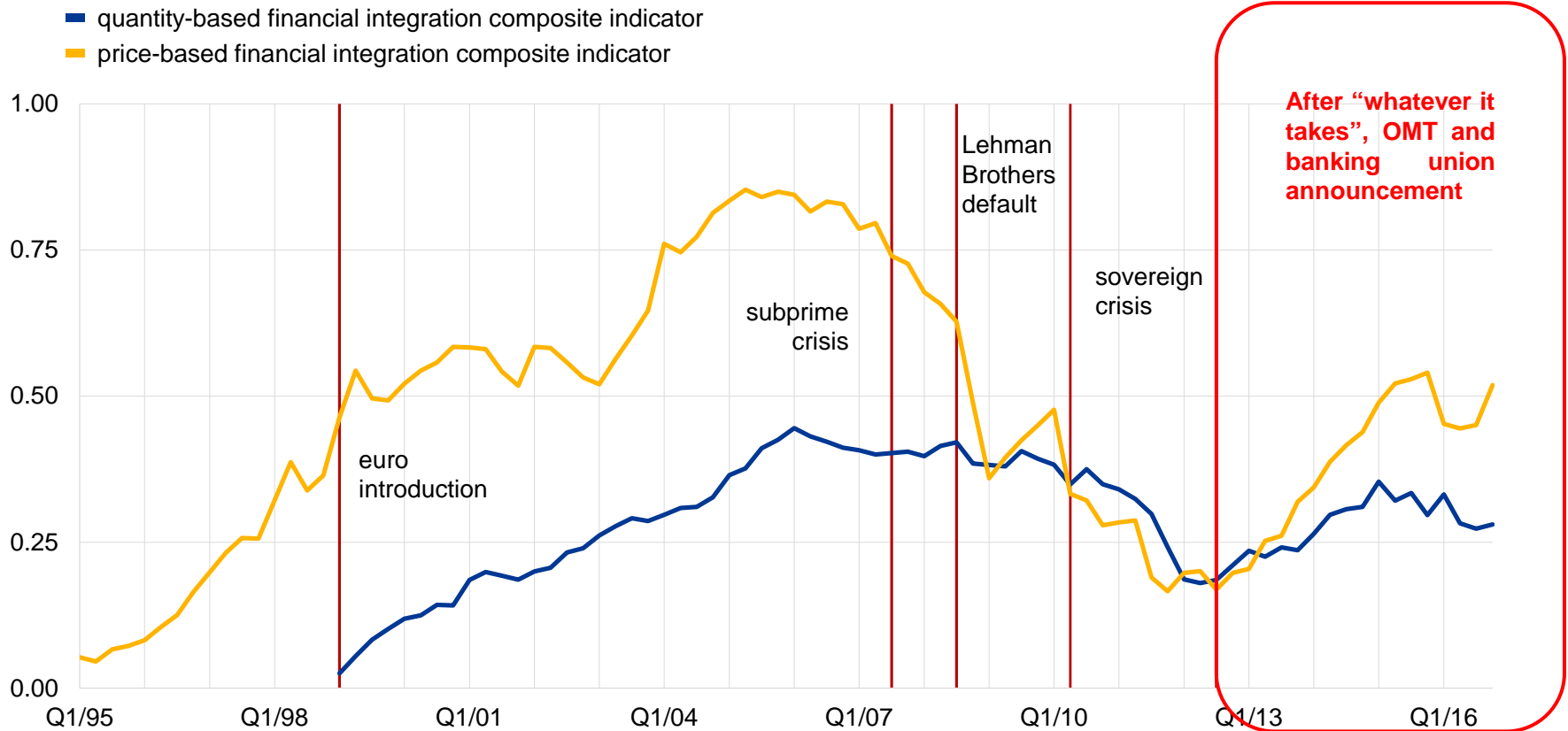
Aggregate price-to-book ratios for euro area and US multiples



Source: Bloomberg. Notes: The chart shows aggregate price-to-book ratios based on regional bank indices. The shaded area shows the valuation discount of euro area banks versus US banks.

4. Financial integration

ECB indicators of financial integration (price and quantity-based)

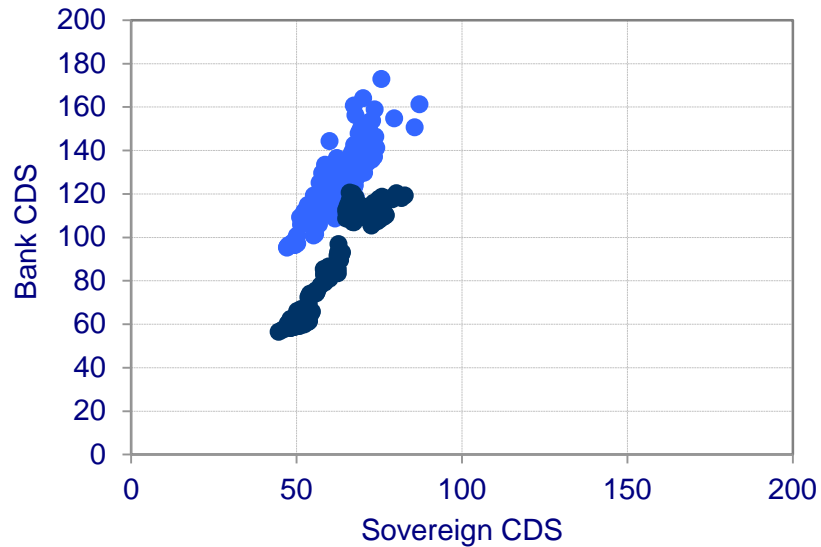


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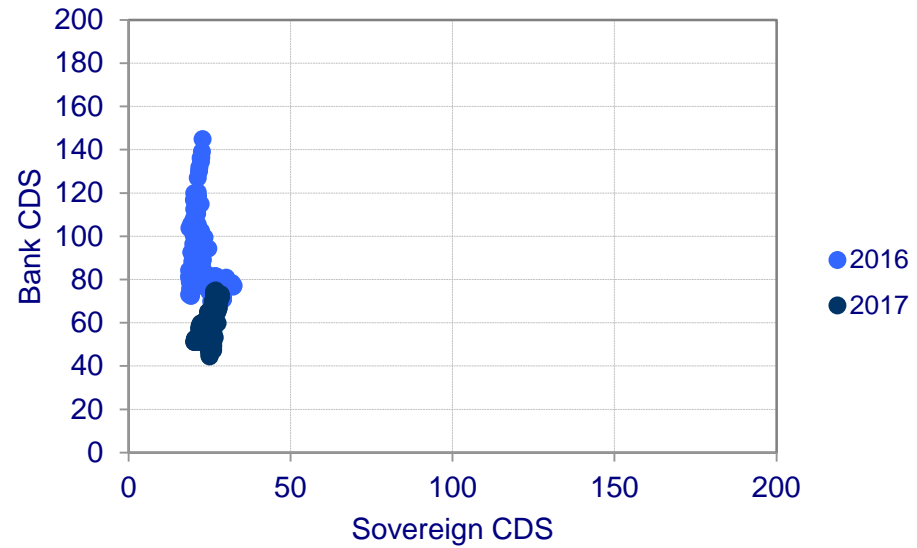
4. “Doom loop” between banks and sovereigns

Correlation between bank and sovereign CDS spreads: 2016-2017 (bps)

Euro area



United States

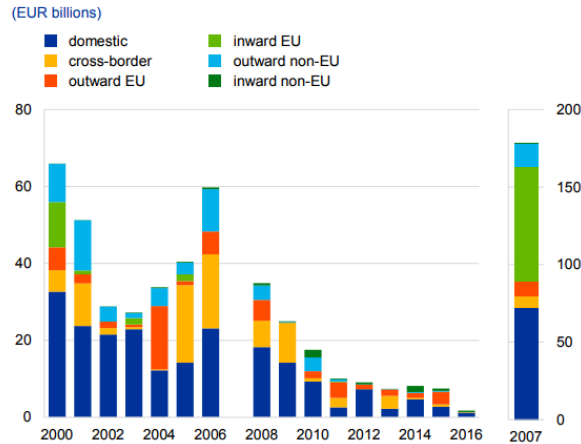


Source: Thomson Reuters Datastream, ECB calculations

4. Cross-border mergers and acquisitions

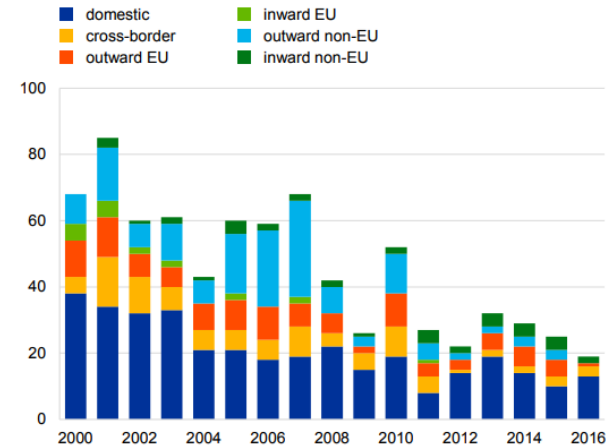
Bank consolidation has remained limited in recent years, especially in cross-border terms

Bank M&As in the euro area – value of transactions



Source: Dealogic M&A, ECB Report on Financial Structures 2017

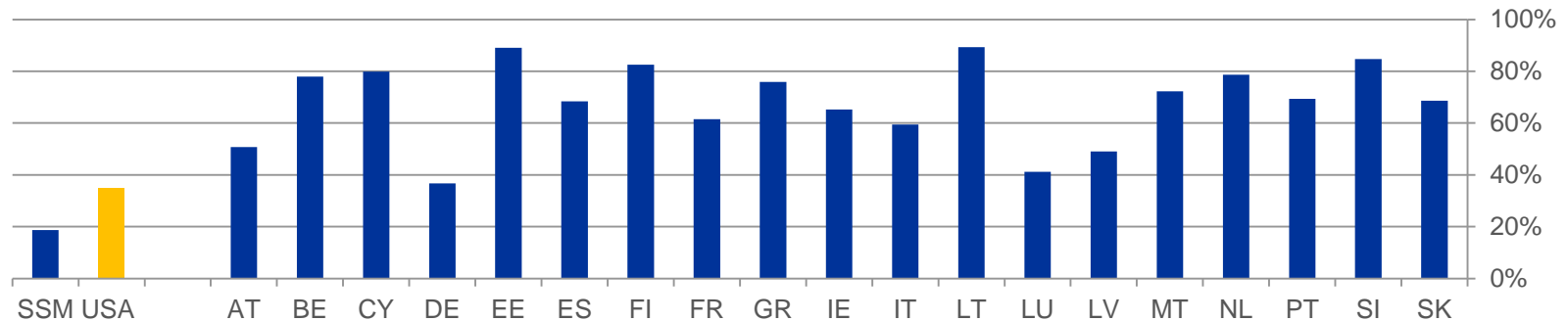
Bank M&As in the euro area – number of transactions



Source: Dealogic M&A, ECB Report on Financial Structures 2017

Banking sector concentration in the SSM

Assets of top 3 banks as a share of total assets



Source: COREP data for euro area SIs and LSIs, end-2016, World Bank Financial Structure Database for US, end-2015.

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5. Complex and fragmented legal framework

- The ECB applies EU law when it exists, otherwise national laws
- The SSM regulation empowers the ECB to undertake several supervisory actions under national law (license withdrawal, fit-and-proper testing, and other)
- If EU law is in the form of a Directive (like CRDIV), national transposition laws provide the legal basis
- Directly applicable EU law (like CRR) contains a large number of optional or discretionary provisions, only partly harmonised (ECB guide on Options and Discretions)
- The current CRD and CRR review does not fix the problem

5. Hurdles to banking integration

- An integrated banking union presupposes free movement of capital and liquidity; banking union is expected to remove or soften national capital and liquidity “silos”
- As of now, cross-border groups cannot freely allocate capital and liquidity among parent and cross-border subs
- Some margins of flexibility were granted by the ECB through its guide on Options and Discretions
- Member states can impede liquidity movements further by applying large exposure limits at national level
- The CRD and CRR review does not make progress in this area in spite of ECB support, amid firm opposition from part of the member states

5. Underdeveloped framework for resolution and crisis management

- The SRM is working on resolution plans, with support from the ECB, but work is still incomplete
- Target levels for capital in resolution (MREL) are still being set; their phase-in will take years
- Resolution, national liquidation and state aid rules not fully integrated
- The single resolution fund will phase in until 2024
 - ✓ The SRF became operational in 2016 and its target level (around €55 billion) will be gradually built-up until 1 January 2024
 - ✓ In February 2017, the SRB concluded Loan Facility Agreements through which each Member State provides a bridge financing during the transitional period until the SRF is fully mutualised
 - ✓ A public backstop should be in place by 2024 at the latest and modalities are being negotiated
- Crisis management procedures successfully tested
 - ✓ Few resolution and liquidation cases so far, sometimes under heavy time pressure
 - ✓ Smooth cooperation among stakeholders; no evidence of contagion

5. Limitations of macroprudential policy

- SSM Regulation establishes the ECB as macroprudential authority
- ECB competent only over a limited set of instruments, covered by EU law (details in Annex)
- Borrower-based instruments remain under national competence
- ECB can only “top up” (tighten) the macroprudential policy stance, using instruments in EU law
- Coordination (involving also the European Systemic Risk Board) is complex and cumbersome (details in Annex)
- As of now, policy instruments have only been activated by national authorities

5. Missing deposit insurance

Progress on a European Deposit Insurance Scheme has stalled

- At the moment there is only minimum harmonisation of national schemes, in the form of a Directive (minimum guarantee, time for disbursement)
- **Proposals by the Commission**
 - ✓ funded by banks through risk-weighted contributions
 - ✓ three phases (re-insurance, co-insurance, full insurance)
 - ✓ strict conditionality to prevent moral hazard
 - ✓ latest Commission proposal does not refer to full insurance, which however should remain the ultimate objective
- **Compromise blocked by controversy between risk reduction and risk sharing (link with sovereign risks in bank portfolios)**
 - ✓ A recent ECB paper shows no systematic cross-country subsidisation arising from the proposed EDIS, once the other elements of the banking union are in place (J. Carmassi et al, ECB Occasional paper n. 208, April 2018)

Euro area banks have made major advances:

- ✓ System-wide capital ratios up by 300bps (14.2% CET1 at end-2017)
- ✓ NPL *stock* reduced by 25% (NPL *ratio* at 4.8% at end-2017)
- ✓ Liquidity buffers have been strengthened
- ✓ Profitability is recovering
- ✓ Some bank restructuring and consolidation underway, mostly domestic
- ✓ Banking union crisis management framework is in place

Major obstacles to further progress remain:

- ✓ Legal framework fragmented along national lines
- ✓ Tight limits to cross-border banking integration persist
- ✓ Elements of crisis and resolution framework missing
- ✓ Sovereign-bank nexus persists, somewhat diluted
- ✓ Incomplete macroprudential policy framework
- ✓ No common deposit insurance

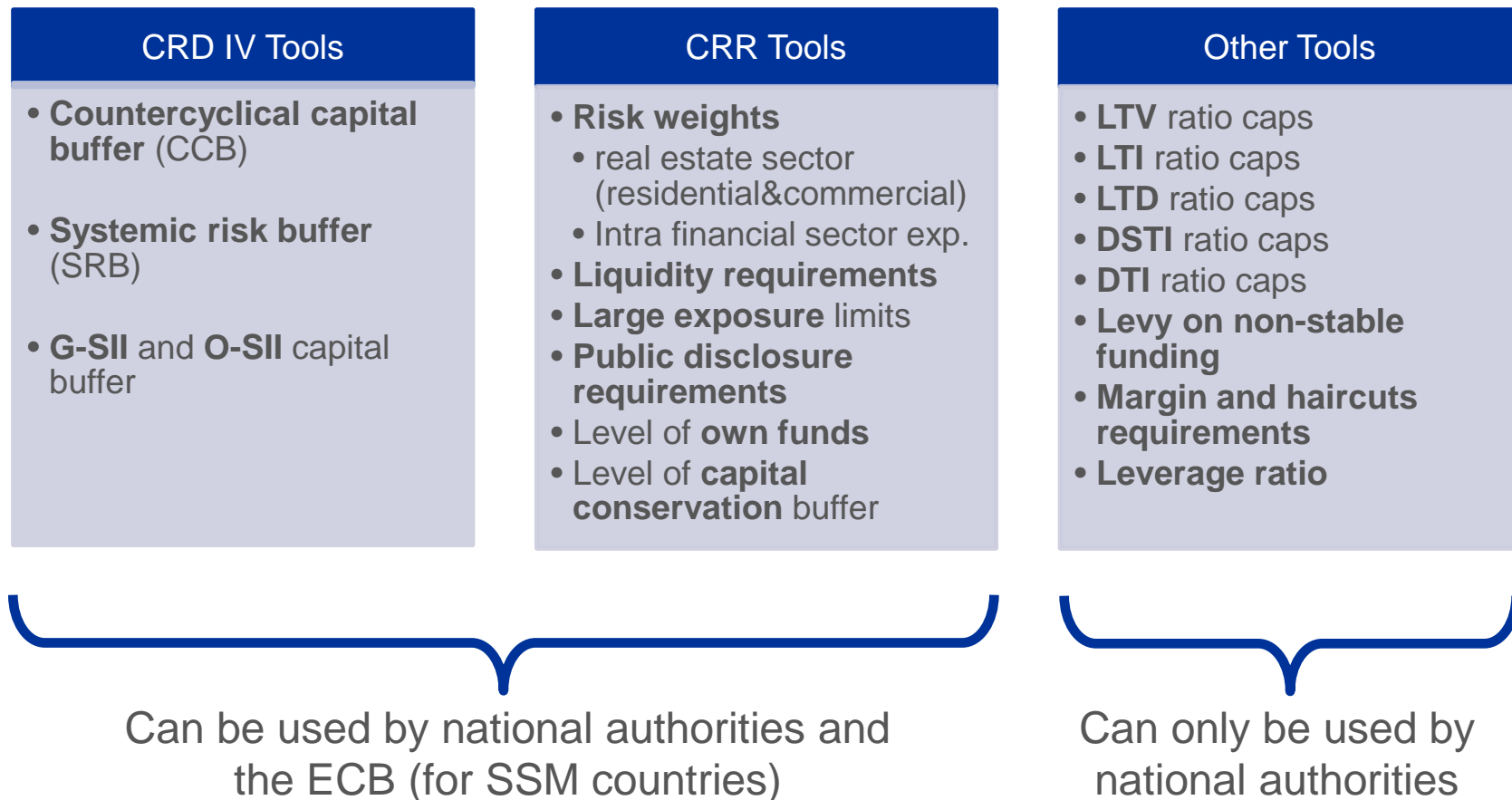
- The banking union has already led to a more solid and healthy banking sector
- Its full potential cannot be exploited until several hurdles are removed
- We are driving a F1 car in an unlevelled country road
- Firm determination by Commission, member states, Parliament is needed going forward

- risk reduction 😊
 - risk sharing 😞
 - weaken the 'doom loop' 😞
 - macroprudential policy 😞
- Financial Stability*
- banking integration 😞
 - level-playing field 😊
 - higher supervisory standards (less capture, more independence, transparency, scrutiny 😊)

ANNEX

Complex decision-making process, large number of instruments distributed between ECB and national authorities

Legal basis of macroprudential instruments in Europe



Complex decision-making process, large number of instruments distributed between ECB and national authorities

