Risk sharing and risk reduction in the Euro Area banking sector: progress and next steps

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The mantra of the European authorities when talking about the completion of the Banking Union is that there needs to be risk reduction in the banking sector before introducing further mechanisms of risk sharing. What form of risk sharing might this take and what are the risks that banks need to reduce?

Risk sharing according to the European institutions means two things: putting in place the third pillar of the Banking Union (i.e. the European Deposit Insurance Scheme - EDIS) and providing a backstop for the Single Resolution Fund (part of the second pillar of the union, i.e. the Common Banking Crisis Resolution Framework). Risk reduction means essentially decrease the risk of a bank of becoming insolvent or illiquid due to shocks impacting on both the asset and the liability side.

Risk reduction and risk sharing have been embedded into the Banking Union, from the common supervisory authority for the bigger Euro area banks, to provide better monitoring of a banking sector less subject to the regulatory capture of national supervisory institutions, to the new crisis management tools that greatly reduce the possibility of passing on the cost of a banking crisis to national taxpayers, and a common depositor guarantee scheme that should improve risk-sharing, based on the concept that domestic shocks can be buffered more easily by a pan-European insurance mechanism.

The latest milestone toward the completion of Banking Union was the EU summit that took place on the June 29th 2018. The summit however made only limited progress, restating the commitment to start working on a roadmap for the European Deposit Insurance Scheme and establishing that the European Stability Mechanism (ESM) will provide a backstop to the Single Resolution Fund in the form of a revolving credit line. The Summit will reconvene in December this year to agree on a term sheet for the further development of the ESM while the backstop will become operational ahead of the end of the transitional period in 2024 "*if sufficient progress is achieved in risk reduction measures*". Progress in risk reduction will be assessed in 2020 on the basis of the trend in NPLs reduction and MREL build-up, as stated in the letter of the president of the

Eurogroup ahead of the June Euro Summit.[1]

It is clear from the conditions stated in the letter that there is a consensus about the main vulnerabilities Euro Area banks still need to improve upon. The first is the risk of further losses from uncertainty in the value of deteriorated assets and the second is of insufficient own funds and other liabilities to cover for losses without involving depositors and tax payers in case of resolution.

One measure of risk that seems to have disappeared from the most recent public discourse is the concentration of domestic government bonds in banks' balance sheets, something that seemed to especially worry German authorities, while another issue, the holding of illiquid assets, so-called Level 2 and Level 3 assets, was never centre-stage. On all other measures of credit and liquidity risk – capital ratios, leverage ratios, liquidity and stable funding ratios – banks have instead achieved steady progress under the pressure of regulators and market discipline, as widely reported by all main regulatory and supervisory authorities.

1 How much risk reduction has already been achieved?

As the document of the European Council on Progress in Achieving Risk Reduction Measures makes clear, the key risk indicators used to measure the reduction in risks in the banking sector relate to capital, leverage, liquidity, net stable funding, non-performing loans and the MREL buffer.[2] We shall see now the progress made on some of these measures for which data are available.

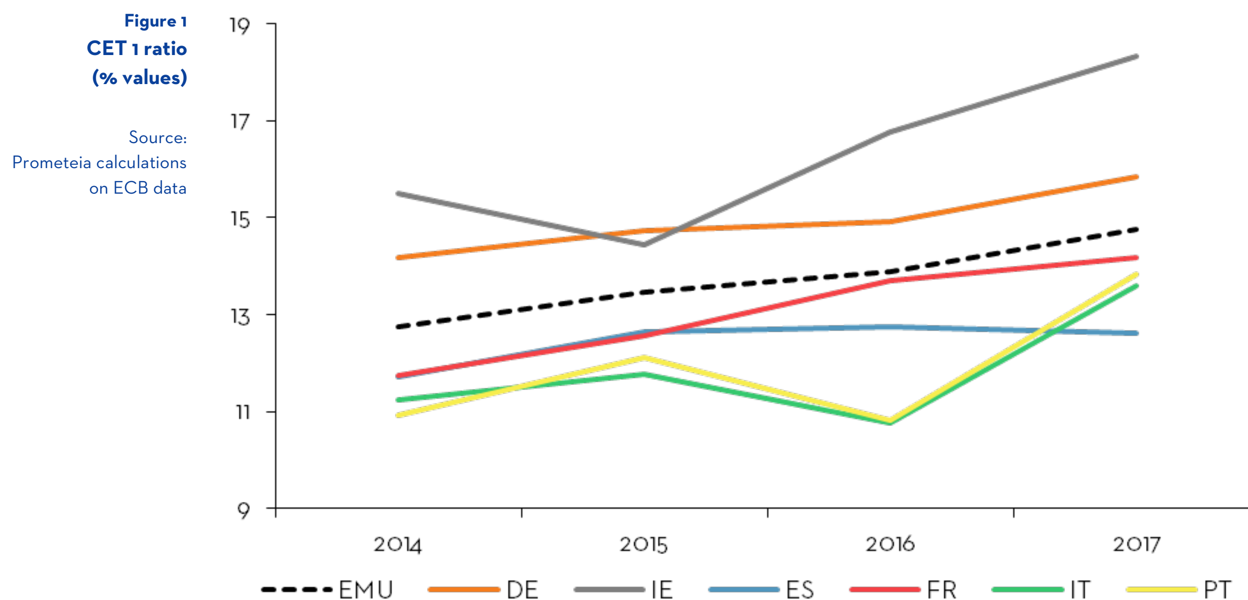
Common equity tier 1 ratios have been increasing steadily over the last few years (Fig. 1) and tier 1 ratios and leverage ratios are much higher than they were ten years ago (respectively 86% and 68% higher for the aggregate Euro Area at end 2017 than in 2008).

[1] Letter of president Centeno to president Tusk, 25-06-2018, *http://www.consilium.europa.eu/media/35798/2018-06-25-letter-president-centeno-to-president-tusk.pdf*

[2] See http://www.consilium.europa.eu/media/35862/riskreduction.pdf

Figure 1
CET 1 ratio
(% values)

Source:
Prometeia calculations
on ECB data

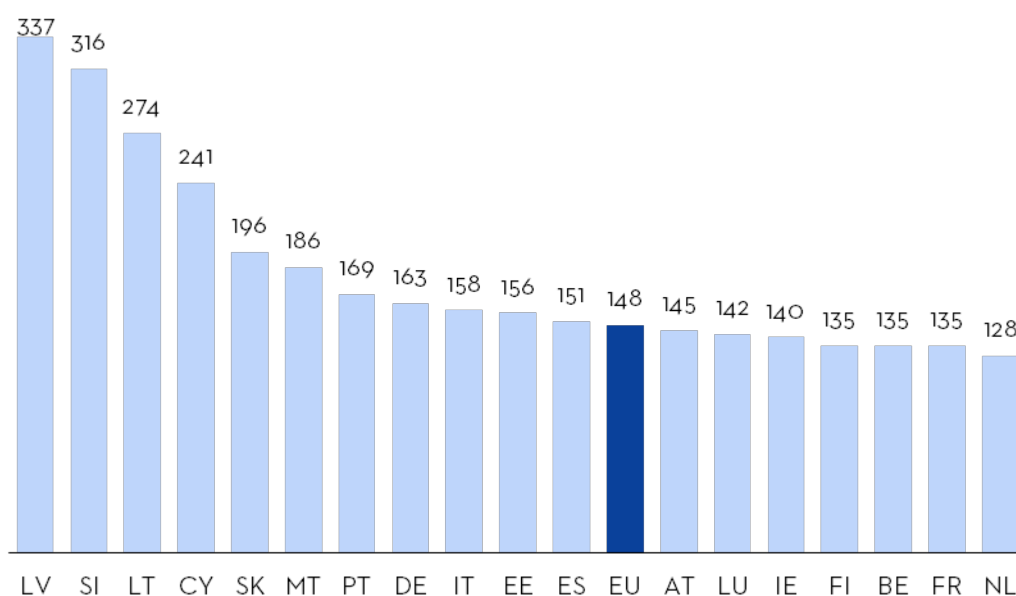


All these indicators demonstrate the Euro area banking sector is well capitalised and should therefore be able to withstand the level of losses that are commonly associated with an economic downturn or negative financial shocks. In addition to higher capital, banks have been improving their short-term and long-term liquidity indicators to comply with the Basel III requirements, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). Available data on the first of the two requirements show that the ratio is well above the regulatory threshold of 100%, at least on an aggregate level, for all Euro Area countries (Fig. 2). Little information is instead available on the MREL, the requirement envisaged in the BRRD on banks liability structure.[3] There are some estimates given by the European Banking Authority (EBA) at the end of 2016 balance sheet data of 112 EU banks, representing 60% of the EU banks' assets, according to which the average MREL was 37.9% of RWAs, with the median value standing at 29.3% of RWAs. Based on these, the estimated MREL needs to reach a hypothetical Loss Absorption Buffer –calculated as 2 x (Pillar 1 + Pillar 2 requirements + combined buffer requirement) – which would be around 207 billion euros.

[3] In the current version of the BRRD there is no requirement for banks to disclose their specific MREL threshold.

Figure 2
LCR
(% values at 2017)

Source:
Prometeia calculations
on EBA Risk
Dashboard data



Some progress towards compliance with the requirement is likely to have been made in the more than one and a half years since the latest EBA estimate. Some evidence is available from information on the TLAC (Total Loss Absorbing Capacity) ratios of some G-SIFIs (for the G-SIFIs the MREL will most likely converge toward the TLAC). For instance, for the three top French banks that disclosed the information, the TLAC increased from 2016 to the end of the first semester of 2018 by a minimum of 40 up to 220 bps (Table 1). Despite some progress since the last EBA update, the new requirement has the potential to create a non-negligible impact on banks funding cost, depending on the capacity of markets to absorb the volumes of bond and capital instrument issuance needed to comply with the MREL.

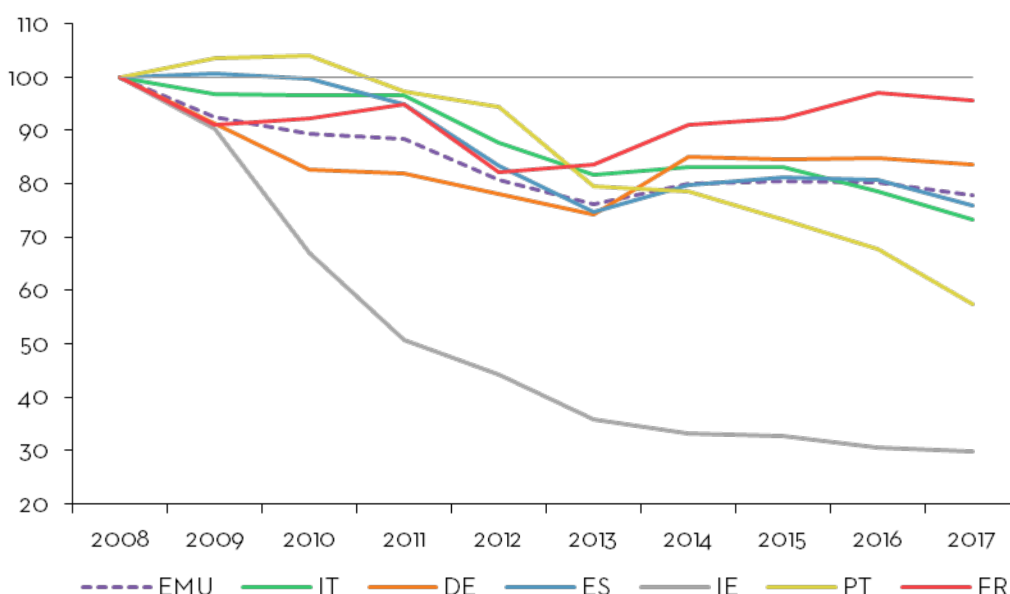
Table 1
TLAC

	TLAC 2016	**TLAC 2018-H1**
Crédit Agricole Group	20,3%	21,2%
Société Générale	21,5%	21,9%
Group BPCE	19,4%	21,6%

As well as on the liability side, progress was also made in reducing risk on the asset side of banks' balance sheets. A general process of de-risking, with banks cutting back on loans to riskier borrowers and on investments in more volatile financial assets, is evident from the evolution in RWAs (Fig. 3).

Figure 3
RWA
(index, 2008 = 100)

Source:
Prometeia calculations
on ECB data



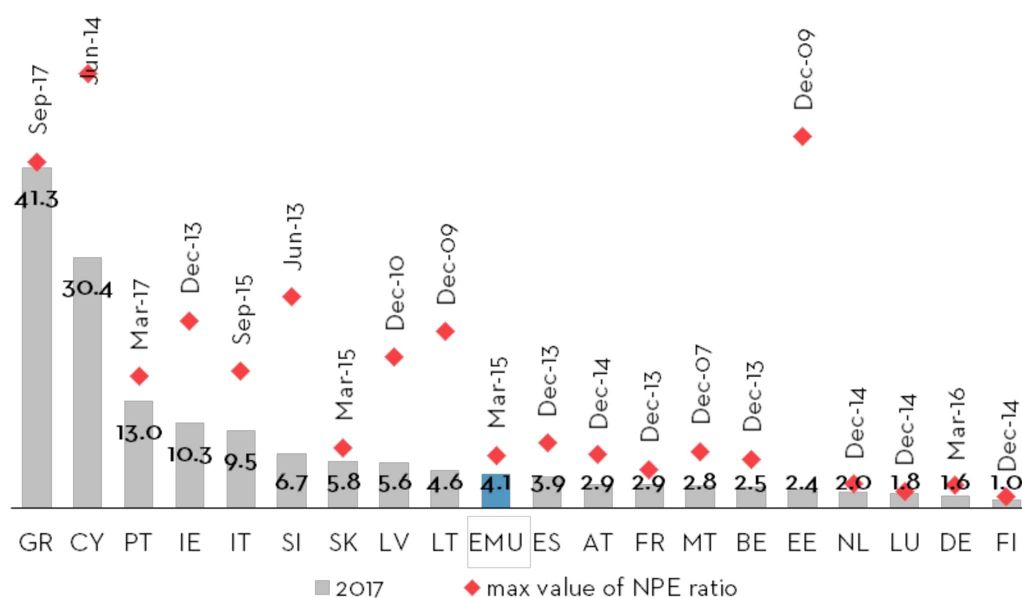
However, the focus of political and supervisory European authorities has been the amount of deteriorated loans accumulated by the banking sectors in countries whose growth was most affected by the sovereign debt crisis or that did not use large amounts of public funds, when it was still possible, to recapitalize their banks. Despite the reduction achieved since their peak levels, the stock of non-performing loans is still high in Greece, Cyprus, Portugal, Ireland and Italy (Fig. 4), and it remains a sticking point in any discussion towards more risk sharing within the Euro Area. Since it became the euro zone's top banking supervisor in 2014, the ECB has been pushing for a quicker clean-up of banks' balance sheets. To this end, in March 2018 the Bank published an addendum to its guidance to banks on non-performing loans, part of a comprehensive framework to deal with the issue. The European Commission also published a consultation on the regulation of the minimum NPE Coverage the same month. While the Addendum of the ECB is a Pillar 2 requirement and applicable to all significant banks supervised by the ECB, the European Commission proposal is a Pillar 1 requirement, therefore binding, and is applicable to all banks. Both prescribe a policy of so-called calendar provisioning that forces banks to quickly write down non performing exposures. The policy, which should reduce the possibility to accumulate large amounts of NPLs in the future, does not address the issue of the existing stock. While the ECB was expected to publish last March a first draft of new measures targeting the stock of deteriorated loans, the document outlining the new supervisory approach to stocks was released in July

and instead of prescribing a fixed rule it establishes that the ECB will have bank-specific expectations on NPL policies based on a benchmarking of comparable banks and guided by individual banks current NPL ratio and main financial features. The approach aims to achieve the same coverage of the stock and flow of NPLs over the medium term. In response to the latest supervisory initiatives, the Italian banks supervised by the ECB reviewed their NPL reduction targets aiming at lower ratios to be reached over a shorter horizon.

Finally, as mentioned earlier, the holding of domestic sovereign bonds by banks seems to have moved from the spotlight and there is no mention of the issue in the latest official statements on the Banking union road map.

Figure 4
Gross NPE ratio (% values)

Source: Prometeia calculations on ECB data



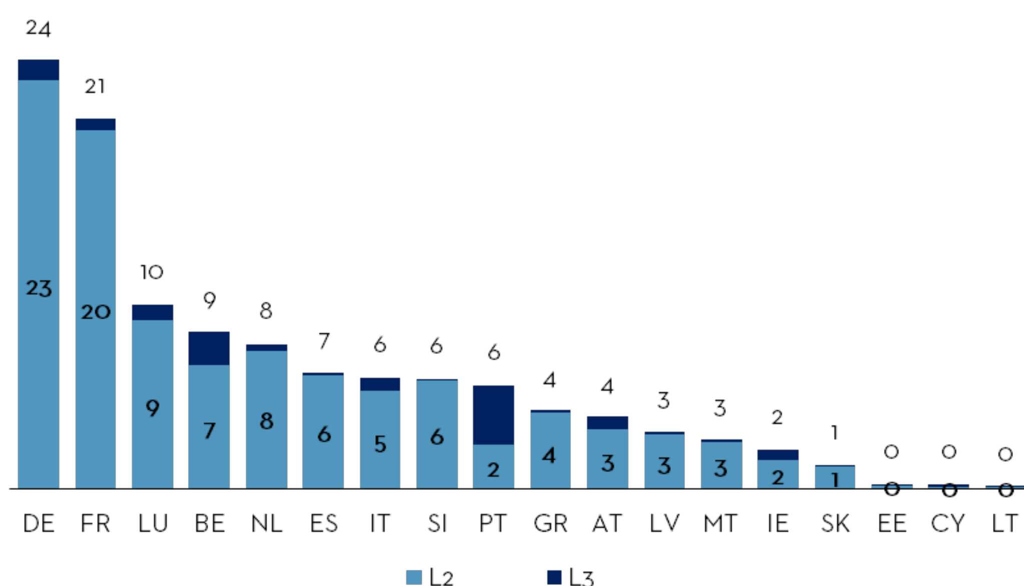
2 The issue of illiquid assets

While a lot of attention has been given to the high level of deteriorated loans as a key source of vulnerability, the holding of high illiquid assets – a legacy, at least partly, of the disruption in the market of complex securitized assets following the 2008 financial crisis – does not seem to have attracted the same level of scrutiny. However, at the end of February,

talking to the Committee on Economic and Monetary Affairs,[4] ECB President Mario Draghi mentioned Level 2 and Level 3 assets[5] as a concern in view of deeper risk-sharing. Specifically, he mentioned the need to reduce holding of these type of assets as well as NPLs. The monitoring of complex financial instruments like Level 2 and Level 3 assets on banks' balance sheets is among the SSM supervisory priorities for 2018. So they might start to become more of a concern among investors if the supervisor review highlights shortcomings in the way they are valued, considering that some large French and German banks still hold non negligible amounts of these instruments ten years after the start of the financial crisis (Fig. 5).

Figure 5
L2 and L3 assets (as % of total asset)

Source: Prometeia calculations on SNL Financial data



Sample of 75 banking groups of 18 EMU Countries sorted in descending order by [(L2+L3 assets) / total asset]

[4] Committee on Economic and Monetary Affairs, Monetary Dialogue with Mario Draghi, President of the European Central Bank, Brussels, Monday, 26 February 2018, transcript of the hearing; https://www.ecb.europa.eu/pub/pdf/annex/ecb.sp180226_1_transcript.en.pdf?417780fc4802bedec405eb034836a701

[5] Assets for which market prices are available are categorized as Level 1 assets. Level 2 assets include securities whose values are based on their quoted prices in inactive markets, or whose values are based on models - but the inputs to those models are observable either directly or indirectly. Level 3 assets are the most illiquid category of securities and that are valued only based on models.

Conclusions

European leaders have recently reaffirmed their commitment to strengthening the Banking Union which was launched in 2012 to ensure that the banking sector was in a stronger position to face future crises.

As reported in the note prepared on the request by the President of the Eurogroup, Mario Centeno, before the June summit, there has been a sustained trend in risk reduction in the Euro Area banking sector and that progress should now be made on further risk-sharing measures.

We will have to wait and see whether concrete steps towards a Euro Area Deposit Insurance Scheme will be made by the December deadline.

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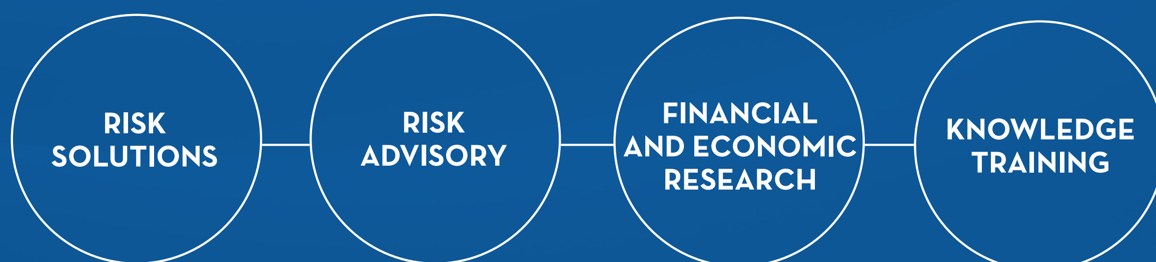

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