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The Outlook for EU Banking Systems

Presented by Michael Foley, Managing Director, Global Financial Institutions, Moody's, at the Peterson Institute for International Economics, Washington, DC
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Do we face upward rating pressure due to fundamental improvements on a system-wide level?

Fundamental improvements

- How has the credit profile of banks improved since the financial crisis?
  - Improvements in financial metrics
  - Improvements in regulation, regulatory oversight & governance frameworks

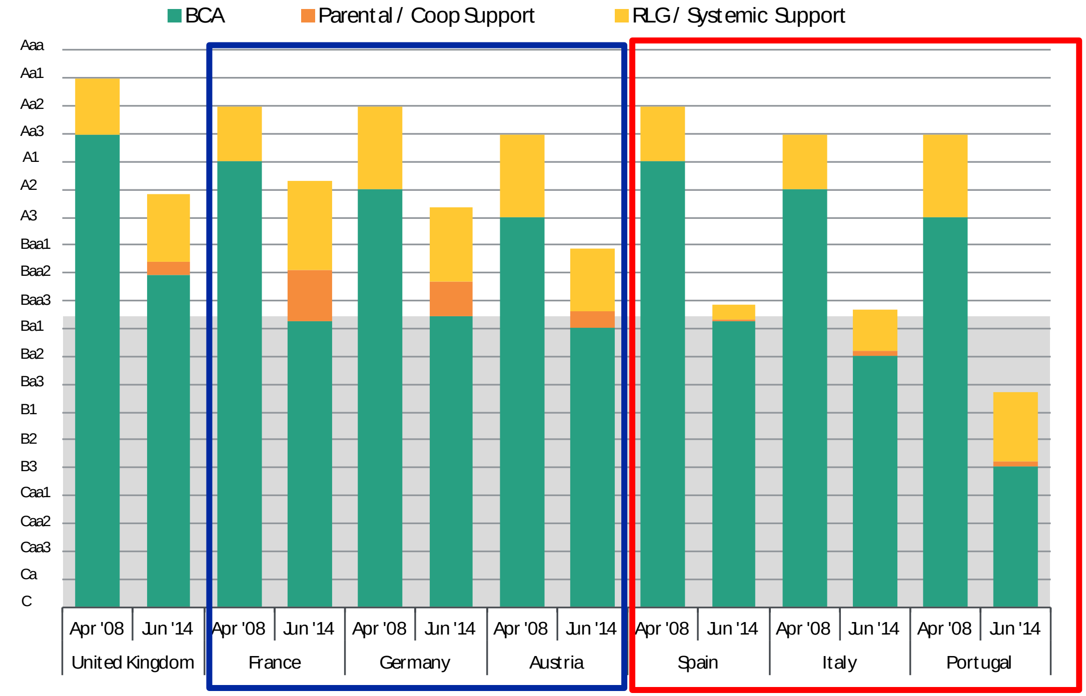
Analytical context and concerns

- Impact of paradigm shift in regulation in EU: Raising the bar
- Reduced systemic support under BRRD
- What are our main concerns?
  - Remaining weaknesses
  - Macroeconomic environment
  - Governance and regulation

Context: EU Bank ratings on negative outlook due to pressure on support

- **Support environment.** Bank ratings currently still benefit from substantial support
  - Euro area core: **2.77 notches**
  - Euro area periphery: **1.18 notches**
- **Fundamental credit assessment.** European banks' average financial strength (BCA) in the Euro area is at **ba1**
  - Euro area core: baa3
  - Euro area periphery: ba2

Average Bank Ratings for selected European countries



Source: Moody's Investors Service

Euro area core

Euro area periphery

Focus of this presentation: Fundamentals of European banks

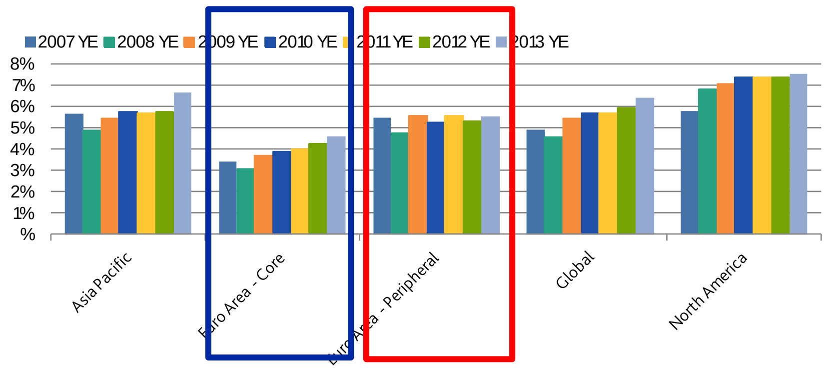
Bank capital has improved and balance sheets continue to be cleaned up

Increased quantity and quality of capitalisation

» Relative to RWA, tangible common equity has increased from 7.4% in 2007 to 12.7% in 2013 in the EU

» Increased focus on leverage as a complement to capital measures

Tier 1 leverage ratio



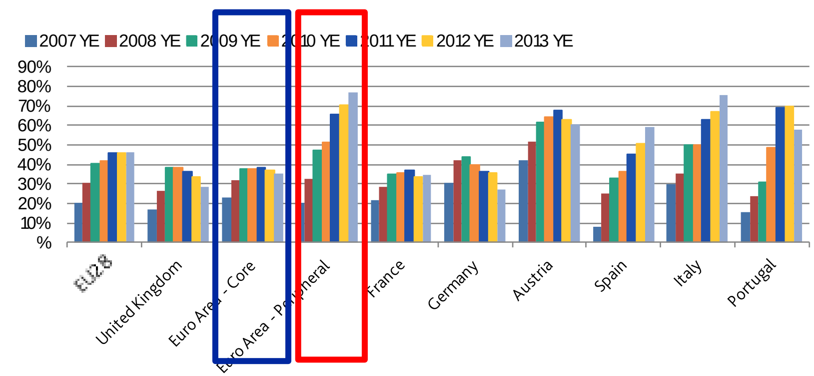
Source: Moody's Rated Banks

Balance sheets have been cleaned up in the UK and core Euro area

» After increase from 20% in 2007 to 46% in 2011, problem loans as percentage of equity and loan loss reserves stabilized on average in the EU

» Further clean up induced by ECB's AQR

Problem Loans / (Shareholders Equity + LLR)



Source: Moody's Rated Banks

Euro area core **Euro area periphery**

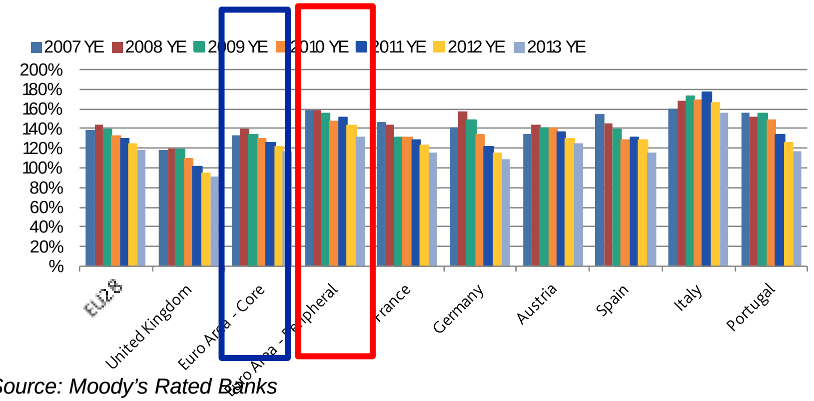
Better liquidity, reduced asset & liability mismatch

European banks' liquidity has improved significantly since the financial crisis

» **Market Funds less Liquid Assets** as % of total assets has decreased to 3.0% from 14.3% for EU banks

» The **loan to deposit ratio** for EU banks decreased from 144% in 2008 to 118% in 2013

Loan to deposit ratio



Source: Moody's Rated Banks

Euro area core **Euro area periphery**

» Greater constraints on asset liability management (ALM), also due to new regulatory ratios (NSFR and LCR)

- force banks to reduce maturity transformation risks, and
- force banks to increase funding maturity;

» but also negative impact on profitability

Weak profitability the "Achilles-Heel" of European banks, also as a result of low efficiency

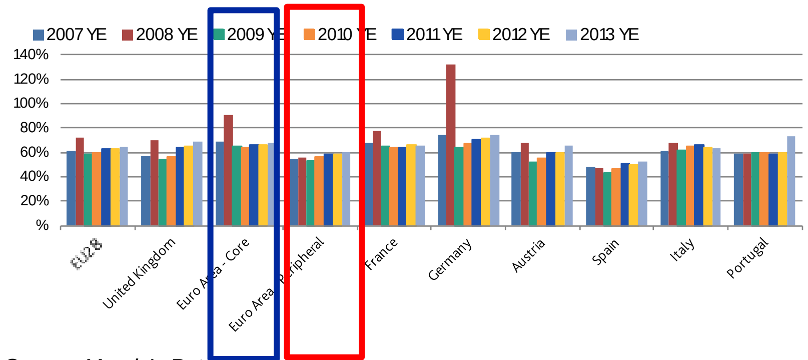
Profitability of banks remains under pressure

- Reduced earnings from ALM/ exposure to yield curve, also as a result of stricter regulation
- Greater focus on conduct risk raises barriers to leveraging customer relationship
- Excess capacity among European banks further depresses pricing power
- Pressure to generate higher returns may lead to:
  - Higher risk activities
  - Increased regulatory arbitrage (risks will be hidden)
  - Political pressure to loosen capital/liquidity requirements (to facilitate lending, avoid price hikes for consumers, SMEs, etc.)

Costs in the banking system remain a concern

- Cost Income Ratio in Core Euro Area only marginally reduced (67.9% in 2013 from 69.4% in 2007)

Cost Income Ratio



Source: Moody's Rated Banks

Euro area core

Euro area periphery

Ongoing headwind from economic environment in Europe and impact from low interest rates

Fragility of the macro-economic outlook

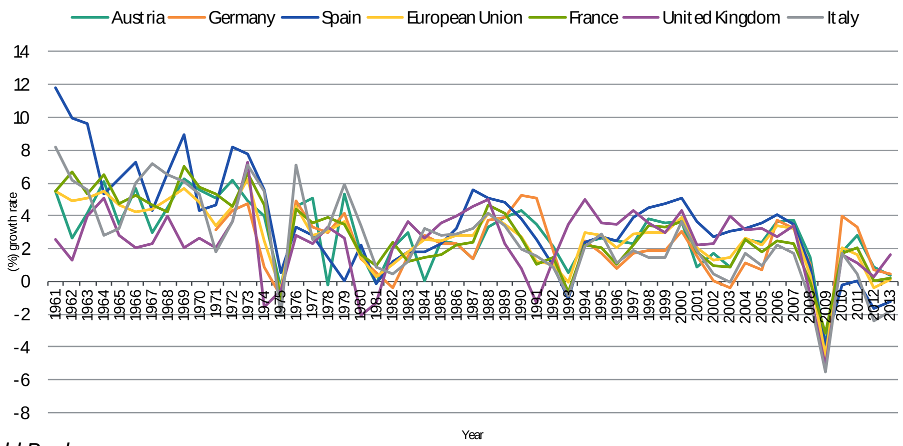
» Reduced sovereign risk within EU

» …however, higher geopolitical risks in Russia / Ukraine and Middle East

» Ongoing pressure on asset quality

» …suppresses business volumes

GDP growth rates since 1960



Source: World Bank

Unknown impact of low inflation / low interest rate environment

» Pressure on net interest income (NII)

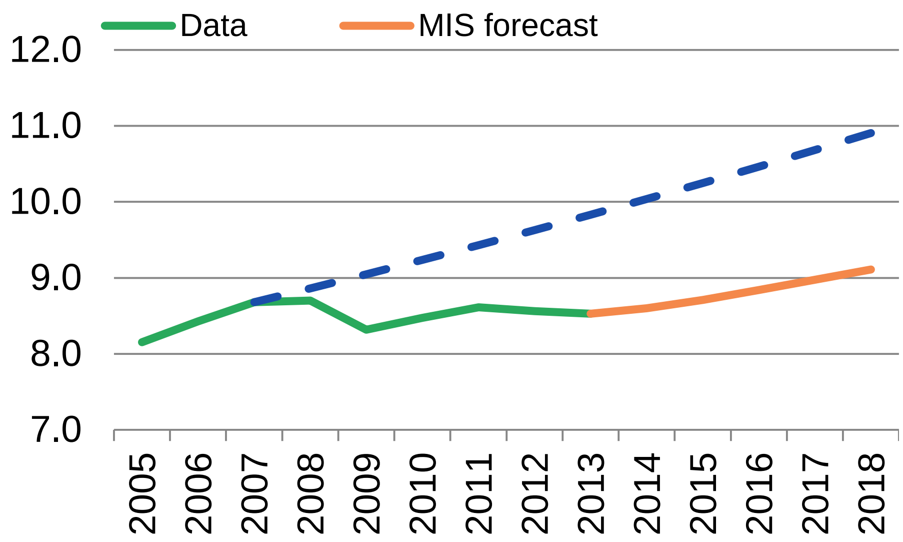
» Pushes banks to seek higher risk to compensate for lower yield

» Little experience of what sustained low growth/ deflation may mean for European banks

Euro area GDP 15% smaller than pre-crisis trend by 2018

- Outlook for growth suggests “Lost Decade”
  - Low inflation fuelled by and fuelling low growth
  - Low demand puts pressure on prices
  - High unemployment a multiyear drag on growth
- Credit conditions to remain tight for some time
  - Banks’ restructuring process underway
  - Alternative sources of finance growing but as yet too small
- TLTROs and ABS/covered bond purchases will provide cheap funding
  - But funding was (one of) 2011-12’s issue(s), not 2014’s
  - Unlikely to lead to significant increases in bank lending

Euro area GDP



Source: Eurostat, MIS

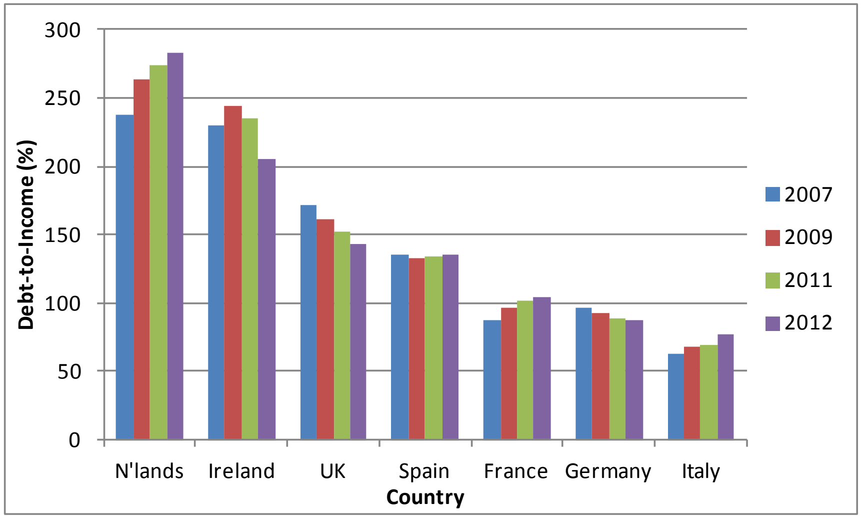
And not all financial indicators point towards stronger bank fundamentals

Household leverage and asset encumbrance have increased:

» **Higher customer leverage:**

– Increase of private debt-to-income in many European countries since the financial crisis, in particular in the European periphery

Debt-to-Income (%) for selected countries



Source: Haver Analytics

» **Asset encumbrance** of banks balance sheets has increased

– Collateral increasingly transferred from banks to funding providers (e.g. covered bond investors)

Raising the bar: SSM & SRM have changed the paradigm for European banks

Shift in Regulatory Paradigm…

- ***From "gone concern"…:*** Creditor risk driven by unlikely event of liquidation/ "gone concern"
- ***To "going concern" loss absorption:*** Now, creditors at risk in "going concern", as they are source of "going-concern support" for all other stakeholders including taxpayers

Progress towards banking union increases the likelihood of intervention/failure of banking institutions

- ***Reduced forbearance***: Protection of banks by national authorities ("banking nationalism"), e.g. via forbearance, likely to significantly decrease in SSM with ECB as supervisor
- ***Greater choice of resolution tools***: Progress towards resolvability of banks (structural, legal, operational changes) lowers hurdle for going-concern bail-in

… Has to be Reflected in BCAs

- **Baseline Credit Assessment (BCA)** measures probability of a bank defaulting on any of its rated instruments (excluding high-trigger Coco's and preference shares), in the absence of external support

- The risk of a BCA event has significantly increased recently

- **BCAs** need to reflect dual risk for creditors, of a **more likely intervention/failure** and **increased exposure of creditors in that event**

Resolution/Bail-in regimes (e.g., under BRRD) would also impact supported debt and deposit ratings

In Moody's proposed bank rating methodology, banks in countries with operational resolution regimes would be rated using Loss Given Failure (LGF) liability analysis.

- Specific legislation enabling orderly resolution of failed bank
- Clear understanding of impact on depositors and other creditors
- Reduced likelihood of support for senior creditors

WHERE:

European Union, Norway, Liechtenstein, Switzerland, United States (Title I and Title II), Others (esp. G-20) likely to follow

1 – Determination of Loss Rate →

Loss rate is determined by a combination of **asset** volatility and **resolution approach.** Loss rate (e.g. 5% or 10% of liabilities) determines notching threshold.

2 – Determination of Liability Structure →

Construction of expected liability and capital structure at the time of failure.

3 – Loss Given Failure (LGF) Waterfall →

Allocation of expected firm-level losses to each creditor class. Uses probabilistic weighting of "de jure" and "de facto" waterfalls if creditor treatment is uncertain.

4 – Loss Given Failure (LGF) Liability Analysis

Expected loss for each debt or deposit class based on probabilistic weighting of the two scenarios. Notches up or down from adjusted BCA (-1 to +3).

Finally, a word on risk governance and regulation

Yes, regulatory oversight and risk governance have improved

Improved regulatory oversight

- Improved definitions and measures of funding and liquidity risk
- Better supervision: ESM to reduce potential for regulatory arbitrage
- Enhanced regulatory focus on recovery and resolution plans

Better governance

- Greater focus by banks on core activities
- Improved risk function
- Increased disclosure

However, regulation is not a panacea

Limits to regulatory oversight

- Regulatory measures of risk are by nature incomplete / unstable and can be arbitraged
- Deleveraging may cause secular lower growth and political sympathy may shift from regulatory vigilance to fostering growth
- Weakness of European banks in their core activities and profitability pressures are a key concern…
- …as they are likely to incur other risks which may be less visible