

European Banking Union / Asset Quality Review: Not Yet Out Of The Woods

Global Economic Prospects

Washington D.C.

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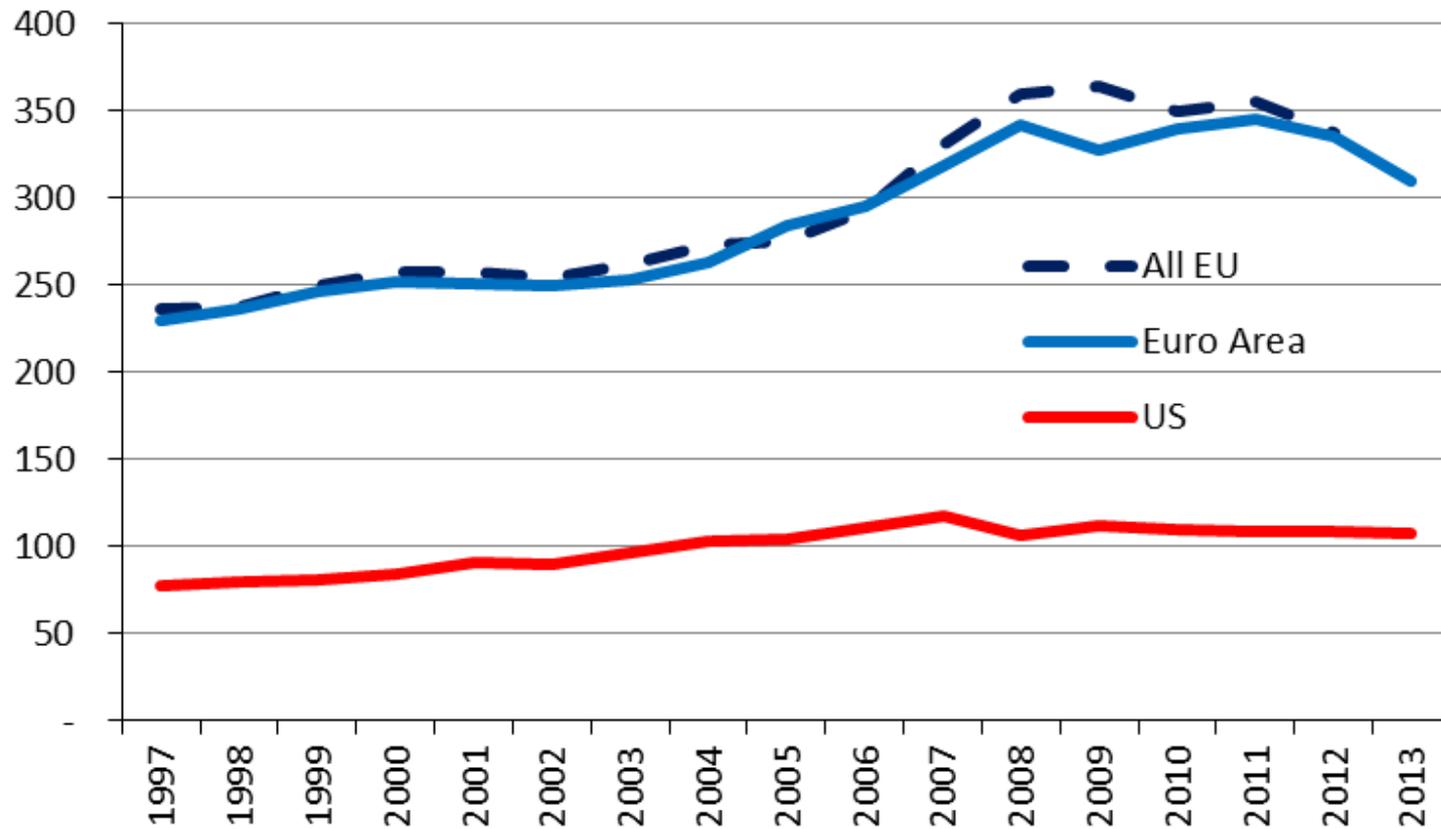
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Europe's Banking Problem

Total Banking Assets (% of GDP)



US figures include broker-dealers. Sources: European Central Bank, Eurostat, Federal Reserve Board, US Bureau of Economic Analysis; author's calculations with help from Anish Tailor

EU Legislation Is In Place

“We affirm that it is imperative to break the vicious circle between banks and sovereigns”

Euro Area Summit Statement, June 29, 2012

- “Half Banking Union”
 - 1 Supervision: SSM (created within ECB, late 2014)
 - ½ Resolution: SRM (hybrid with new agency, 2015-16)
 - 0 Deposit Insurance: off limits for now (fiscal link)
- Mix Euro (SSM) / EU Single Market (SRM)
 - “Banking Union Area” (e.g. Denmark, Romania to join)
- Vicious circle not entirely broken
- Still, promises more resilient monetary union

2014 Transition Is Crucial

- ECB Licensing Authority from Nov 4, 2014
 - Need to check all banks are sound
- Comprehensive Assessment
 - (1) Supervisory Risk Assessment + (2) Asset Quality Review + (3) Stress Test (EU-wide, EBA-led)
 - “Distilled” Capital Gap number at end (October)
 - AQR is key difference with earlier stress tests
- Bank repair is integral part of “AQR”
 - Key role for DG COMP: new state aid rules Aug 2013
 - No disbursement before DG COMP approval
 - Junior debt bail-in before any state aid (≠ senior debt)
 - Less flexibility from January 2015 (new BRRD directive)

AQR Has Begun

- Encouraging start
 - Strong legal basis (e.g. ECB access to information)
 - Senior recruitments
 - Effective communication
 - Consultants: Oliver Wyman + Big 4 in member states
 - At least 1,000 auditors currently reviewing banks (Bloomberg)
- ECB encourages proactive recapitalization
 - Initial market impact e.g. UniCredit, Intesa SP, Dexia
- Hardest part still ahead
 - “Problem banks”: weakest, possibly insolvent
 - May be unable to recapitalize proactively

Dilemma: AQR v Stress Test

- Debated but unresolved since \approx mid-2013
- Assuming weaknesses are uncovered
- AQR (narrow sense): balance sheet impact
 - Loss of face: national supervisor, auditor, management
 - Restatement obligations on public issuers
- Stress Test: supervisory judgment
 - Procyclicality
 - Bail-in problematic, and thus state aid
- Differentiated geographical impact
 - Stress test harsher on periphery, AQR neutral

Other Challenges

- ECB skills, experience, logistics
- Interim disclosures by (listed) banks
 - *“We still have to discuss internally how we deal with that”*
(Jens Weidmann on April 2)
- Restructuring challenges
 - Some member states (FR, IT) not ready for bail-in
 - Tensions between ECB and DG COMP
 - Inadequate structures to manage failed banks / assets
- Reputational challenges of SSM principals?
- Proactive recap hinges on credibility

Where Are The Gaps?

- Difficult to tell
 - Limited transparency/consistency: thus AQR so crucial!
 - Also dependent on ECB methodological choices
- Moving Target
 - Stealthy bail-outs: Deferred Tax Assets, Banca d'Italia
 - External / macro environment: Ukraine, Fed tapering...
- Surprises outside of program countries?
 - $CY+ES+IE+GR+PT = 1/5$ of total assets under review
 - Of the rest, $2/5$ (or $1/3$ of total) are unlisted (e.g. DE, FR)

Prospects for AQR Success

- What is success?
 - Not “big number” aggregate capital gap
 - Heal the wounded, kill the zombies: not Dexia 2011
 - Assessment likely to remain ambiguous for some time
- Market “consensus”: smooth path
 - ECB forbearance + some restructuring of problem banks
 - But can this be enough to bridge the gap?
- If not = escalation, political stress
 - Serious bank restructuring is painful
 - Good news: sovereign debt market impact unlikely
 - Unless major institutional deadlock

Macro Implications

- AQR Success
 - Gradual healing of credit conditions
 - Removes current drag on periphery
 - ECB fixed-rate full allotment withdrawn ca. mid-2015
 - Banking sector consolidation, much of it cross-border
- AQR Failure
 - Banking system remains dysfunctional, drag on growth
 - ECB reputation impaired: consequences beyond banking
 - Not an option? Or delay?
- Next few weeks are important