

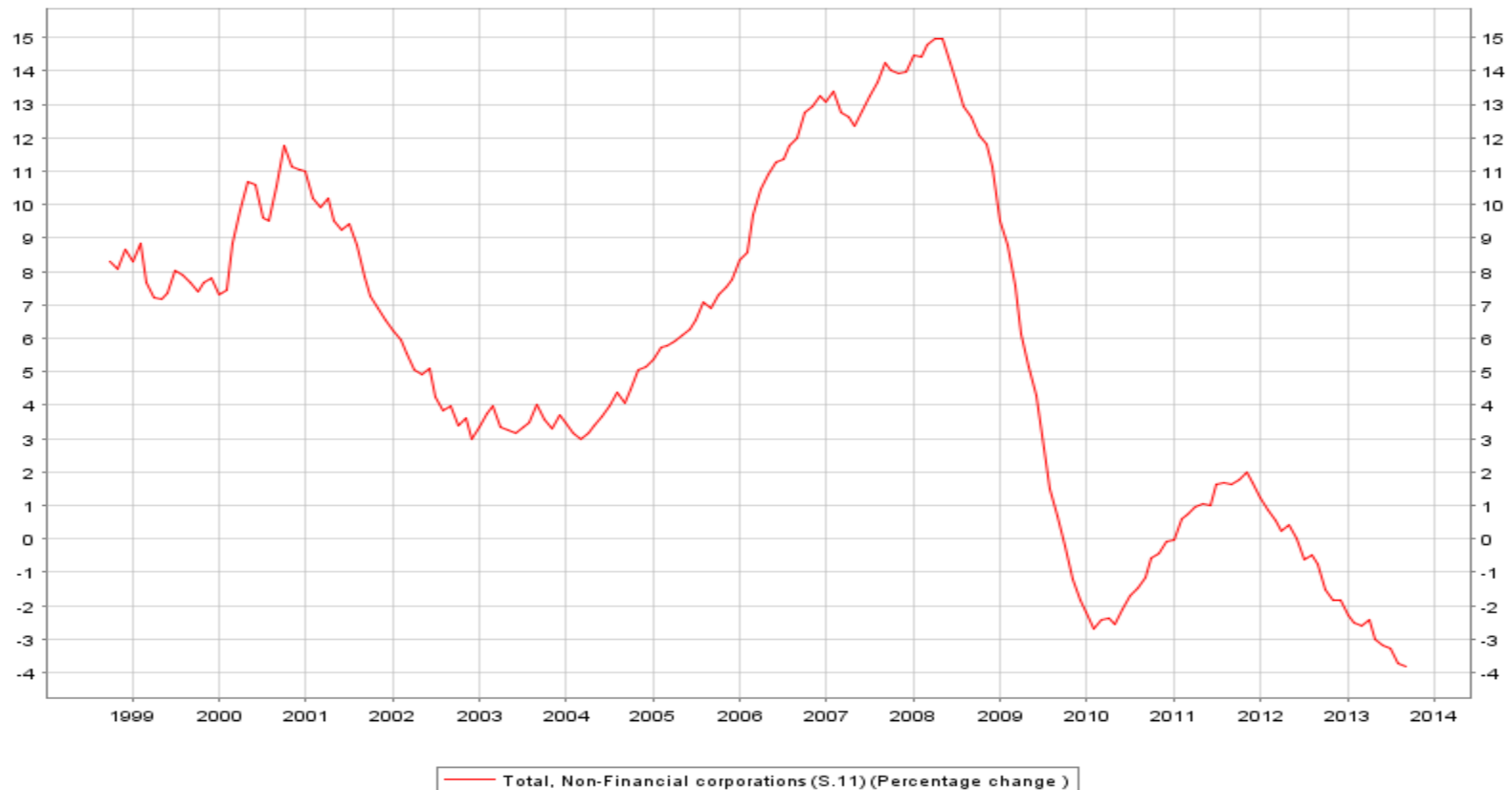
Resolving Europe's Banking Crisis

Karl Whelan
University College Dublin
Dublin Economics Workshop
Limerick, October 19, 2013

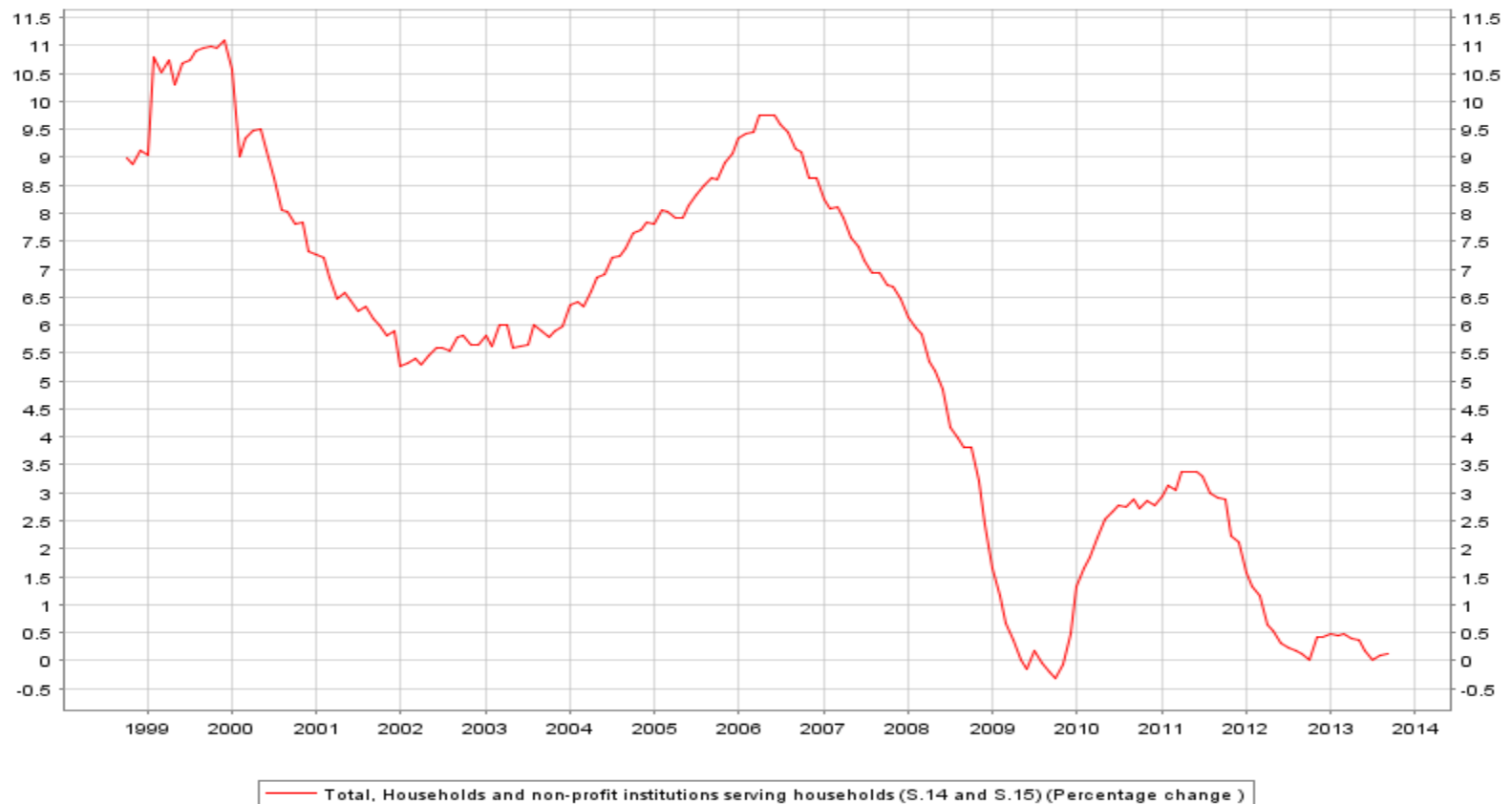
Plan For This Talk

- Weak credit in the euro area.
- Reasons for the credit crunch
 - Regime change in banking
 - Funding problems
 - Capital problems
- Stress tests as resolution of banking problems?
 - Many complex issues to be resolved
 - Three scenarios

Annual Growth in Euro Area Loans to Nonfinancial Corporations



Annual Growth in Euro Area Loans to Households



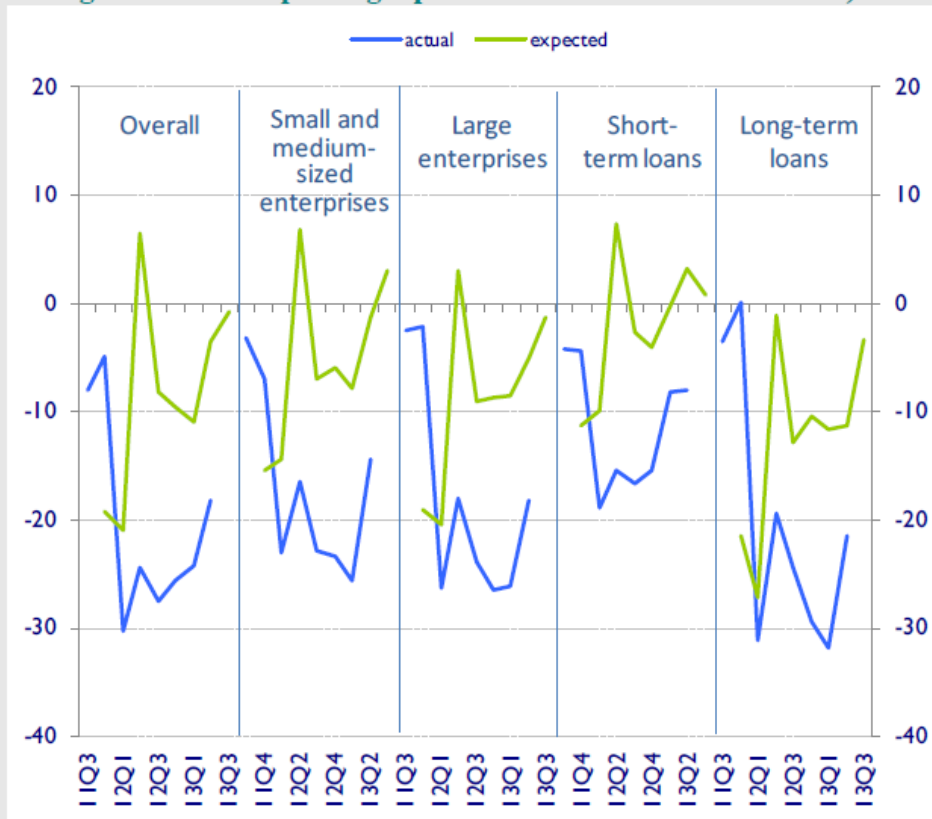
Is It Simply Weak Demand?

- No.
- Weak demand is definitely part of the reason.
- But there is plenty of evidence of active restriction of supply by banks.
 - SAFE survey of small businesses reports access to bank loans getting tougher (though some signs the tightening is easing).
 - ECB Bank Lending Survey report banks admitting tightening credit conditions and raising margins on loans.

Weak Demand for Credit

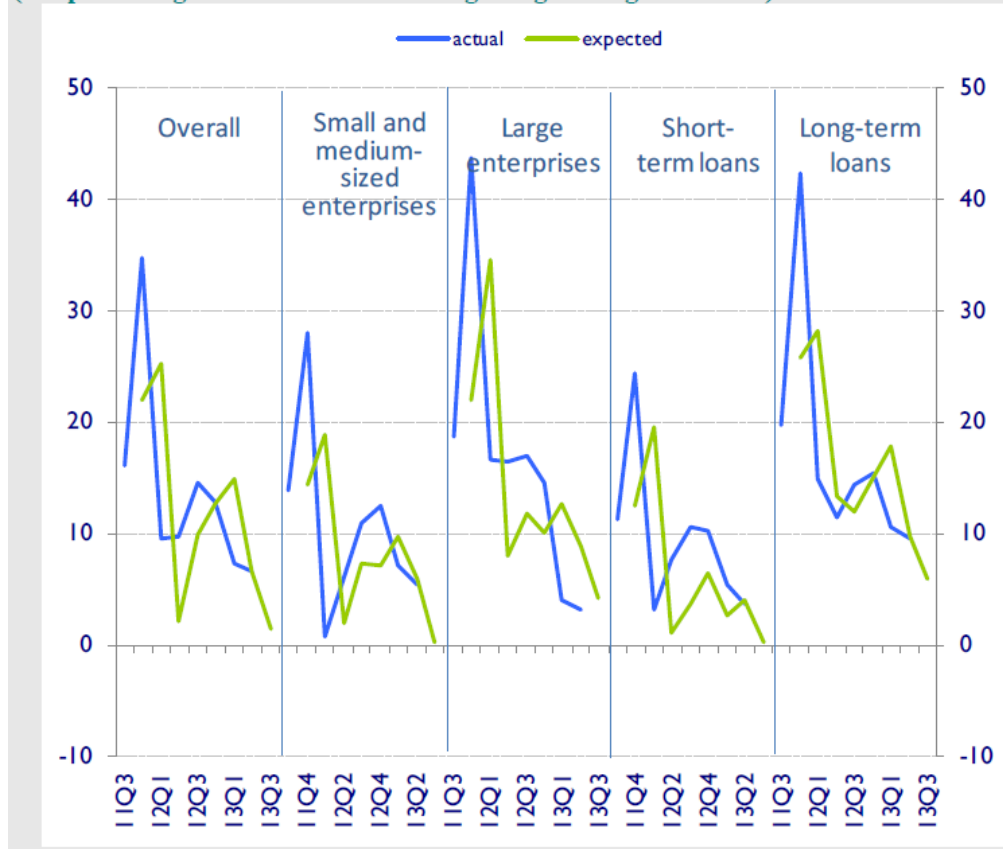
CHANGES IN DEMAND FOR LOANS OR CREDIT LINES TO ENTERPRISES

(net percentages of banks reporting a positive contribution to demand)



But Banks Admit They Have Tightened Credit Standards

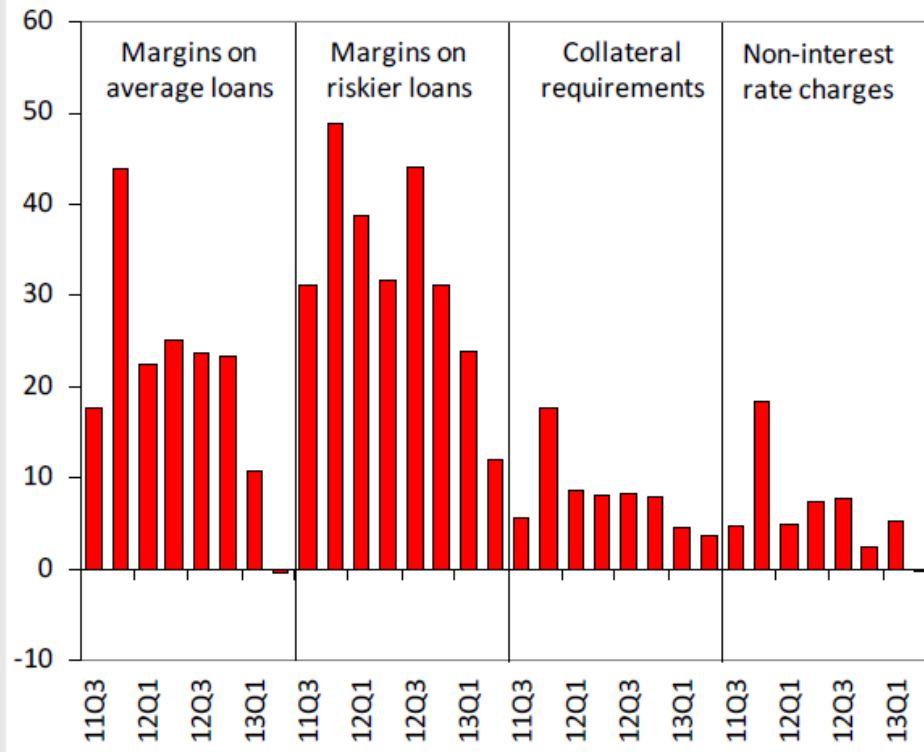
CHANGES IN CREDIT STANDARDS APPLIED TO THE APPROVAL OF LOANS OR CREDIT LINES TO ENTERPRISES
(net percentages of banks contributing to tightening standards)



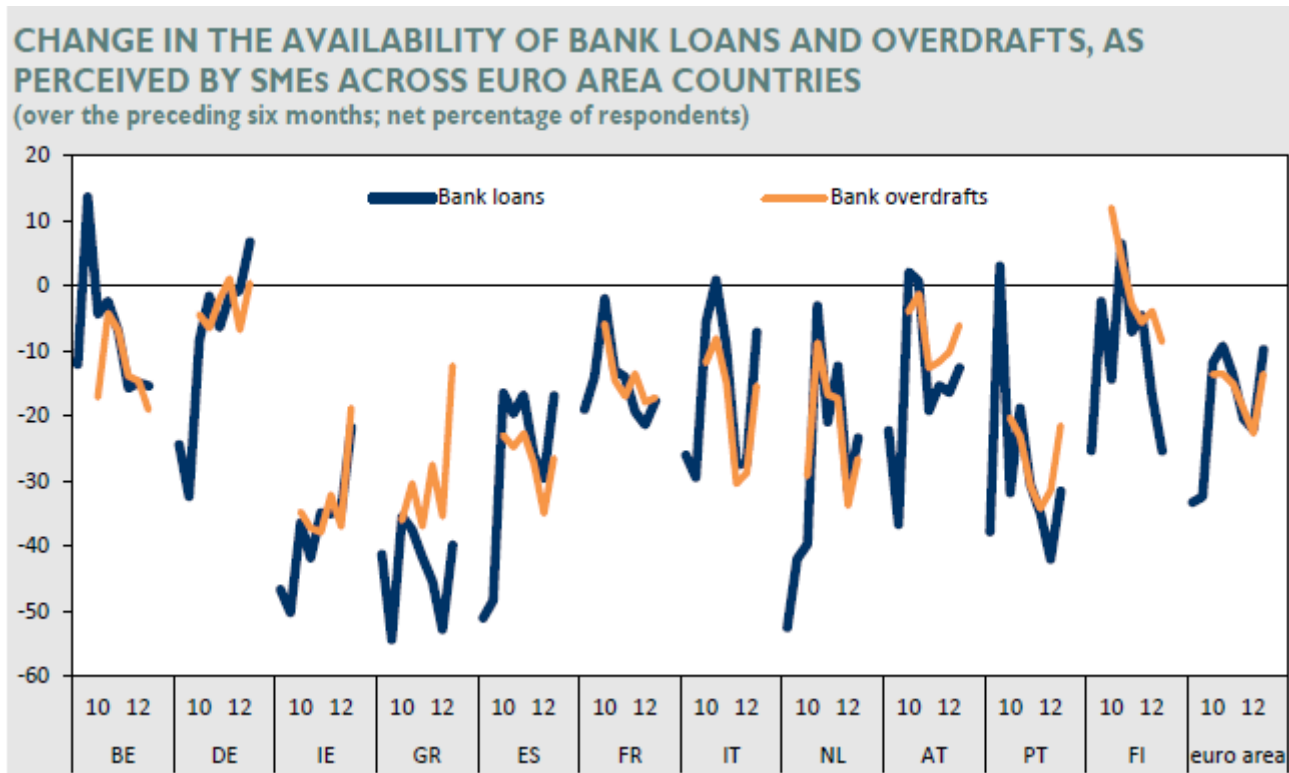
And Raised Margins on Loans

CHANGES IN TERMS AND CONDITIONS FOR APPROVING LOANS OR CREDIT LINES TO ENTERPRISES

(net percentages of banks reporting a contribution to tightening terms and conditions)



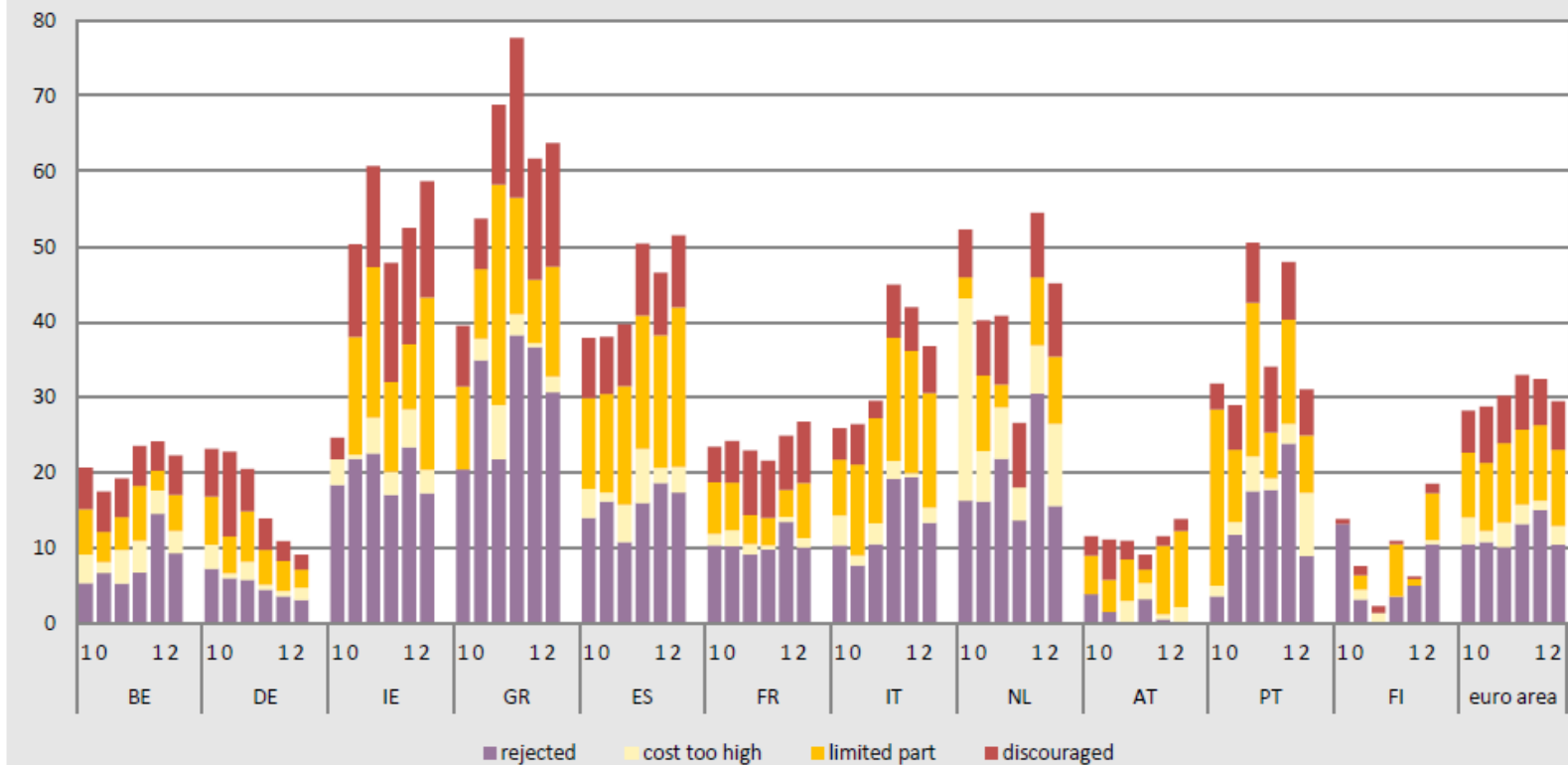
Small Businesses Also Reporting Problems With Credit Availability



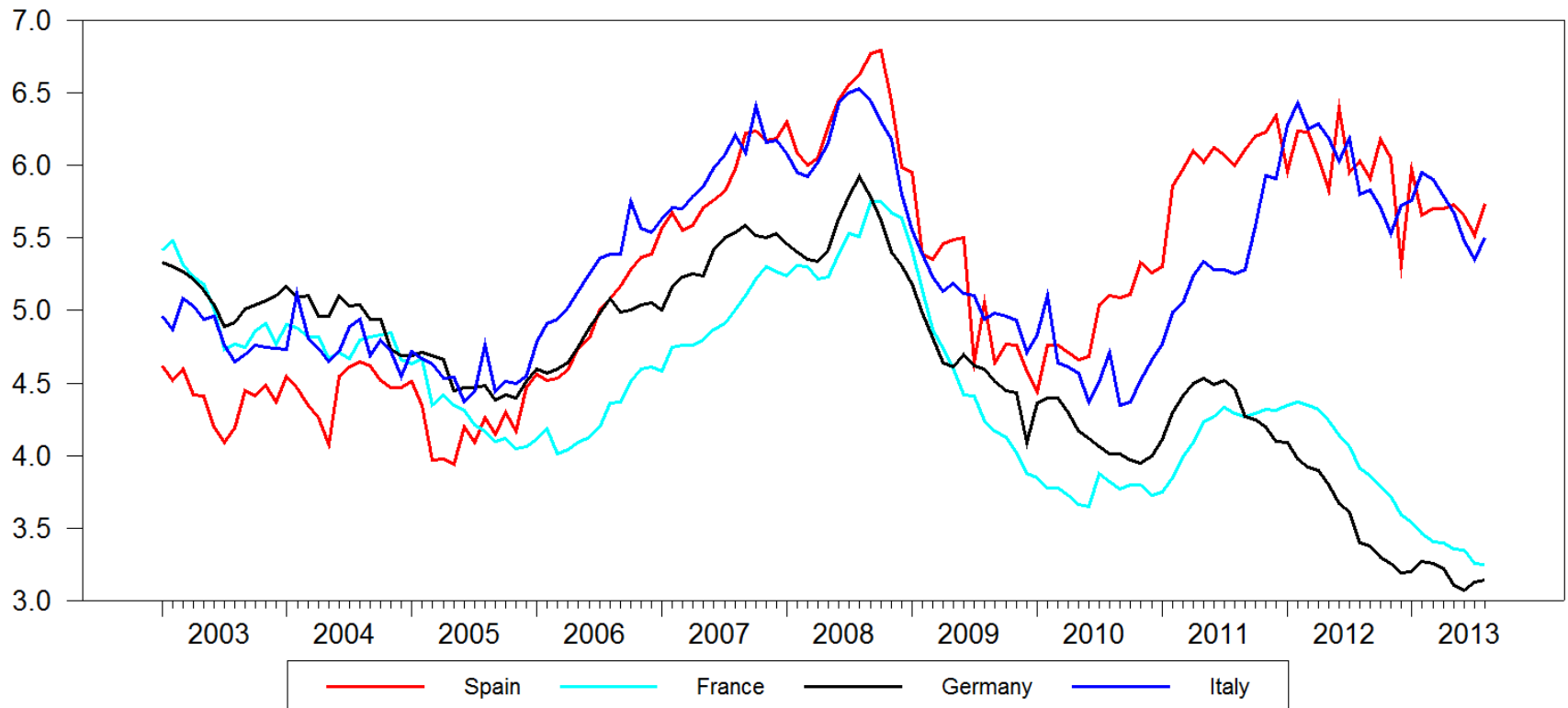
Lots of Ways to Discourage Credit

FINANCING OBSTACLES OF SMES FOR RECEIVING A BANK LOAN ACROSS EURO AREA COUNTRIES

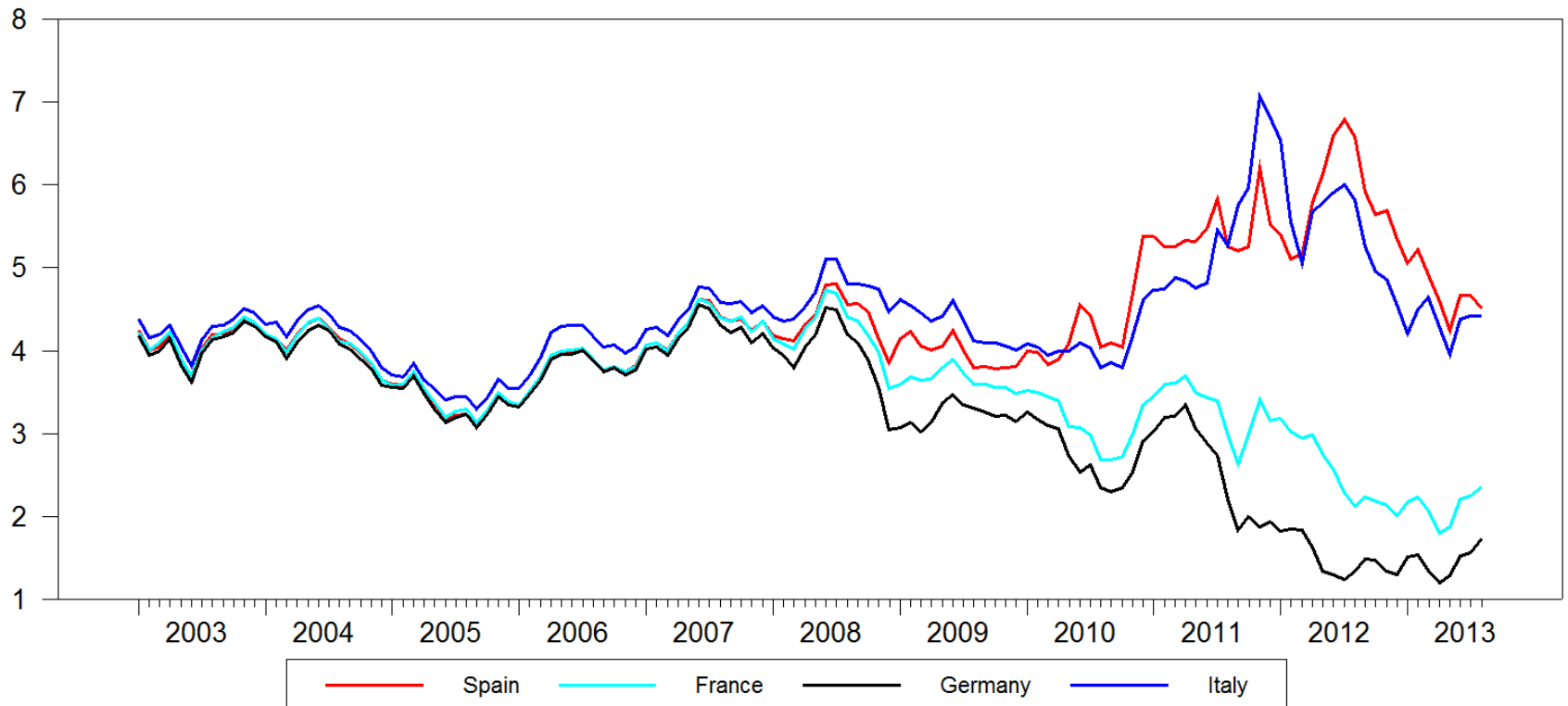
(over the preceding six months; percentage of respondents)



Interest Rates on Small Business Loans



Interest Rates on Ten-year Sovereign Bonds



Three Reasons for the Credit Crunch

1. Regime shift in banking
2. Funding problems
3. Capital adequacy problems

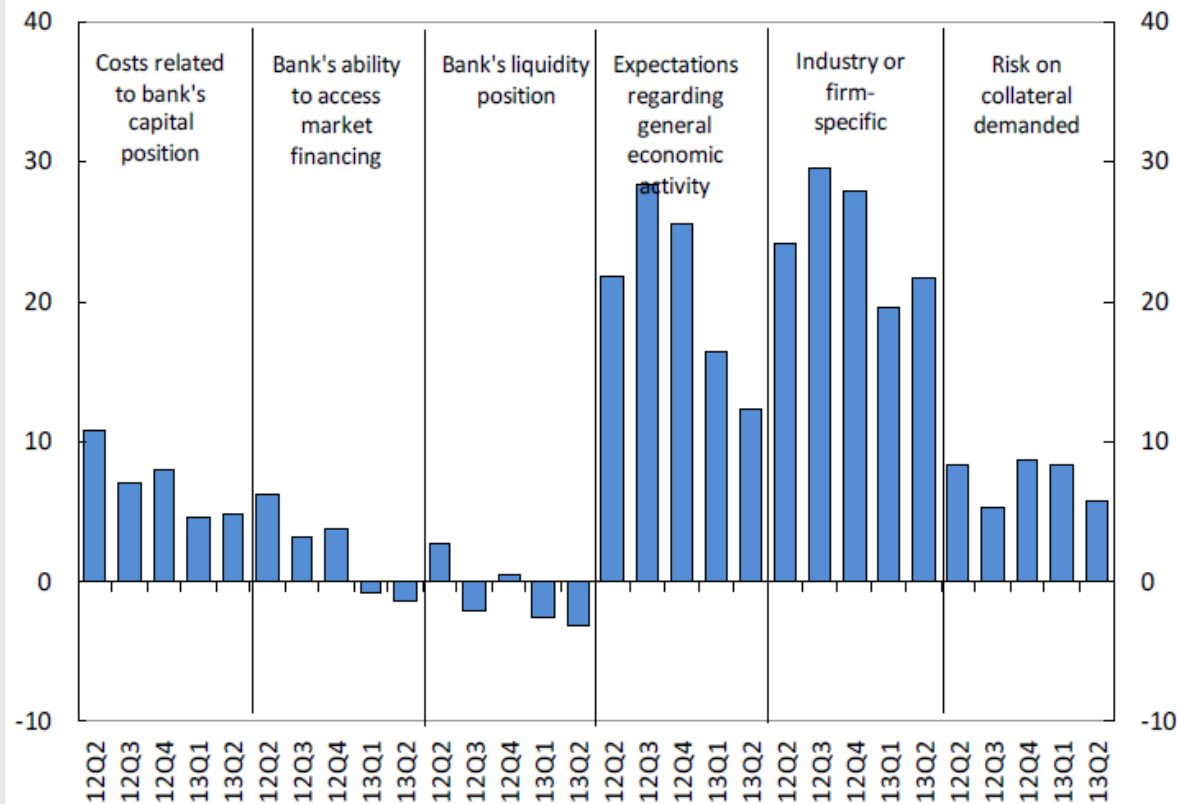
A Regime Shift

- The banking environment has fundamentally changed in recent year.
 - Heightened (more realistic?) risk aversion given recent previously unthinkable events (Lehmans, Greece, Cyprus).
 - Greater (but perhaps justified) pessimism about economic outlook when assessing credit risk.
 - Loan officers reluctant to be responsible for problem loans.
- Consistent with a slower pace of credit growth.

Reasons Banks Give for Tightening Credit

FACTORS AFFECTING CREDIT STANDARDS APPLIED TO THE APPROVAL OF LOANS OR CREDIT LINES TO ENTERPRISES

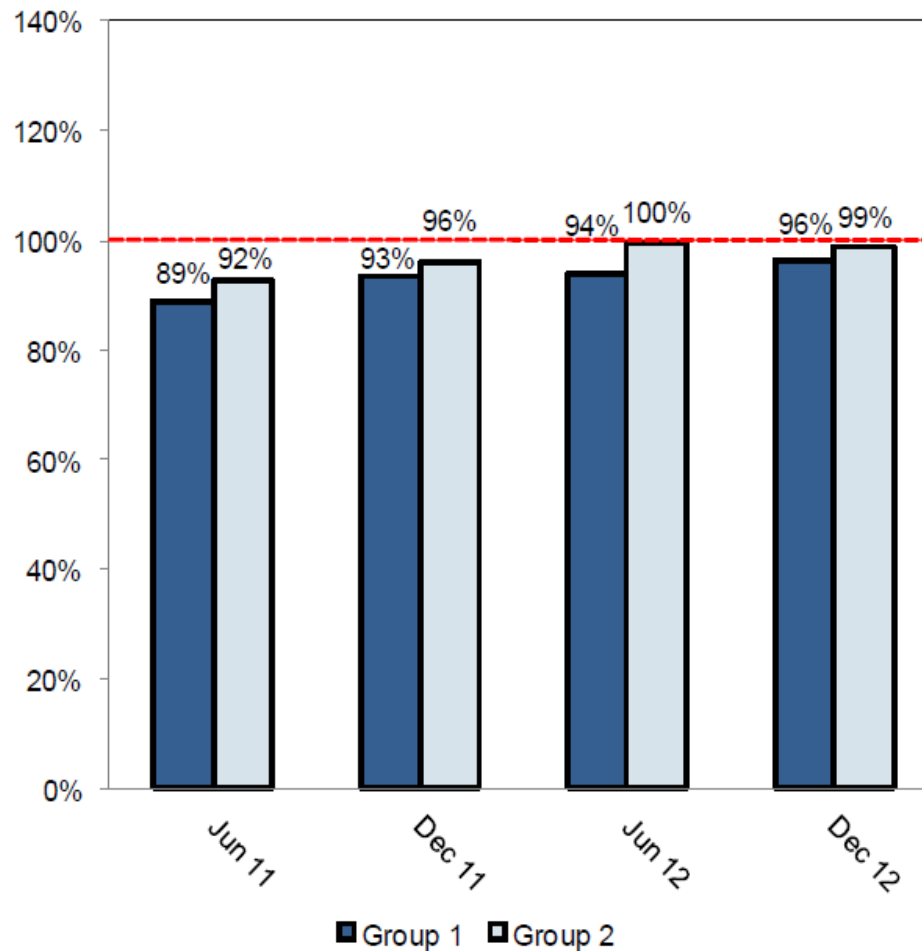
(net percentages of banks contributing to tightening standards)



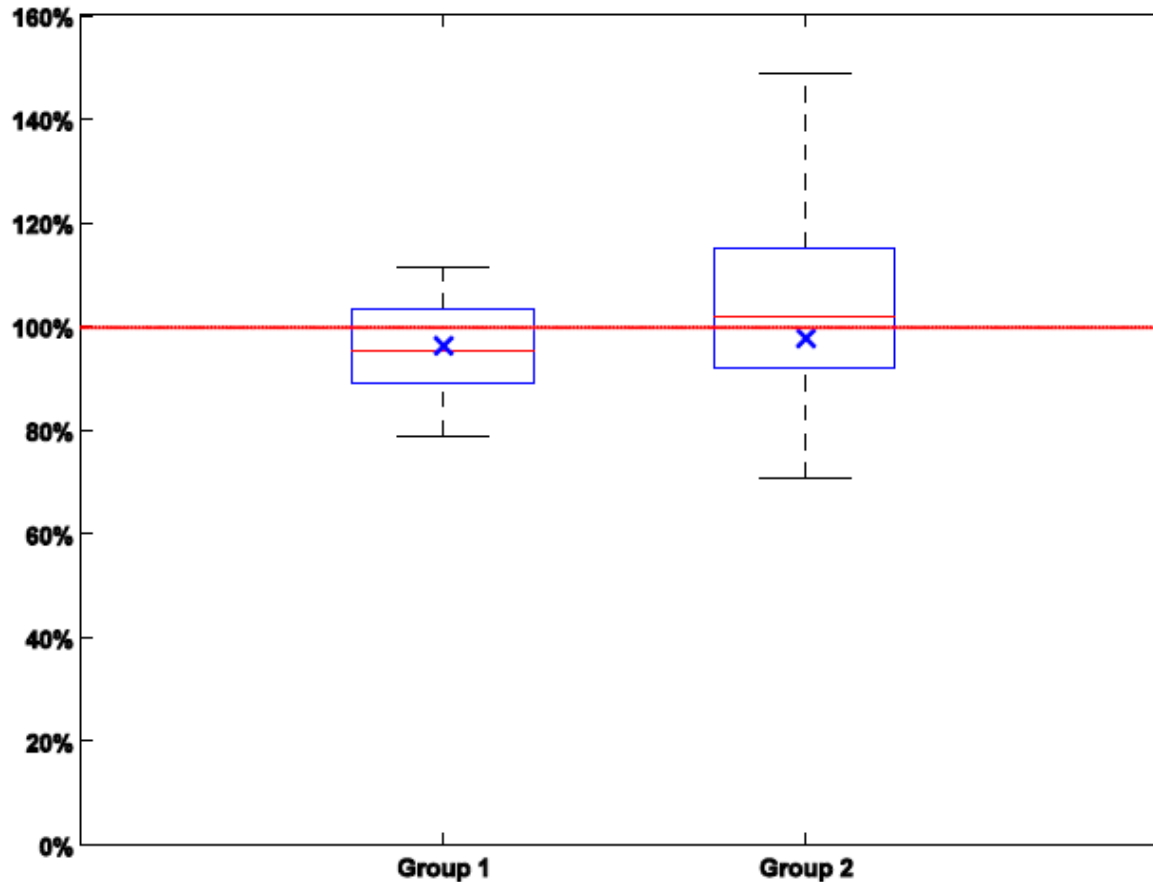
Broken Funding Models

- Many banks (particularly in the periphery) had relied on large amounts of non-deposit funding.
- Basle 3 rules on Net Stable Funding Ratio discourage over-reliance on “hot money” non-deposit funding.
- With concerns about bail-in increasing over time, the cost of this funding has increased reducing attractiveness of high leverage.
- For many peripheral banks, non-deposit funding is way down and reliance on ECB is still high (but strong pressure to pay back).
- These factors discourage balance sheet expansion.

EBA Basle 3 Review: Progress Towards Net Stable Funding Goal

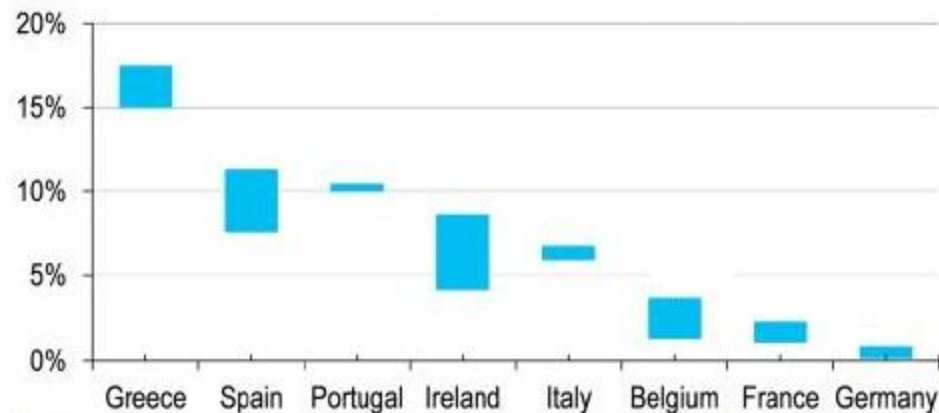


But Many Banks Still A Long Way From Target



Heavy Periphery on ECB Funding But Improvements Happening

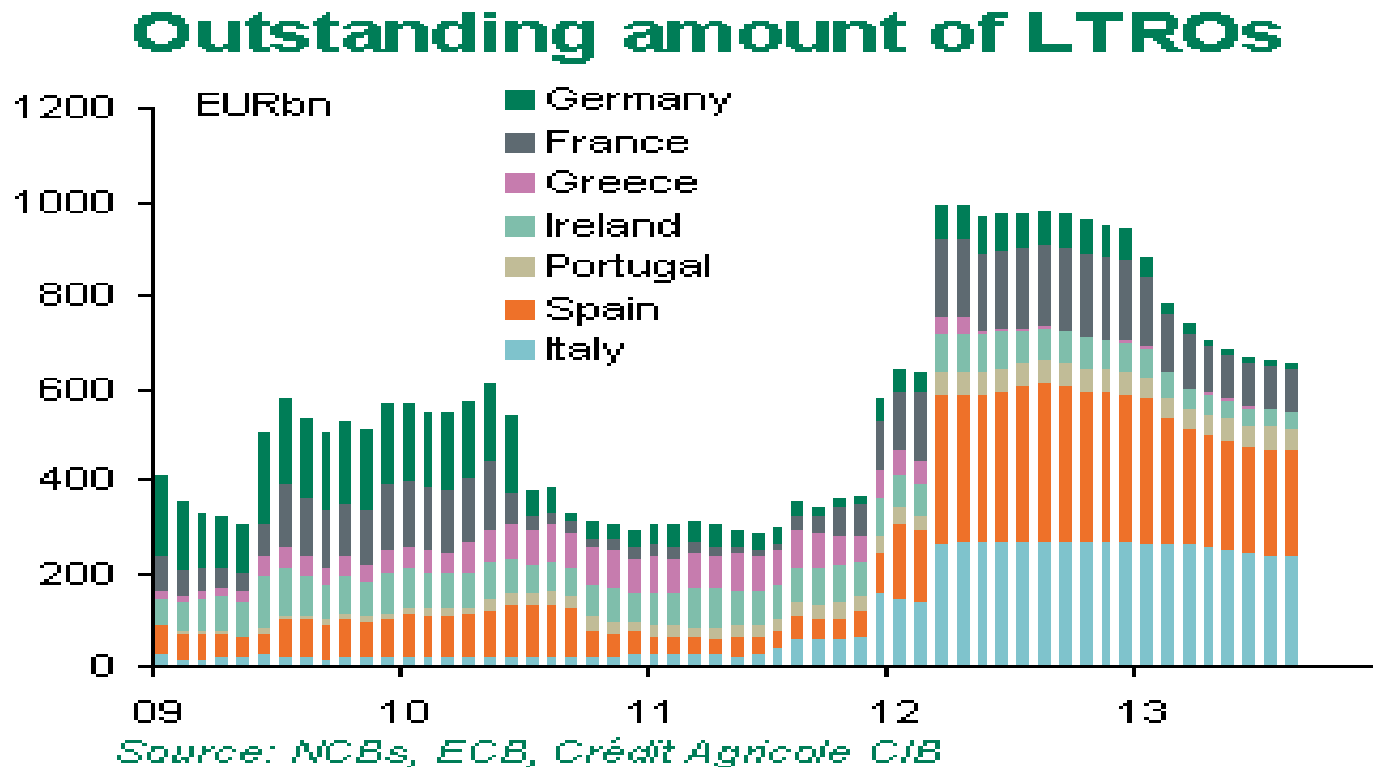
Figure 1. *Chart of the Week*: Total ECB Funding as a % of System Banking Assets



Source: Haver's; Note: Top of each bar gives the peak value while bottom point gives Aug 2013 value

- *Chart from Citibank.*

Spanish and Italian Banks Still Owe Lots of LTRO Funds to ECB

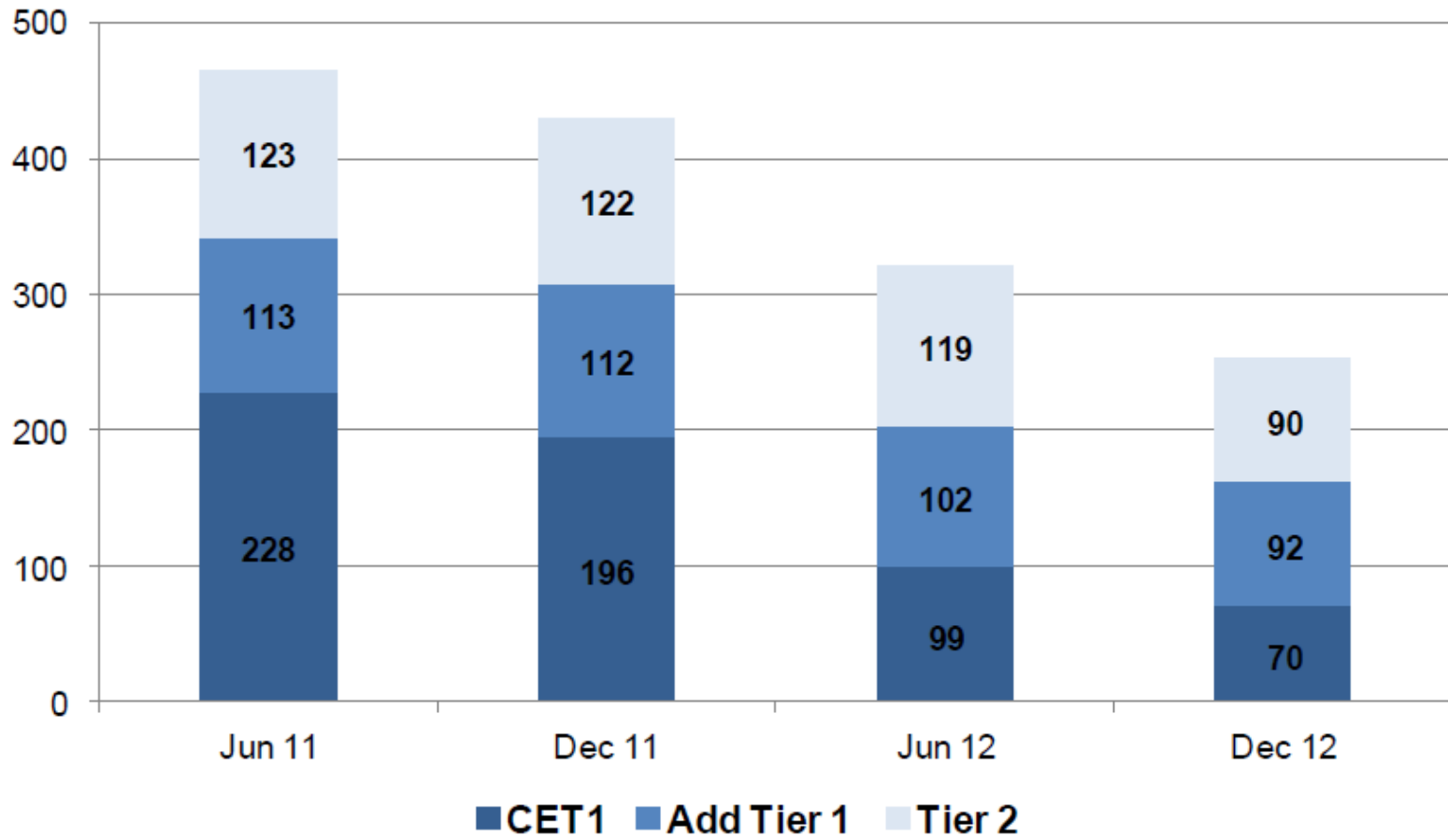


- *Chart from Frederik Ducrozet (Crédit Agricole)*

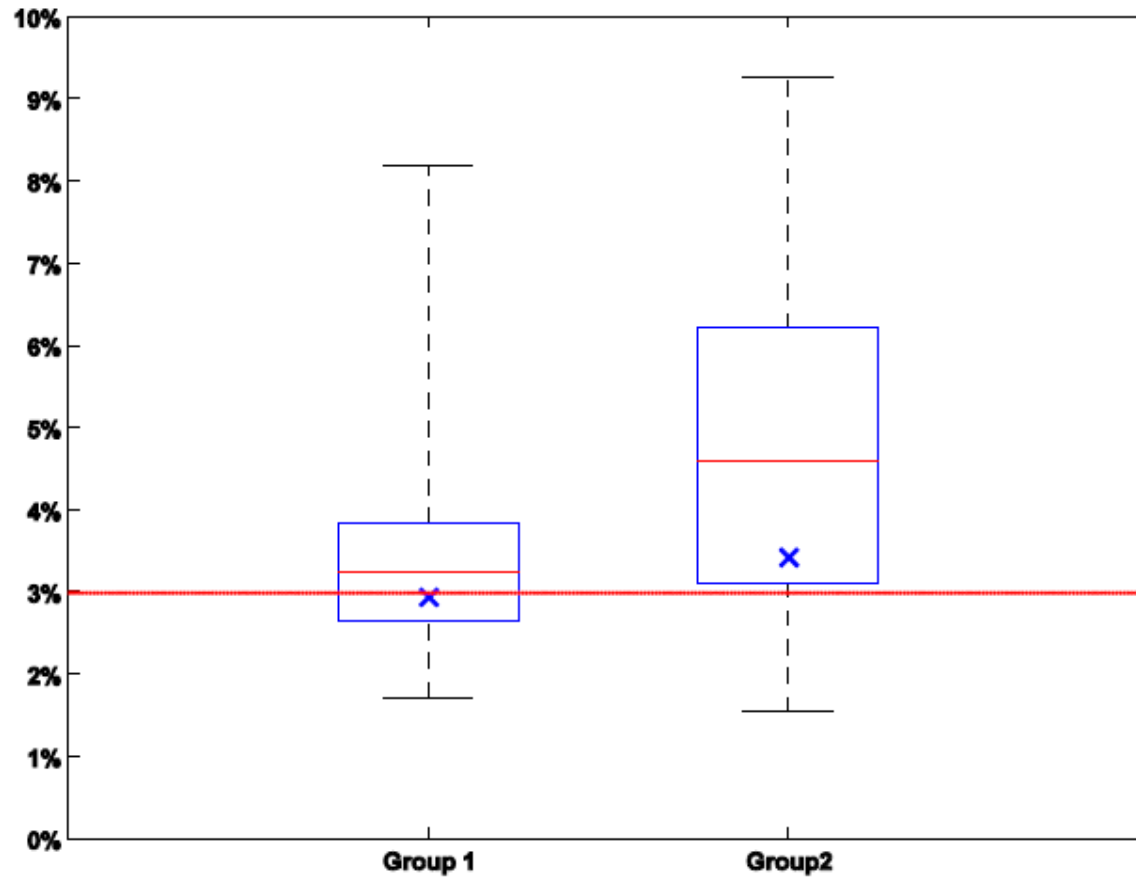
Capital Problems: Basle 3

- Even without questions about problem assets, European banks have a capital problem.
- In June 2011, they were €544 billion short of the capital required to meet the “normal times” requirement of Basle 3.
- In December 2012, this was down to €303 billion so progress is being made.
- Goals being met by capital raising and retained earnings but restraining balance sheet size and taking less risk helps with RWA numerator.

Estimated Capital Shortfalls Relative to Basle 3 Requirements



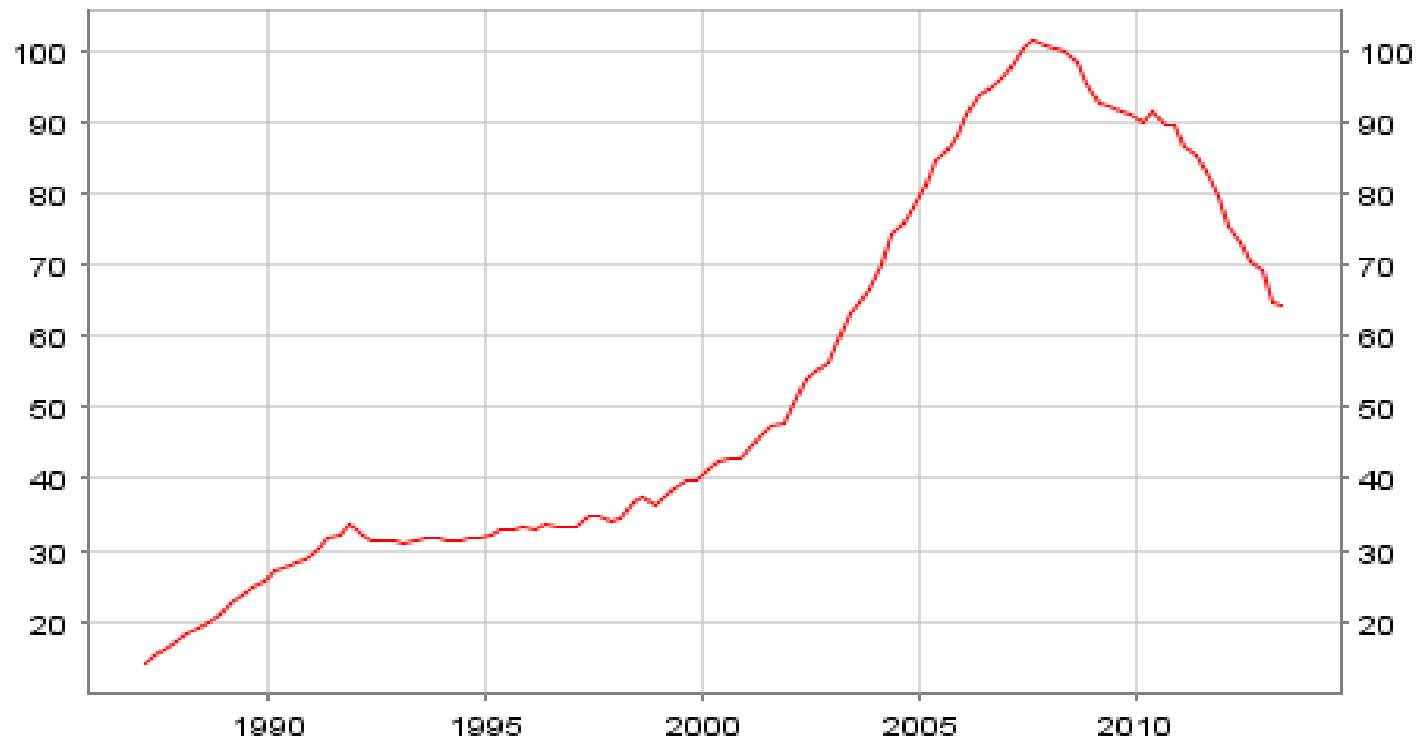
Unweighted Leverage Ratio Also A Problem for Some Banks



Lots of Uncertainty About Asset Quality

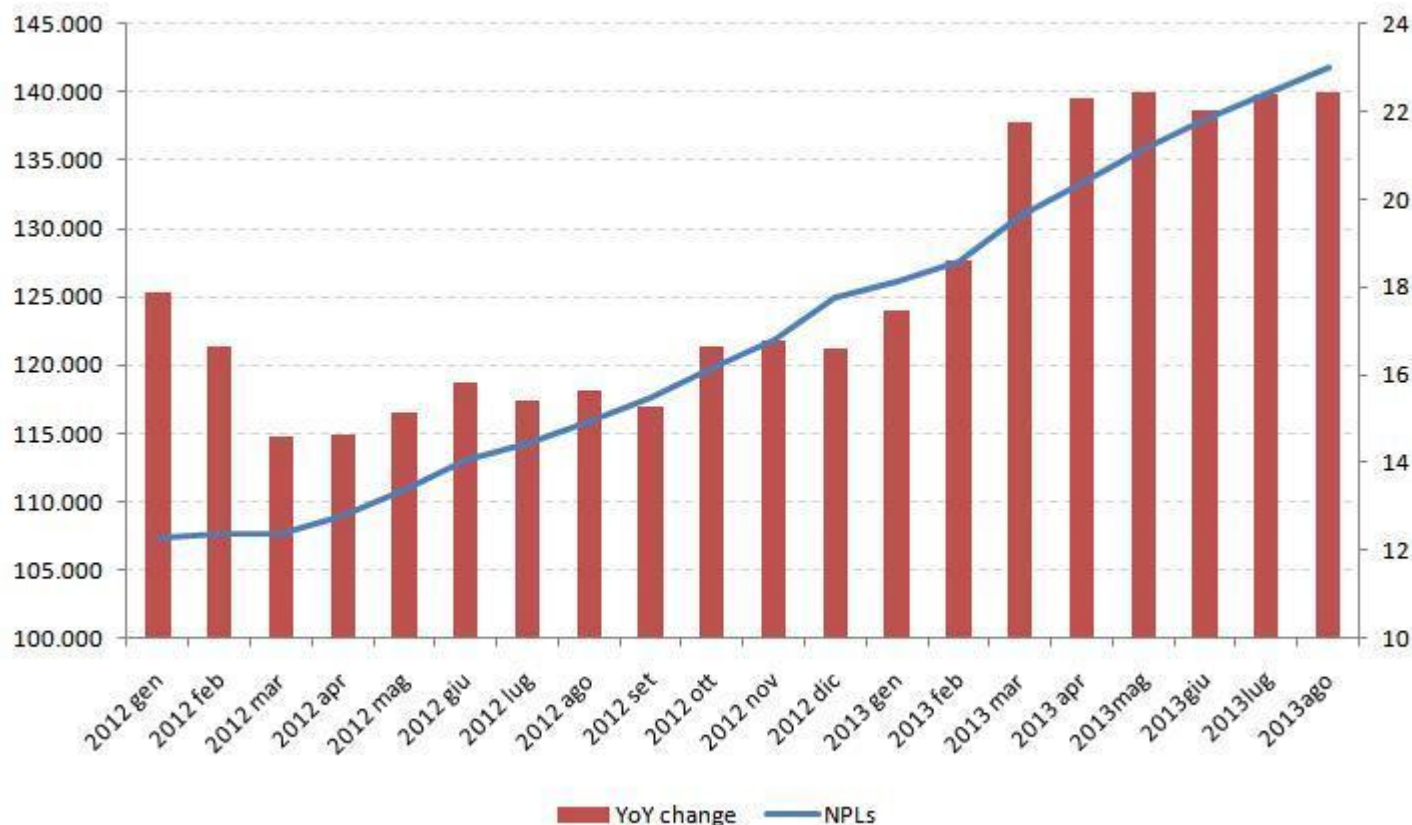
- Authorities in Ireland have been relatively open about the problems of asset quality.
- Less true elsewhere and previous EBA-lead bank stress tests have failed to convince investors that they had revealed true extent of problems.
- Spanish stress tests estimated capital needs of €60 billion. Credible? (Keep in mind Irish costs.)
- Even without property bubbles ongoing slumps in Italy and Portugal also suggest serious questions about asset quality.
- And then there's risk from sovereign bonds ...

Spanish House Prices



Italian Credit Quality Sliding

Non Performing Loans At Italian Banks



Source:BoI

Stress Tests Part Trois: A Chance to Fix the System?

- Can new ECB-lead “Asset Quality Review\balance sheet assessments\stress tests” work?
- The theory:
 - Tests will be credible, transparent and independent due to ECB.
 - Weak banks will have to strengthen via recapitalisation or bail-in.
 - With capital problems solved, funding problems will be alleviated and no further need to squeeze credit.

Uncertainties About AQR\Stress Tests

- Loads of questions about the process:
 1. Treatment of impaired loans\provisioning.
 2. Risk weight methodology.
 3. Sovereign risk.
 4. Treatment of assets yielding below cost of capital (i.e. tracker mortgages).
 5. Penalties for over-reliance on ECB funding?
- Tests could be tough or soft depending on decisions taken on these issues.

Factors Complicating the Stress Tests

1. **Technical:** ECB still only setting up as supervisor so severe test of execution capacity of brand new organisation.
2. **Independence:** National supervisors sit on the SSM's Supervisory Board so still have lots of influence. Much of the work on the tests will be outsourced.
3. **Backstops:** Little appetite for using ESM now and no room for some sovereigns.
4. **Resolution:** An EU fund to be in place in the future but not yet and no money for it.

Scenario 1:

Lots of Failures

- ECB officials are (mainly) talking tough about the need for credible tests.
- Given book-to-market ratios for banks, investors believe a credible test would uncover lots of problems.
- If so, what happens if big banks in high-debt countries fail?
- Can ECB\EC\Governments execute a combined recapitalisation and bail-in plan without risking financial stability?
- Cyprus debacle and lack of a resolution fund suggests maybe not.

Scenario 2

Few Failures and Credibility Restored

- ECB officials are pinning a lot of hopes on the idea that harmonisation will, to quote Draghi, “lift the fog surrounding European banks” and credibly show problems are not that bad.
- EBA has done very good technical work on bank risk models and a common approach to asset quality will be very useful.
- I’m not so sure but perhaps this is how it will work out.

Scenario 3

Few Failures and No Credibility

- Some straws in the wind suggesting tests will not be so tough:
 - Draghi has said “national backstops will be sufficient” which sounds like not much money will be needed.
 - Constancio has said he doesn’t expect any major banks to fail.
 - Oliver Wyman, the ECB’s consultants, came up with the €60 billion figure for Spain.
 - Other outside consultants will know which way the wind is blowing.
- Unlikely that the technical wizardry associated with soft tests will impress sceptical markets.

Slow Gradual Improvement Rather Than A Big Bang

- Scenario 3 is my baseline scenario.
- Likely means continuing funding problems for many banks and tighter credit than required by the Basle 3 transitions.
- Not a great outcome but we're asking a lot of completely new institutions (SSM, ESM, resolution fund) to fix this problem in one go.
- Pieces of successful banking union are being put in place.
- Future stress tests (2016?) might be more likely to draw a line under Europe's banking problems.