NEW CHALLENGES FOR CRISIS MANAGEMENT IN EUROPE: BANKS, BANKING UNION AND FINANCIAL STABILITY ISSUES

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AGENDA

The macro-financial landscape
  • Current conditions and expectations

Banks and the broader financial sector
  • Strengths and vulnerabilities
  • Threats to financial stability

Challenges for crisis management
  • Lessons learnt from the banking turmoil
  • Euro area architecture and policy response
EURO AREA GROWTH HAS GROUND TO A HALT AMIDST INFLATION AND FADING FISCAL STIMULUS

- Rebound after the pandemic but the economy is now plateauing
- No more supportive fiscal policy

Source: European Commission. Blue bars represent forecasts.

Source: Eurostat, Bloomberg, European Commission. 1Y ahead recession probabilities are median forecasts derived from the latest monthly and quarterly surveys conducted by Bloomberg and from forecasts submitted by various banks.
HOUSEHOLDS AND FIRMS BALANCE SHEETS SHOWED RESILIENCE, BUT A LARGER SHARE OF INCOME IS SPENT ON DEBT SERVICE

• Debt service capacity deteriorated, as interest payable rose much quicker than firms' gross operating surplus
• Households are experiencing similar dynamics

Source: ESM and ECB. Note: values are in euro million.

HHs and NFCs interest payable

Households interest coverage ratio

Source: ESM and ECB. Note: Interest coverage ratio for HHs is defined as the ratio between gross disposable income and interest payable. Interest coverage ratio for NFCs is defined as the ratio between gross operating surplus and interest payable.
EURO AREA BANKS HAVE SHOWN RESILIENCE

- Rising official rates are boosting banks’ profits
- Asset quality reached the low levels observed in 2007

Source: ESM based on Fitch.

EA banks’ average Pre-Provisioning RoE and Net Interest Margin

EA banks’ average NPL Ratio and NPL Coverage Ratio

Source: ESM based on Fitch.
BUT HIGH INTEREST RATES POSE RISKS...

- Risks from unrealised losses on the Held-To-Maturity sovereign portfolios contained at aggregate level
- Asset quality to deteriorate due to a rise in bankruptcies

Source: Eurostat. Note: the countries included in the average are: BE, DE, EE, ES, FR, HR, IT, CY, LV, LT, LU, NL, PT, SI, SK.

Source: EBA, ESM. Note: calculations based on a sample of SSM banks considering their HTM sovereign portfolios. CET1 ratio as of 2022Q4 and losses were assumed to materialise entirely in 2022Q4.
...AND EXACERBATE REAL ESTATE SECTOR VULNERABILITIES

- Some markets display signs of overvaluations in house prices
- Correction is ongoing particularly in the Commercial Real Estate...
- But margins remain very much compressed

Source: ECB. Note: prices refer to transaction values.

Source: ESM. Note: the chart shows the relative % deviation of real house prices from their “equilibrium” values implied by housing supply and demand factors (as in Philiponnet and Turrini, 2017).

Source: ECB. Note: prices refer to transaction values.

Source: BNP Paribas, ECB and ESM calculations.
RISK PREMIA COMPONENT OF FINANCIAL CONDITIONS REMAINS SUBDUED BUT MARKET SENTIMENT IS VERY VOLATILE

- Tightening of financial market conditions reached its peak
- Volatility reduced but markets remain vigilant

Source: ESM based on BdF and Bloomberg. Notes: Risk-free rates (EA OIS curve, DE/US 10-year yields, EURIBOR 3m), risk premia (10-year gov. spread), corporate (HY EA index), equity (Euro Stoxx, Euro Stoxx banks), uncertainty (Euro VStoxx, Surprise index), inflation (inflation linked swap 5y, 10y), exchange rate (NEER, Euro/Dollar), commodity (global gas, oil, wheat).

Source: Bloomberg, ECB.
BANK LENDING IS DECREASING

- Tight lending standard combined with strong decrease in demand resulted in a decrease of new lending

Source: ECB.

Source: ECB.
DEPOSITS REALLOCATION WILL TURN IN HIGHER FUNDING COSTS AND PRESSURE ON PROFITABILITY

- HHs reallocation to gov bonds
- Ongoing reallocation from current to time deposits for NFCs, more muted for HHs

**Households deposits**

<table>
<thead>
<tr>
<th>Country</th>
<th>Current</th>
<th>Term</th>
<th>Saving</th>
<th>Total Deposits (RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DE</td>
<td>1.3%</td>
<td>0.0%</td>
<td>-2.3%</td>
<td></td>
</tr>
<tr>
<td>ES</td>
<td></td>
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<td>FR</td>
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<tr>
<td>IT</td>
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**Corporate deposits**

<table>
<thead>
<tr>
<th>Country</th>
<th>Current</th>
<th>Term</th>
<th>Total Deposits (RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DE</td>
<td>-3.6%</td>
<td></td>
<td></td>
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<tr>
<td>ES</td>
<td></td>
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<td></td>
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<tr>
<td>FR</td>
<td>-2.2%</td>
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<tr>
<td>IT</td>
<td>-4.2%</td>
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Note: Values refer to changes in average outstanding amounts from 2022 to 2023. Source: ECB.
HIGH UNCERTAINTY FUELS VOLATILITY IN FINANCIAL MARKETS

- Investors’ perceptions of Bail-In and Credit Risk may trigger further market turbulence raising questions for capital market functioning
- While sovereign spreads remained relatively contained, corporate spreads are still on the high side and can jump abruptly

Source: ESM based on Bloomberg. Note: average AAA and BBB are computed over the last year.
DIGITALISATION, MEDIA AND NERVOUS MARKETS MAKE SIZE LESS RELEVANT: SMALL BANKS CAN CAUSE SYSTEMIC RISK

• Fundamentals drive valuations: banks with high uninsured deposits and mark-to-market losses experienced larger price drops
• so do social media: banks with higher Twitter exposure experienced larger price drops

Source: Cookson, Fox, Gil-Bazo, Imbet and Schiller (2023), “Social Media as a Bank Run Catalyst”.
THE NBFI SECTOR CAN ACT AS A SHOCK AMPLIFIER

- Lower allocations to non-investment grade corporate bonds, as sovereign bonds provide sufficiently attractive returns
- Reduction in cash buffers in bond funds warrants attention

![Graph showing allocation to non-investment grade](image1)

![Graph showing cash holdings](image2)

Source: Lipper, ESM calculations
THE EQUITY CONUNDRUM: MISALIGNMENT BETWEEN BANK'S VALUATIONS AND RETURNS’

- Most of European banks are trading below their book value
- Weak economic prospects and uncertainty weighs on market valuations

European banks – sector ROTE vs sector PTBV

Note: 12-month forward price-to-book value and 12-month forward return-on-equity. Source: Societe Generale.

Banks’ valuations look attractive

Note: Banks’ 12-month forward P/E relative to the market. Source: BofA Global Research.
Q & A
GOING BACK TO THE RECENT BANK CRISES
SVB DEMISE AND CREDIT SUISSE RESCUE LESSONS AND KEY CHALLENGES FOR CRISIS MANAGEMENT

<table>
<thead>
<tr>
<th>Lessons and confirmations</th>
<th>Policy reflections and challenges</th>
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<tbody>
<tr>
<td>• Unpredictability of crisis triggers</td>
<td>• More Banking Union for an effective, credible and well-funded resolution regime</td>
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<td>• Speed of contagion: the media effect</td>
<td>• More global coordination of supervision</td>
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<td>• Financial stability dominance under uncertain conditions</td>
<td>• Understanding going-concern/gone-concern conditions</td>
</tr>
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<td>• Systemic risk exception is not available in BU</td>
<td>• Factor in trade-off between effective resolution action and moral hazard</td>
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<td>• More banks can be systemic in failure</td>
<td>• Ensure sufficient loss absorption capacity with instruments ranking below depositors</td>
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<td>• Credibility of the Banking Union response to the Global Financial Crisis</td>
<td>• The design of a public liquidity backstop need to minimise wrong incentives</td>
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<td>• Rule harmonisation</td>
<td>• Deepen resolvability assessment</td>
</tr>
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<td>• High supervisory standards</td>
<td>• Reduce legal uncertainty for cross-border groups</td>
</tr>
<tr>
<td>• Euro Area banks fundamentals proved robust</td>
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<td>• Need for coordinated and timely communication</td>
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POLICY RESPONSE TO THE GLOBAL FINANCIAL CRISIS: BANKING UNION

- Current bank crisis management system:
  - SSM
  - SRM + SRF
  - A set of rules to manage bank failures in an orderly and economically efficient manner (Crisis Management and Deposit Insurance Framework, CMDI)

- Elements to be finalized:
  - Common Backstop
  - Reform of the CMDI framework
  - European Deposit Insurance Framework
  - Liquidity in Resolution

Single Supervisory Mechanism
Single Resolution Mechanism + Single Resolution Fund
European Deposit Insurance Scheme
Backstop

Single Rulebook: CRD IV/CRR, BRRD, DGSD
THE RESOLUTION FUNDING ARRANGEMENTS IN THE BANKING UNION: CURRENT AND FUTURE

**SRF FUNDS**

- SRB manages SRF which is **fully funded by BU banks’ contributions** (amounting to at least 1% of bank covered deposits)
- If a bank goes into distress and needs resolution, SRB can use SRF funds for **resolution**
- Funds used in resolution to be replenished by remaining banks

**ESM FUNDS**

- If SRF funds are depleted, ESM will act as **lender of last resort (common backstop)** to finance the SRB
- ESM backstop is designed as a **revolving credit line** to be repaid in 1, 3 to 5 years
- As SRF is funded by banks’ contributions, EA banks will provide ultimate source of repayment to ESM (**fiscal neutrality**)

*After ESM Amended Treaty ratification*
## CRISIS MANAGEMENT AND DEPOSIT INSURANCE FRAMEWORK: CMDI REFORM

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<tr>
<th>Gaps in the current CMDI framework</th>
<th>CMDI reform</th>
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<tbody>
<tr>
<td><strong>Access to the SRF is difficult for medium banks</strong>, high burden sharing requirement: 8% bail-in may require bail-in of deposits, posing risk to financial stability.</td>
<td>It permits national Deposit Guarantee Scheme funds to be used as a &quot;top-up&quot; to meet the 8% requirement for banks to be resolved under transfer strategy.</td>
</tr>
<tr>
<td><strong>Small and Medium banks managed outside the resolution framework</strong>, often resulting in protracted piece-meal liquidation, which generates significant value destruction.</td>
<td>It improves the usability of tools for an orderly market exit of failing banks of any size with DGS funds for measures alternative to the payout function.</td>
</tr>
<tr>
<td><strong>Unpredictability of the Public Interest Assessment (PIA)</strong>: inconsistency across resolution cases with respect to the outcome of the PIA due to different interpretations.</td>
<td>EC expands the definition of the impact of bank’s critical functions from only the national level previously to now also the regional level; this allows for a broader and more consistent application.</td>
</tr>
<tr>
<td><strong>Early intervention measures (EIMs)</strong>: some EIMs overlap with the supervisory actions and have been rarely used.</td>
<td>The proposal removes the overlaps and provides a clearer legal basis for the ECB to use such measures.</td>
</tr>
<tr>
<td><strong>Preparation for resolution</strong>: SRMR included provisions on the cooperation between the competent and resolution authorities when the financial situation of a bank starts deteriorating; the provisions needed to be strengthened to ensure better and more effective cooperation.</td>
<td>The proposal provides additional details on cooperation in the run-up to resolution, concerning the type of information that should be exchanged.</td>
</tr>
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MAKING DEPOSIT INSURANCE STRONGER IN EUROPE

**EDIS:** uniform and effective level of protection of insured depositors across the entire BU, regardless of their geographic location

**Mutualisation of DGSs:** a bigger and more solid insurance framework which would strengthen financial stability in the euro area

**Progress towards EDIS:** has been hampered by disagreements on the degree of mutual insurance, prudential treatment of sovereign exposures and the home-host issue

**Solutions? How to foster trust-building?** More risk-based contributions? Which risks?
A LIQUIDITY GAP IN RESOLUTION: THE MISSING ELEMENT

- **The gap:** After the resolution weekend a resolved bank might not be able to access liquidity funding from the market nor have sufficient collateral to receive financing through the ECB’s monetary policy operations or a national central bank’s emergency liquidity assistance.

- **Urgency:** The experience with the Swiss and regional US banks earlier this year to show that liquidity provision could be lacking in the current framework.

- **Work in progress:** The policy debate continues. Proposal differ in their reliance on supervisory action (more prevention), backstopping by the central bank (LOLR) or by another public entity.
SOME POINTS FOR DISCUSSION

• Uncertainty is clouding the outlook and markets remain nervous.
• Triggers of vulnerabilities remain largely unknown. Contagion and confidence shocks are a major source of concerns. Is CRE a clear risk?
• Traditional channels of risk contagion still apply; but new propagation channels may emerge, especially from the non-bank financial sector.
• Due to interconnectedness and digitalisation, also small banks can cause systemic risk.
• The euro area institutional framework is strong but incomplete; how can we foster continued effort and foresight?
• What gaps might remain in the crisis management framework beyond those discussed today? Backstop, the CMDI reform, EDIS, liquidity in resolution?
SVB DEMISE – KEY EVENTS

• **Medium-sized bank** ($212bn assets, $15bn equity; 16th)
• **Concentrated portfolio** (tech companies)
• **Uninsured deposits**: 97% ($175bn deposits)
• **Securities as % of assets**: 55%, most of which US treasuries and mortgage-backed securities

**High BM risk - Inherent instability through:**
- Considerable asset-liability mismatch
- Very quick growth – Surge in deposits
- High interest rate exposure, significant (un)-realised losses from rate hikes
- Flighty depositors
- Lack of internal controls / CRO

**Precipitating factors**
High customer withdrawals required bond sales with the consequent realisation of losses. On 8 March SVB announced Q1 losses of $1.8bn and a $2.3bn capital raise. SVB lost over $40 bn deposits in a single day.

**Resolution strategy**
- On 10 March FDIC transferred all SVB deposits and assets to a bridge bank.
- Contagion spread to other US regional banks and a systemic risk exception was approved, extending insurance to all depositors.
- On 12 March, the FRB announced it would make available additional funding to eligible depository institutions to help assure that the banks have the ability to meet the needs.
- The Federal Reserve’s Bank Term Funding Program aimed to ease the liquidity pressures on banks, by providing loans with maturities up to one year to banks against the par value of high-quality securities.
- FDIC entered into a loss–share agreement with the purchaser, thus sharing the losses and potential recoveries on loan portfolios covered by the agreement.
- In May, FDIC performed a special bank assessment to recoup the cost borne by the deposit insurance fund for SVB and Signature Bank ($15.8 bn) from all eligible deposit institutions.
CREDIT SUISSE RESCUE – KEY EVENTS

**Key events prior to the rescue**
- Large Swiss GSIB (CHF 531.4bn assets, ~70% of Swiss GDP, 2nd)
- Investment banking and wealth management
- For long under increased scrutiny by investors and regulators:
  - Involvement in high profile scandals, including ML, and bankruptcies (Greensill, Archegos)
  - High management turnover (3 CEOs in 2 years)
  - Weak financial performance (loss of EUR 6bn in 2022), due to falling investment bank revenues, litigation provisions and losses on leveraged positions

**Key features of the deal**
- On the 19 March, UBS announced its takeover of CS with support from the Swiss federal government, the Swiss Financial Market Supervisory Authority FINMA and the Swiss National Bank.
- UBS purchases CS for a price of CHF 0.76 per share for a total consideration of CHF 3bn.
- The Swiss National Bank provided access to two funding lines (up to CHF 200bn jointly) of which CHF 100 bn with a government liquidity backstop.
- The federal government also provided a “second-loss” guarantee of CHF 9 bn to UBS (solvency guarantee) for an earmarked portfolio of assets, after a CHF 5bn initial loss As part of the deal, FINMA ordered a total write-down of CS’ AT1 bonds, to a total value of CHF 16.1 bn.
- In August, after completion of CS acquisition, UBS announced the termination of the public liquidity backstop and the solvency guarantee agreement.

**Key events prior to the rescue**
- Credit rating downgrades in August (Fitch) and November 2022 (Moodys and S&P)
- Record deposit outflows in Q4 2022 (CHF 111bn)
- Following SVB debacle, the share price dropped by 35% over five trading sessions and the CDS spread jumped to 1400 bps (from 250 bps)
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