European Stability Mechanism

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

Presentation at Zinsforum Digital 2023

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7 December 2023

AGENDA

The macro-financial landscape

- Current conditions and expectations

Banks and the broader financial sector

- Strengths and vulnerabilities
- Threats to financial stability

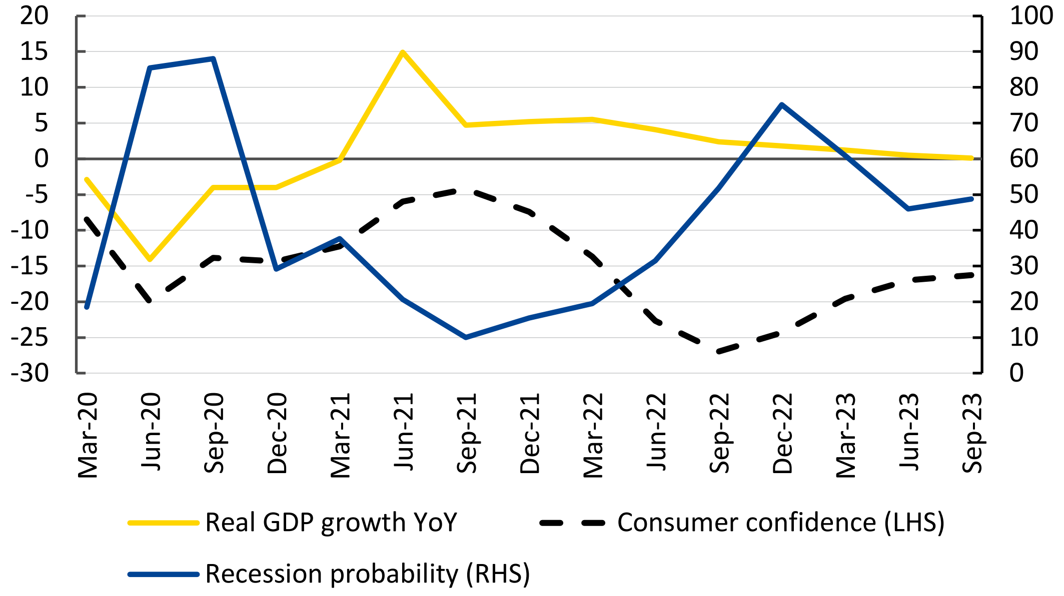
Challenges for crisis management

- 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

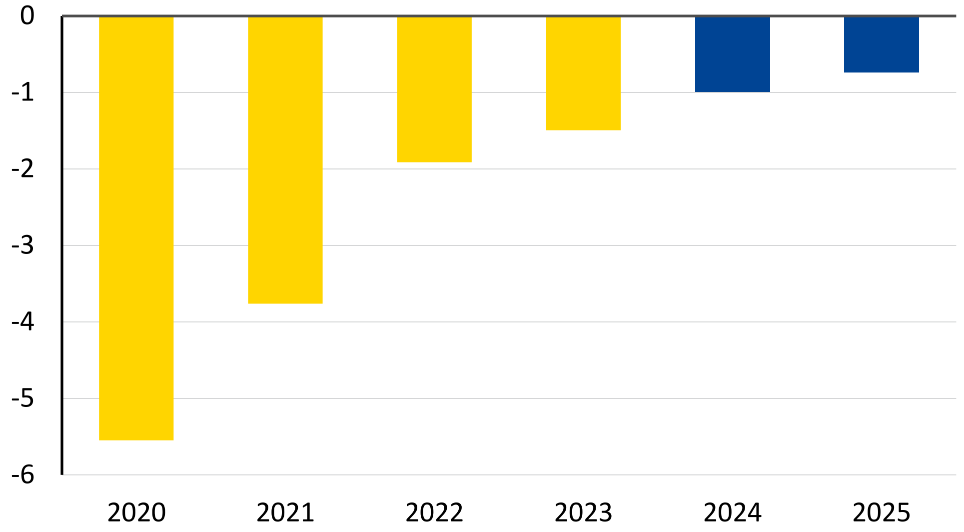
- Rebound after the pandemic but the economy is now plateauing
- No more supportive fiscal policy

EA Real GDP growth (YoY, in %), recession probability and consumer confidence



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.

EA Primary balance (% of GDP)

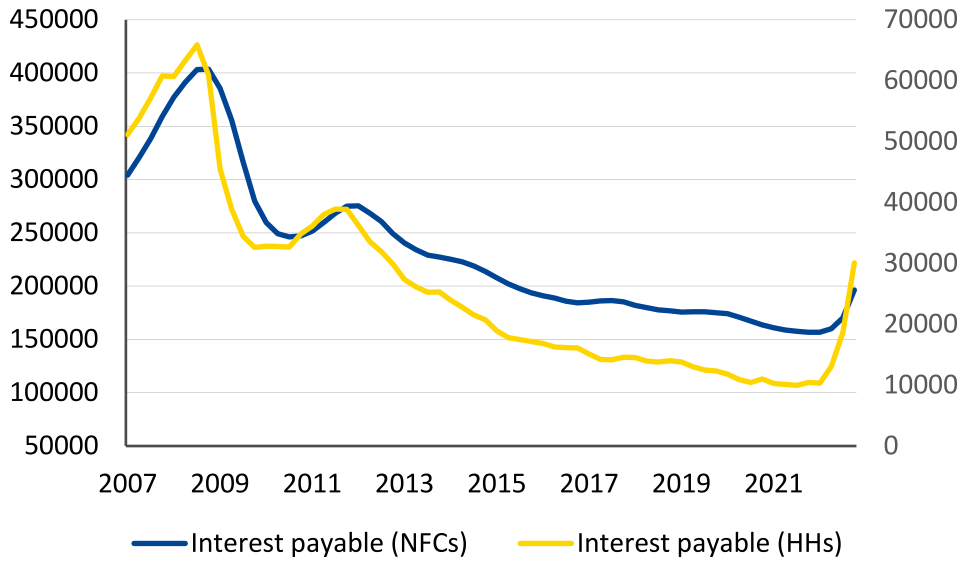


Source: European Commission. Blue bars represent forecasts.

HOUSEHOLDS AND FIRMS BALANCE SHEETS SHOWED RESILIENCE, BUT A LARGER SHARE OF INCOME IS SPENT ON DEBT SERVICE

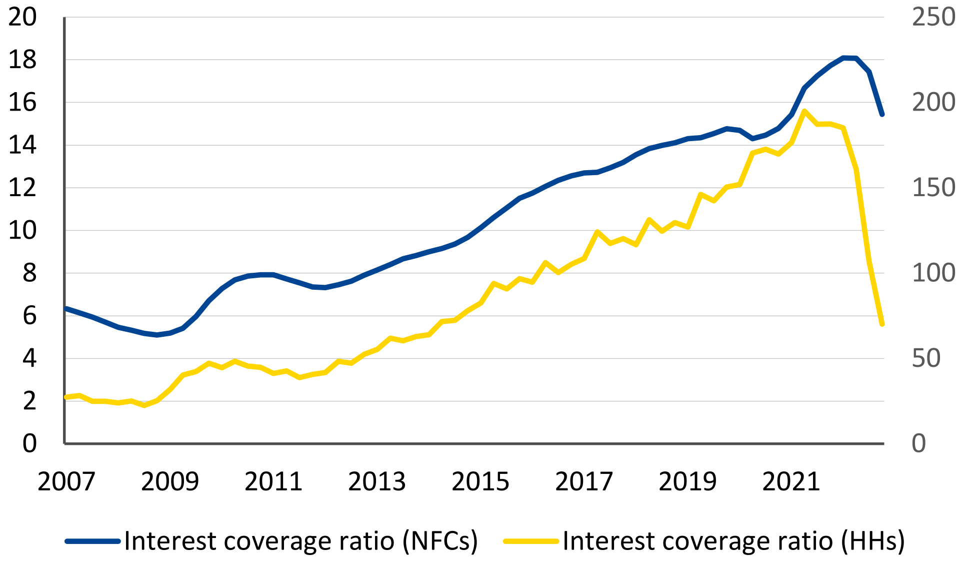
- Debt service capacity deteriorated, as interest payable rose much quicker than firms' gross operating surplus
- Households are experiencing similar dynamics

HHs and NFCs interest payable



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

Households interest coverage ratio

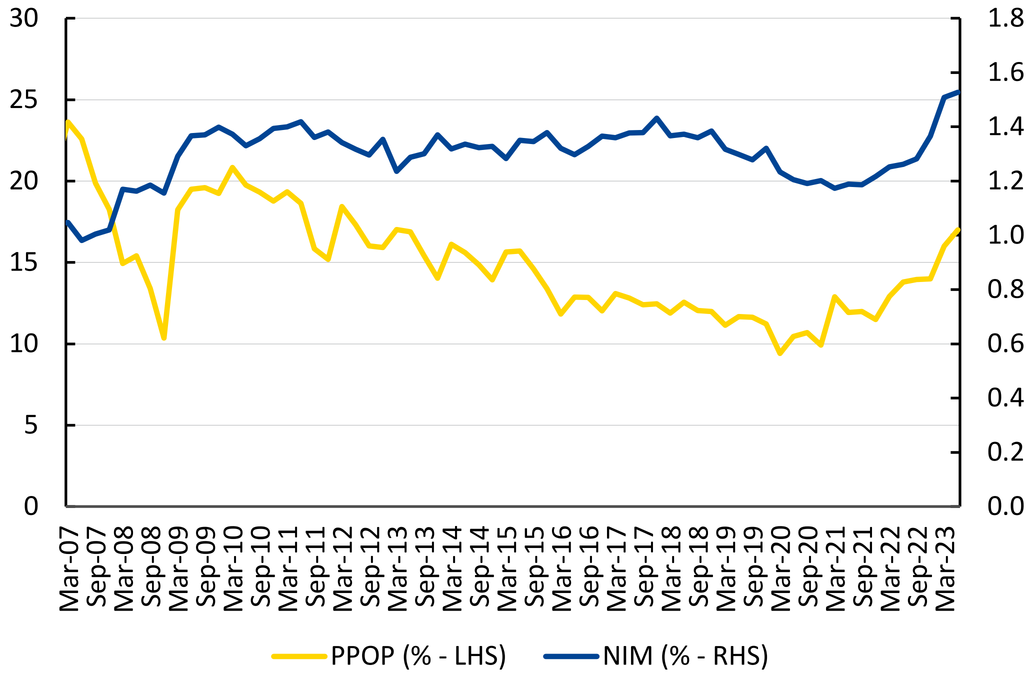


Source: ESM based on ECB. Note: Interest coverage ratio for HHs is defined as the ratio between gross disposable income and interest payable. Interest coverage ratio for NFCs is defined as the ratio between gross operating surplus and interest payable.

EURO AREA BANKS HAVE SHOWN RESILIENCE

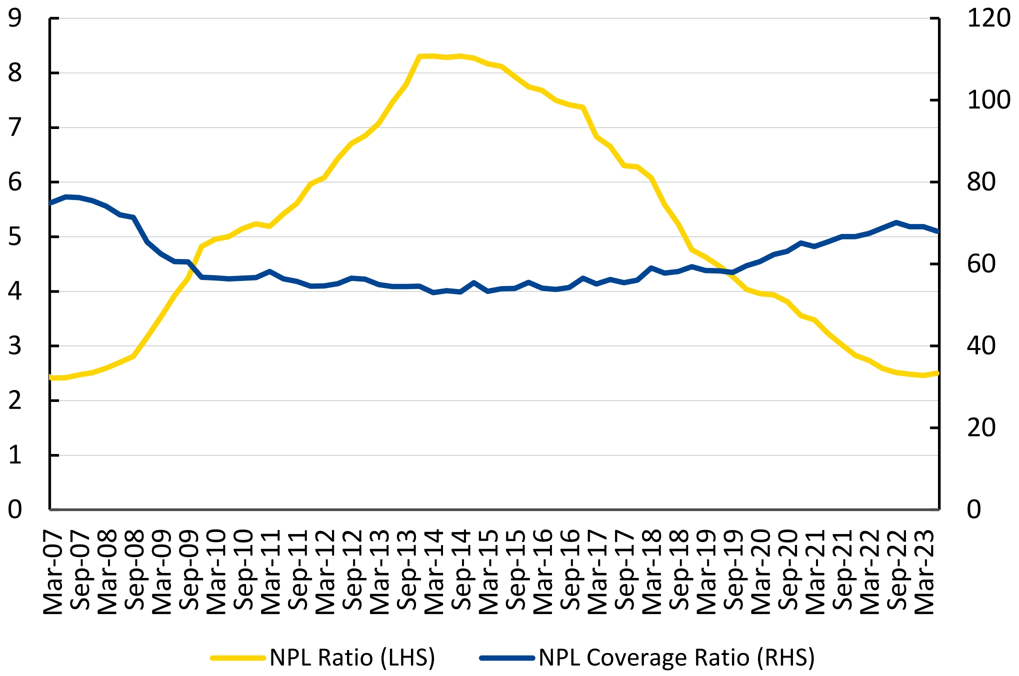
- Rising official rates are boosting banks' profits
- Asset quality reached the low levels observed in 2007

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



Source: ESM based on Fitch.

EA banks' average NPL Ratio and NPL Coverage Ratio

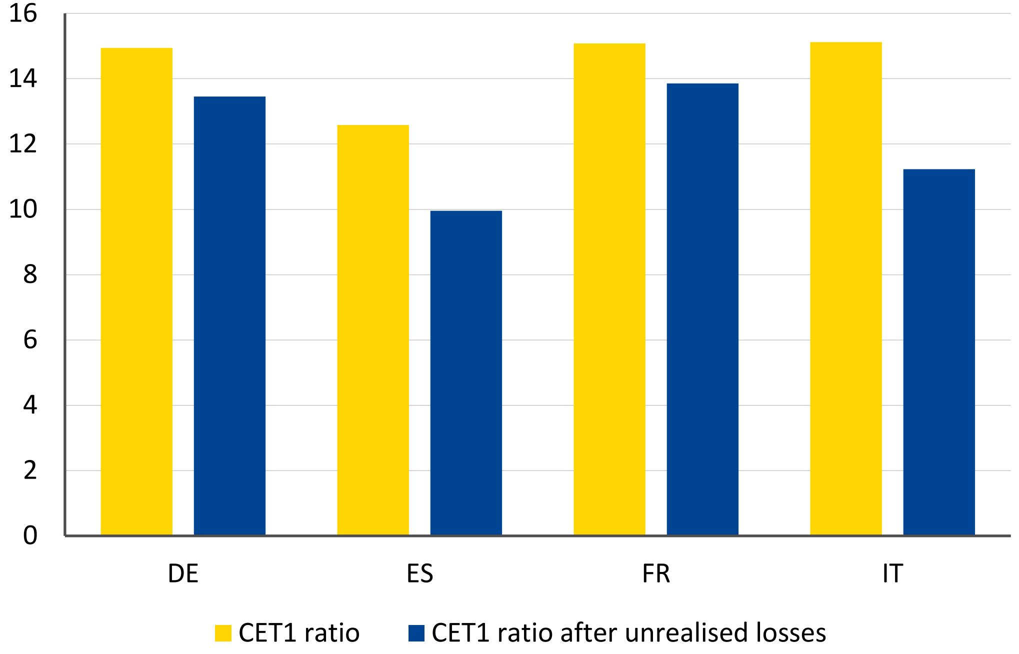


Source: ESM based on Fitch.

BUT HIGH INTEREST RATES POSE RISKS…

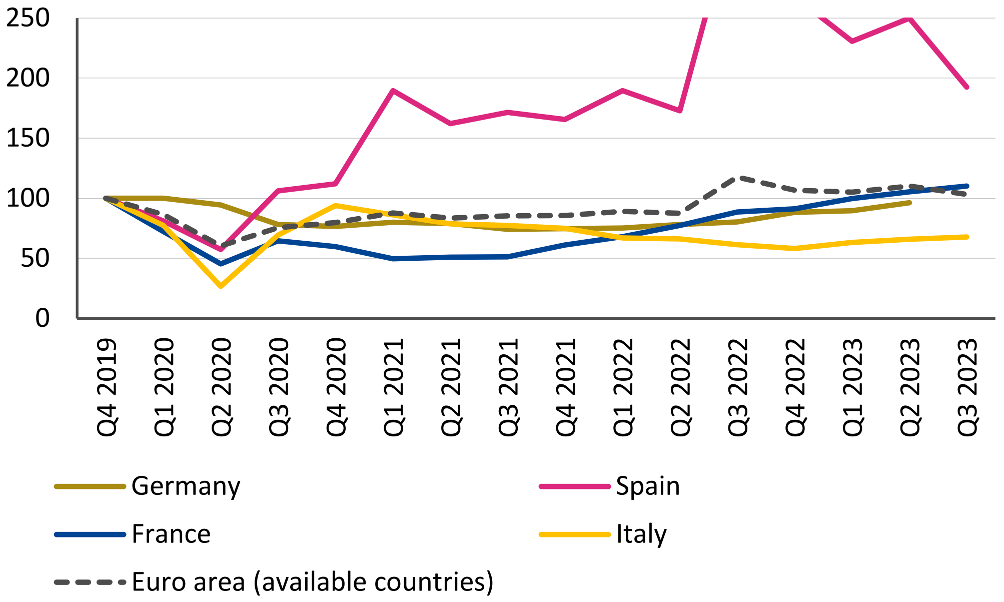
- Risks from unrealised losses on the Held-To-Maturity sovereign portfolios contained at aggregate level
- Asset quality to deteriorate due to a rise in bankruptcies

Unrealized losses (in % of CET1 ratio)



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.

Declarations of bankruptcies, Q4 2019 to Q3 2023 (Index, 2019=100, seasonally adjusted)

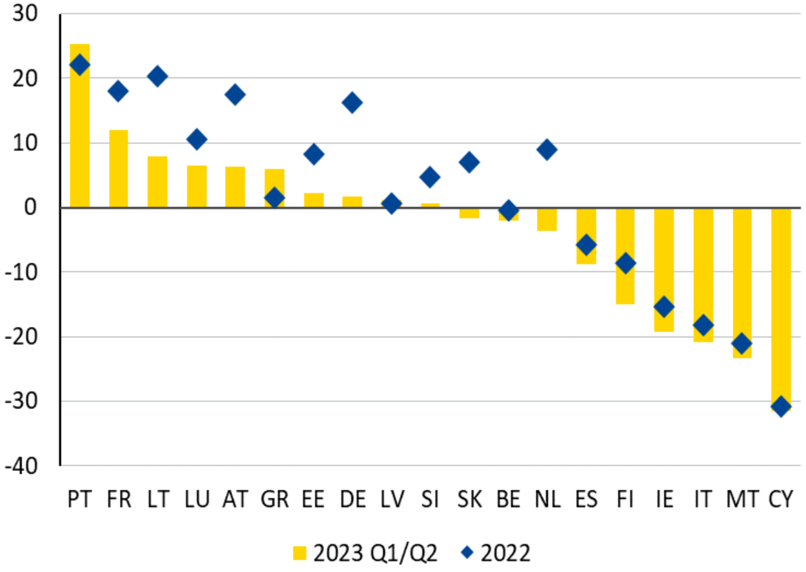


Source: Eurostat. Note: the countries included in the average are: BE, DE, EE, ES, FR, HR, IT, CY, LV, LT, LU, NL, PT, SI, SK.

…AND EXACERBATE REAL ESTATE SECTOR VULNERABILITIES

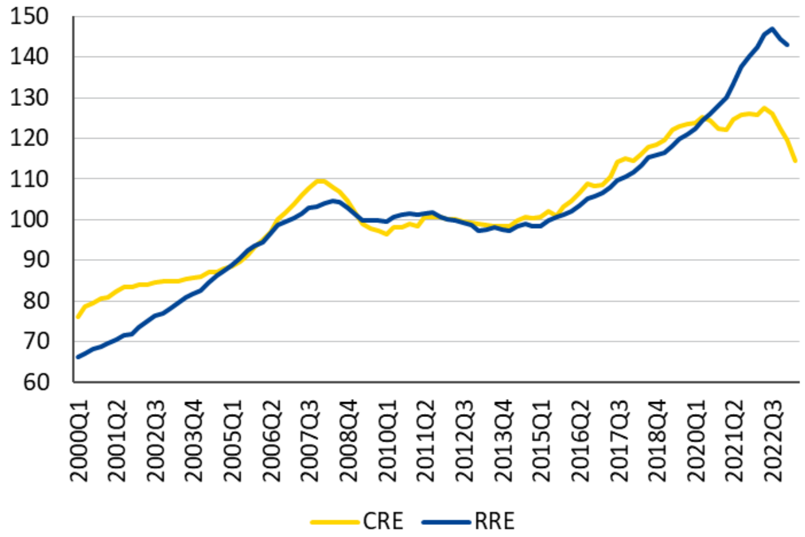
- Some markets display signs of overvaluations in house prices
- Correction is ongoing particularly in the Commercial Real Estate…
- But margins remain very much compressed

House prices misalignment (real, %-dev. from fundamental values)



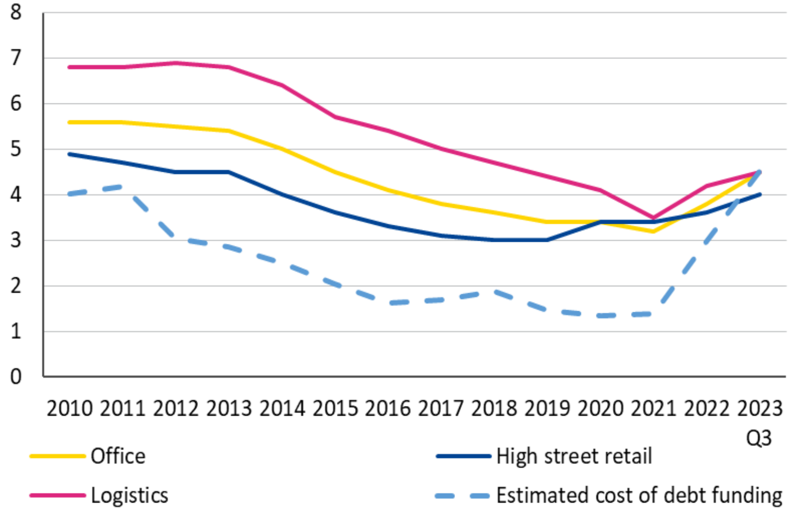
Source: ESM. Note: the chart shows the relative % deviation of real house prices from their "equilibrium" values implied by housing supply and demand factors (as in Philiponnet and Turrini, 2017).

Commercial and residential property prices - EA



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

European rental yields vs funding costs: room for further price adjustments (percent)

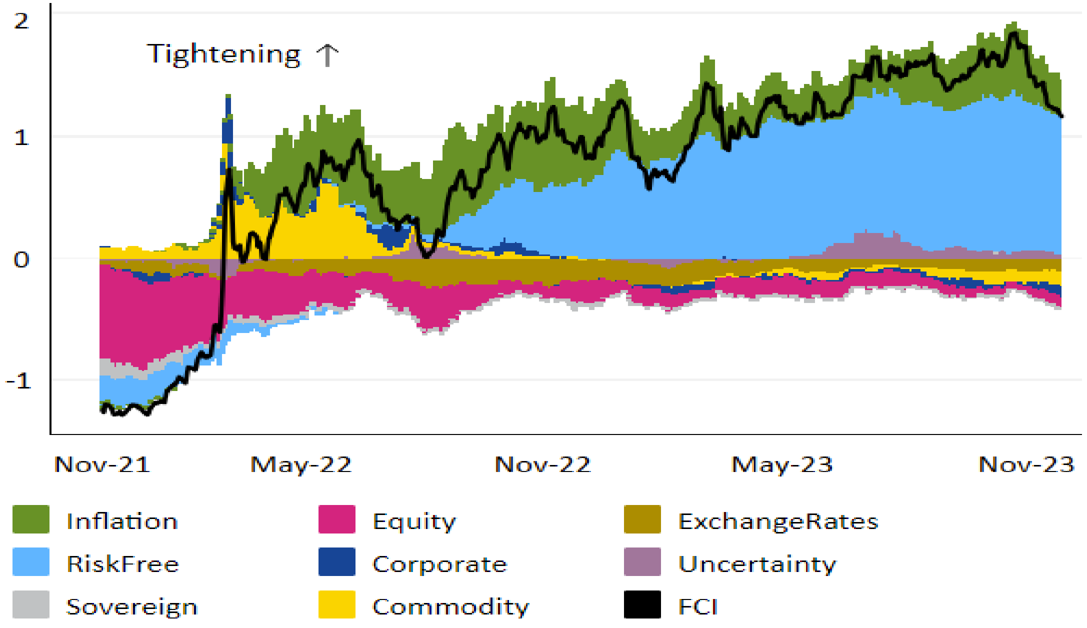


Source: BNP Paribas, ECB and ESM calculations.

RISK PREMIA COMPONENT OF FINANCIAL CONDITIONS REMAINS SUBDUED BUT MARKET SENTIMENT IS VERY VOLATILE

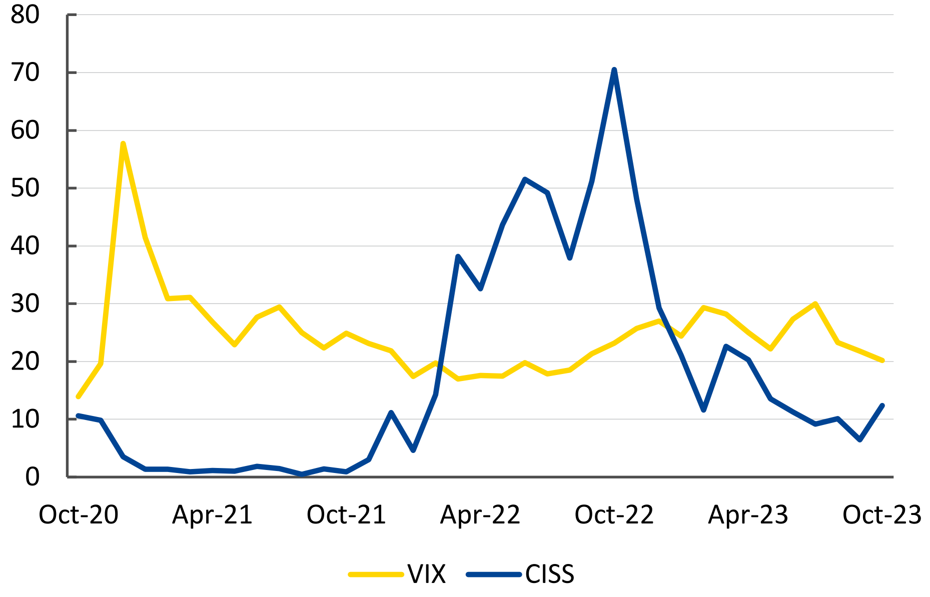
- Tightening of financial market conditions reached its peak
- Volatility reduced but markets remain vigilant

Financial markets conditions index



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).

Global market volatility and EA systemic risk



Source: Bloomberg, ECB.

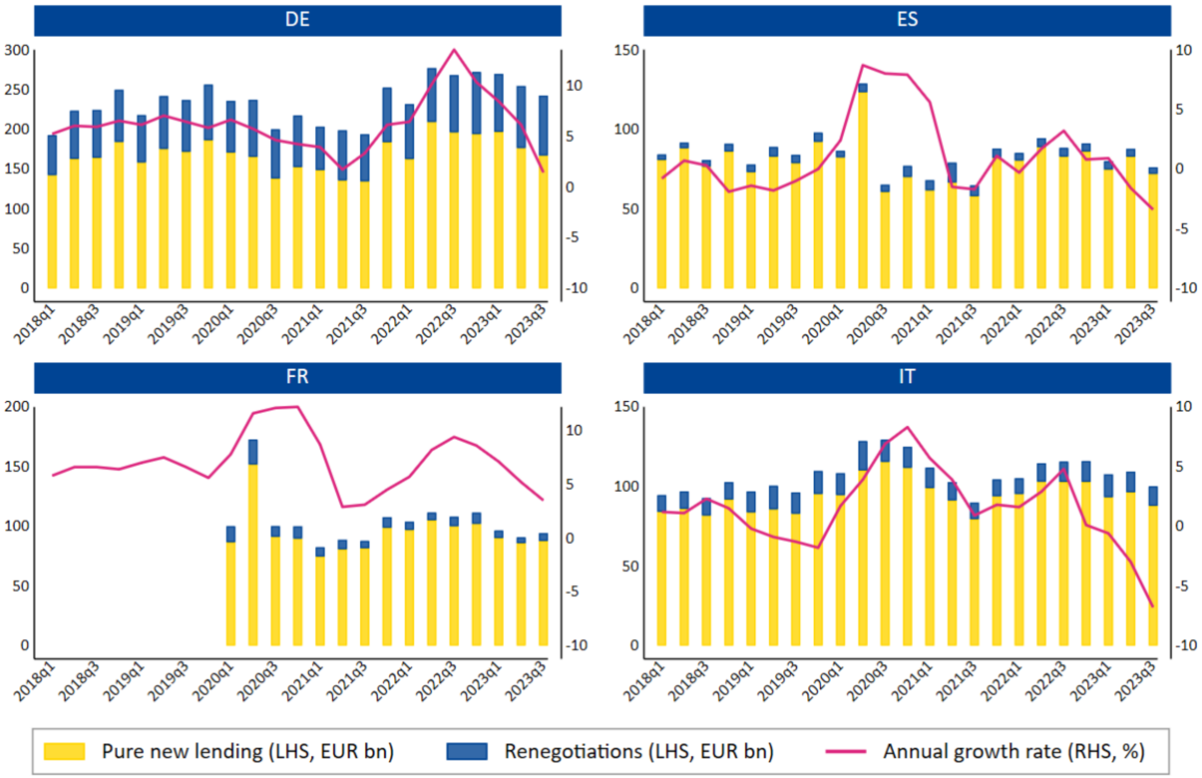
BANK LENDING IS DECREASING

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

Mortgage lending

Source: ECB.

Corporate lending

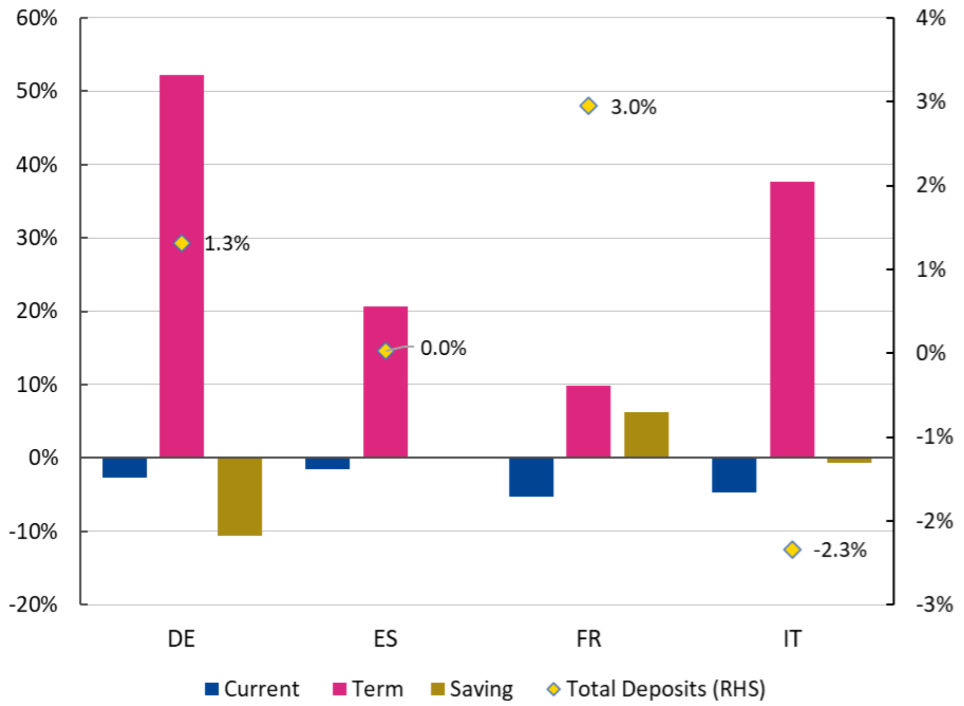


Source: ECB.

DEPOSITS REALLOCATION WILL TURN IN HIGHER FUNDING COSTS AND PRESSURE ON PROFITABILITY

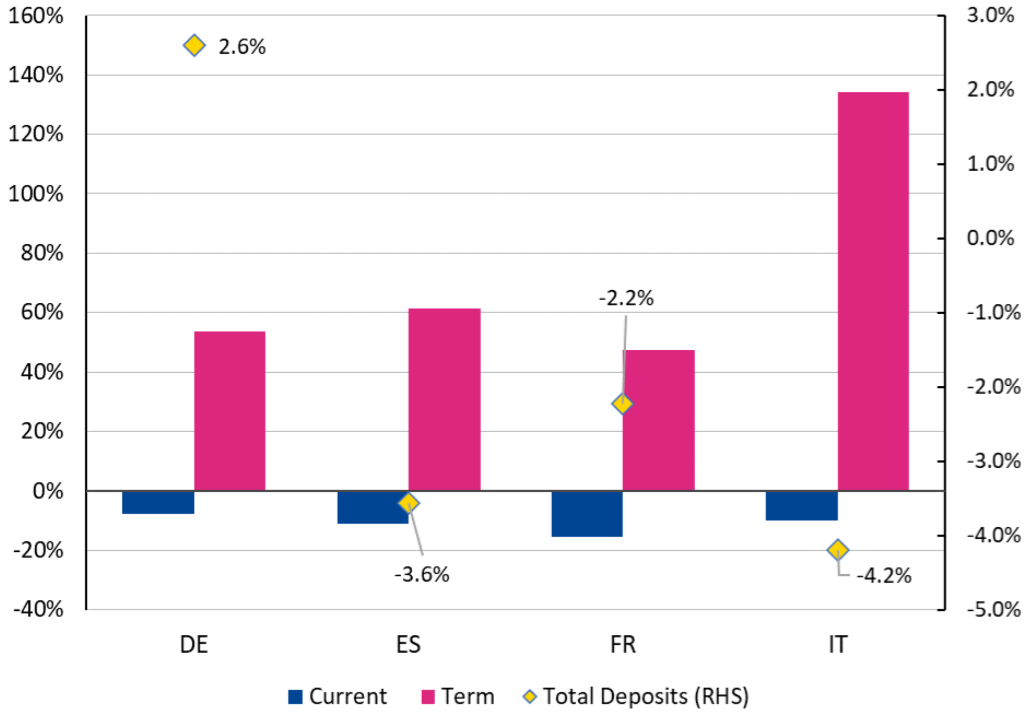
- HHs reallocation to gov bonds
- Ongoing reallocation from current to time deposits for NFCs, more muted for HHs

Households deposits



Note: Values refer to changes in average outstanding amounts from 2022 to 2023.
Source: ECB.

Corporate deposits

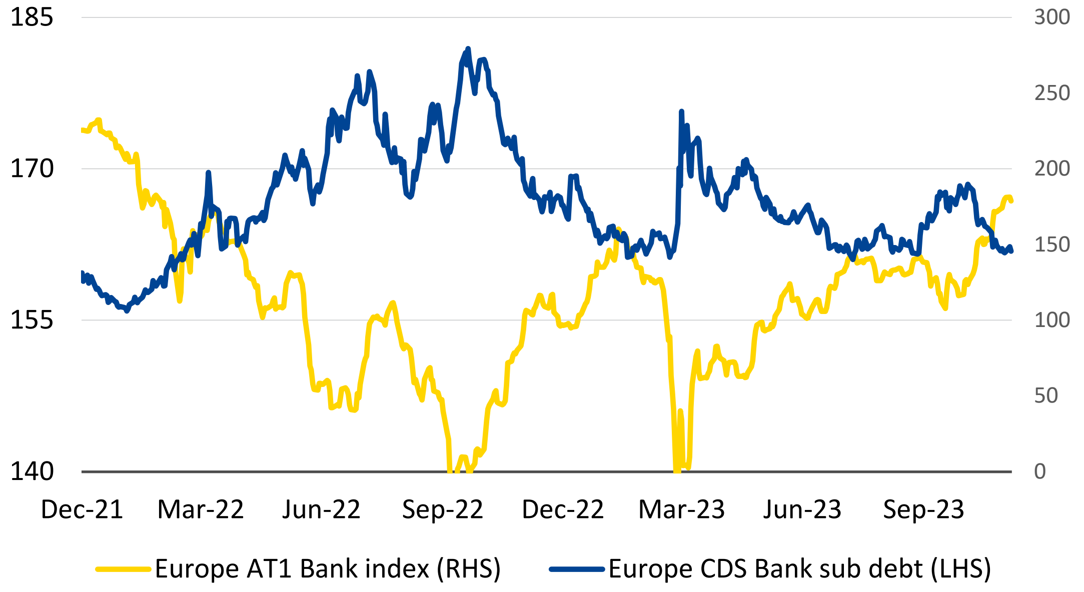


Note: Values refer to changes in average outstanding amounts from 2022 to 2023.
Source: ECB.

HIGH UNCERTAINTY FUELS VOLATILITY IN FINANCIAL MARKETS

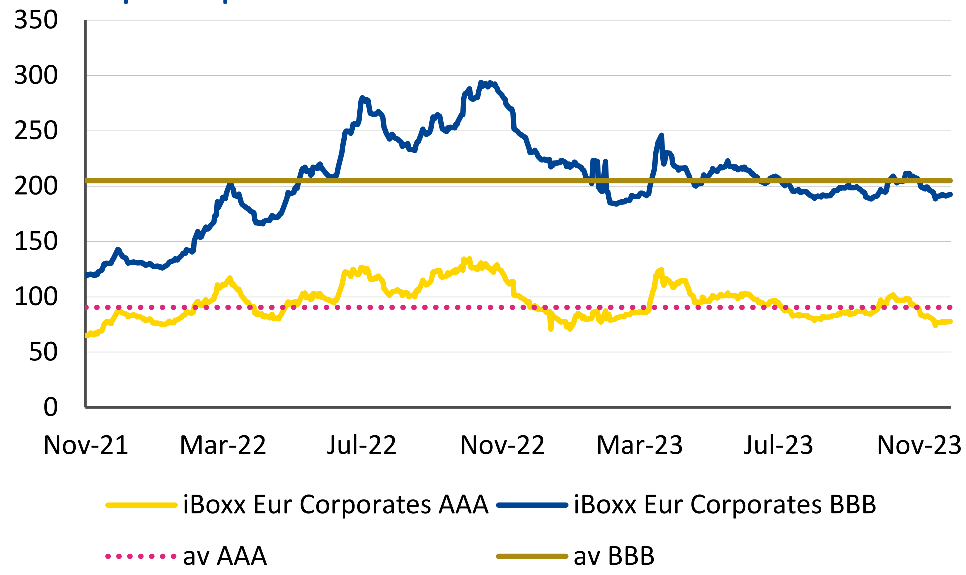
- Investors' perceptions of Bail-In and Credit Risk may trigger further market turbulence raising questions for capital market functioning
- While sovereign spreads remained relatively contained, corporate spreads are still on the high side and can jump abruptly

Investors' perceptions of Bail-In and Credit Risk



Source: ESM based on Bloomberg.

Corporate spreads

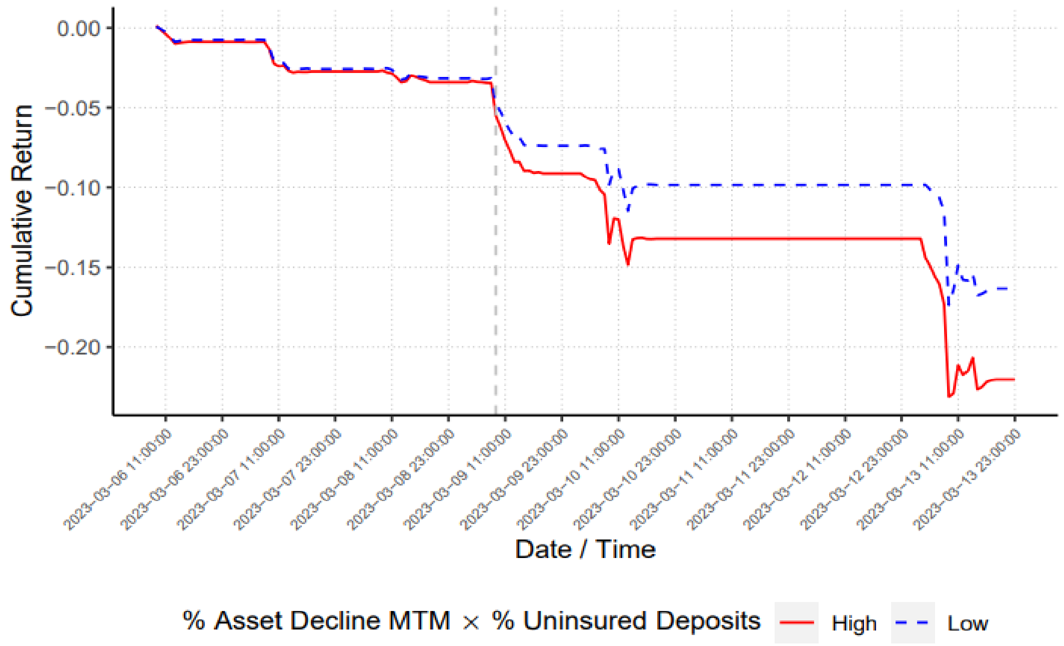


Source: ESM based on Bloomberg. Note: average AAA and BBB are computed over the last year.

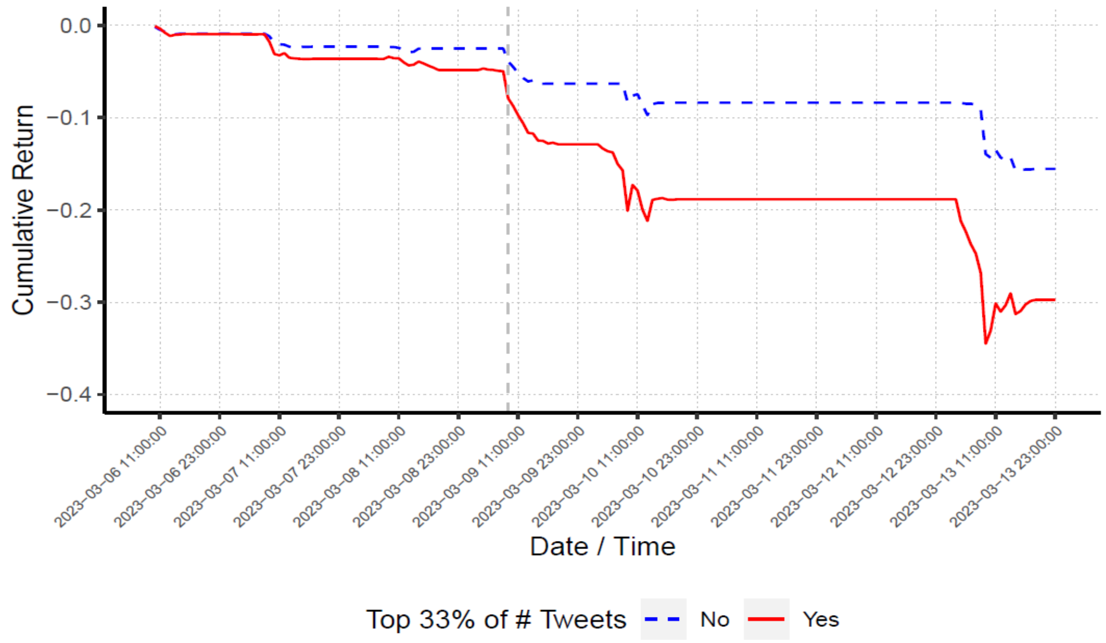
DIGITALISATION, MEDIA AND NERVOUS MARKETS MAKE SIZE LESS RELEVANT: SMALL BANKS CAN CAUSE SYSTEMIC RISK

- 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

Banks' cumulative returns



Banks' cumulative returns (including Silicon Valley Bank)

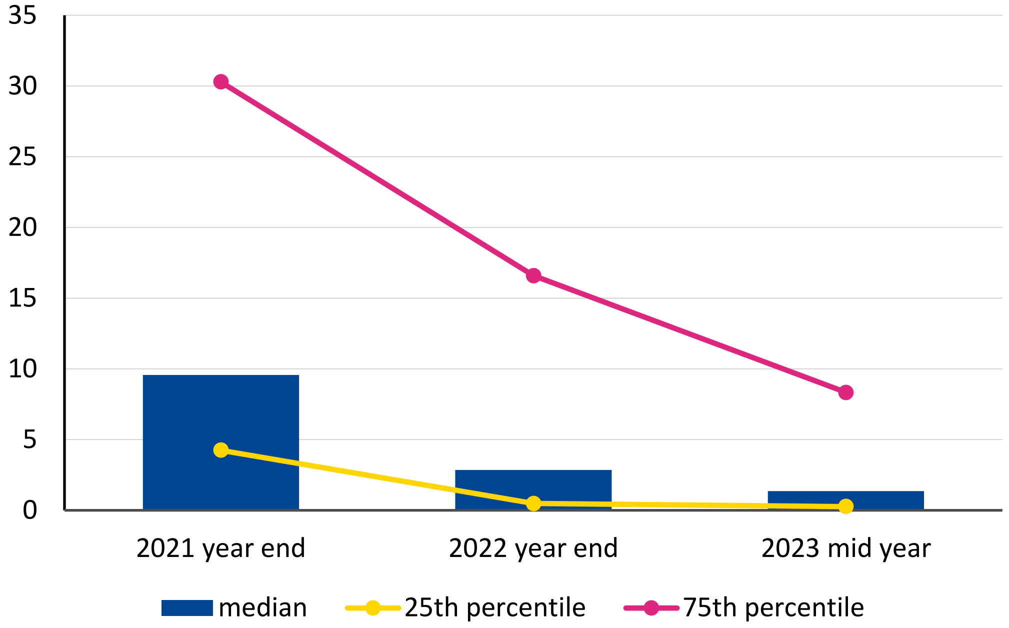


Source: Cookson, Fox, Gil-Bazo, Imbet and Schiller (2023), "Social Media as a Bank Run Catalyst".

THE NBFI SECTOR CAN ACT AS A SHOCK AMPLIFIER

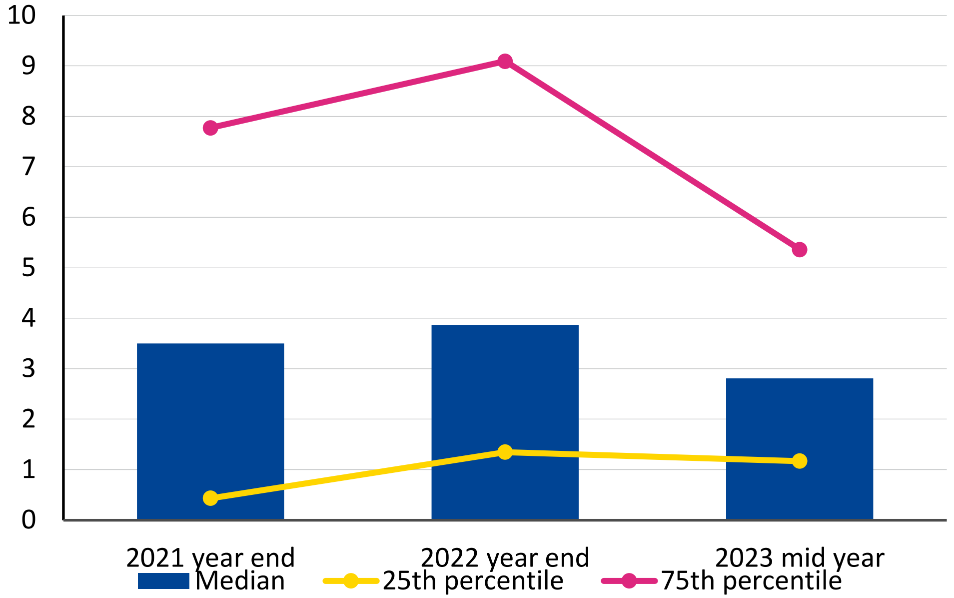
- Lower allocations to non-investment grade corporate bonds, as sovereign bonds provide sufficiently attractive returns
- Reduction in cash buffers in bond funds warrants attention

Euro Area bond funds: allocation to non-investment grade



Source: Lipper, ESM calculations

Cash holdings of euro area bond funds, median and interquartile range (%)



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 reteurn-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

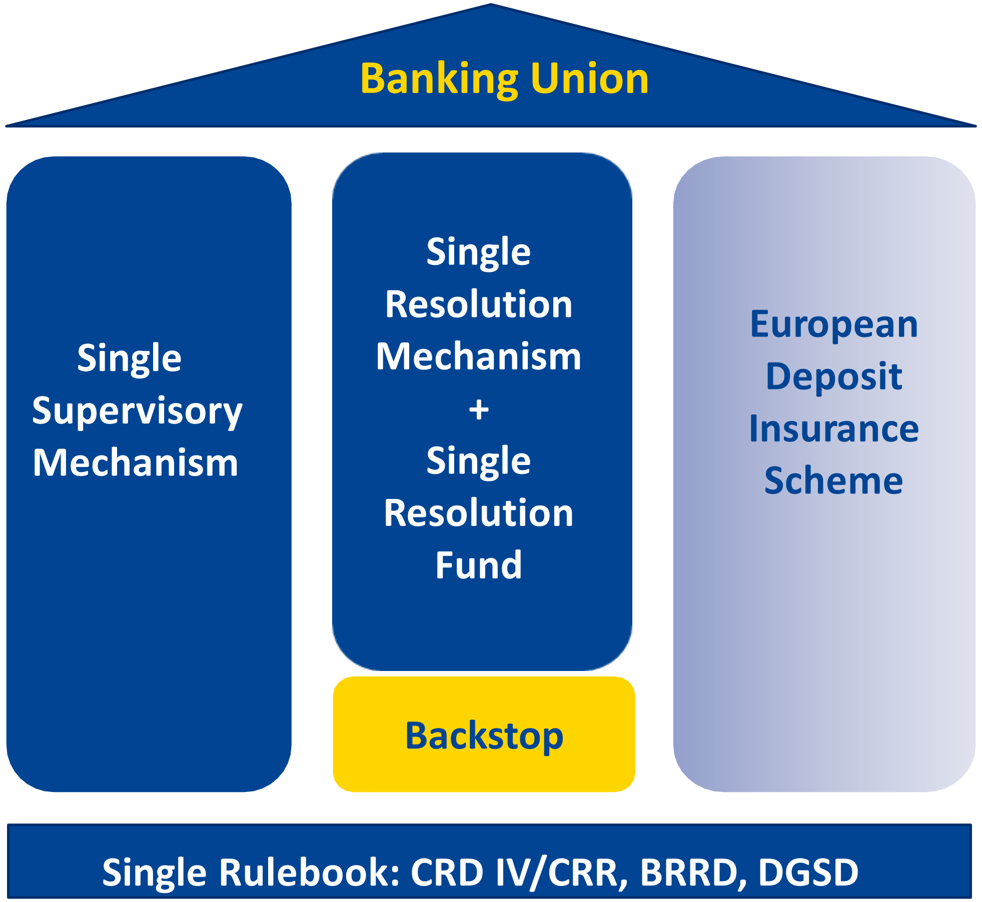
Lessons and confirmations

- Unpredictability of crisis triggers
- Speed of contagion: the media effect
- Financial stability dominance under uncertain conditions
  - Systemic risk exception is not available in BU
- More banks can be systemic in failure
- Credibility of the Banking Union response to the Global Financial Crisis
  - Rule harmonisation
  - High supervisory standards
- Euro Area banks fundamentals proved robust
- Need for coordinated and timely communication

Policy reflections and challenges

- More Banking Union for an effective, credible and well-funded resolution regime
- More global coordination of supervision
- Understanding going-concern/gone-concern conditions
- Factor in trade-off between effective resolution action and moral hazard
  - Ensure sufficient loss absorption capacity with instruments ranking below depositors
  - The design of a public liquidity backstop need to minimise wrong incentives
- Deepen resolvability assessment
- Reduce legal uncertainty for cross-border groups

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)

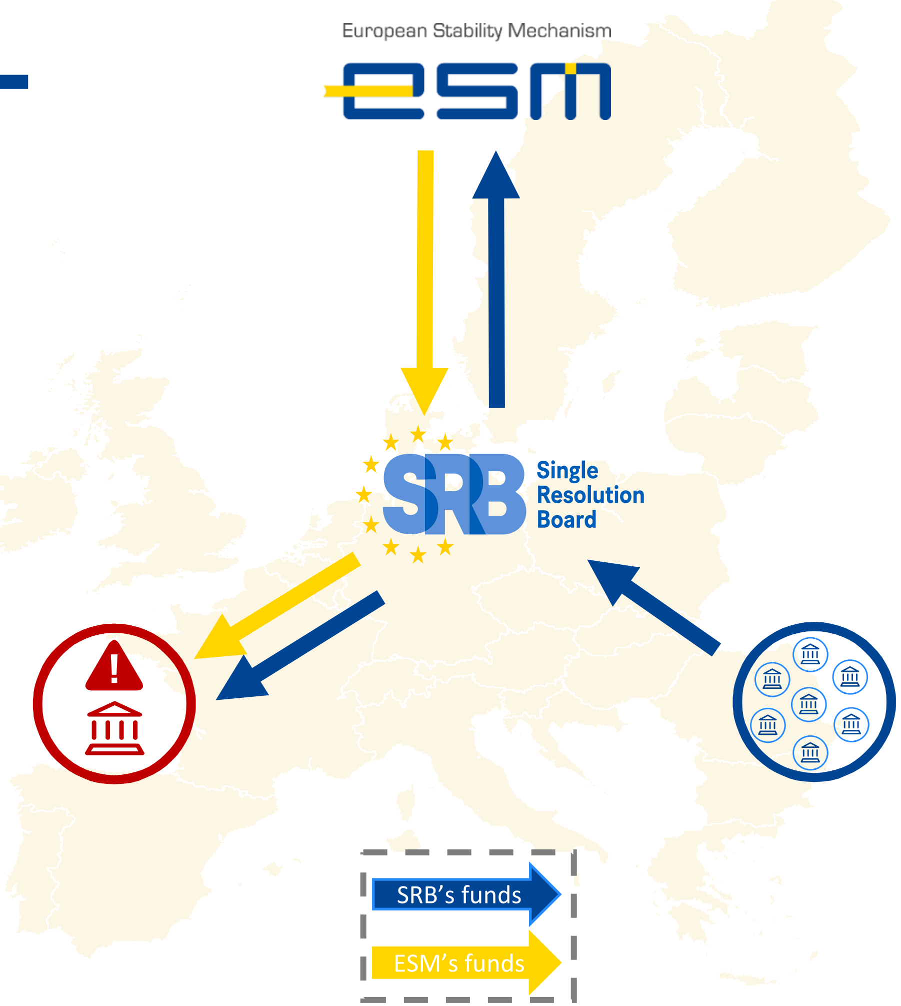
- **Elements to be finalized:**

- Common Backstop
- Reform of the CMDI framework
- European Deposit Insurance Framework
- Liquidity in Resolution

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

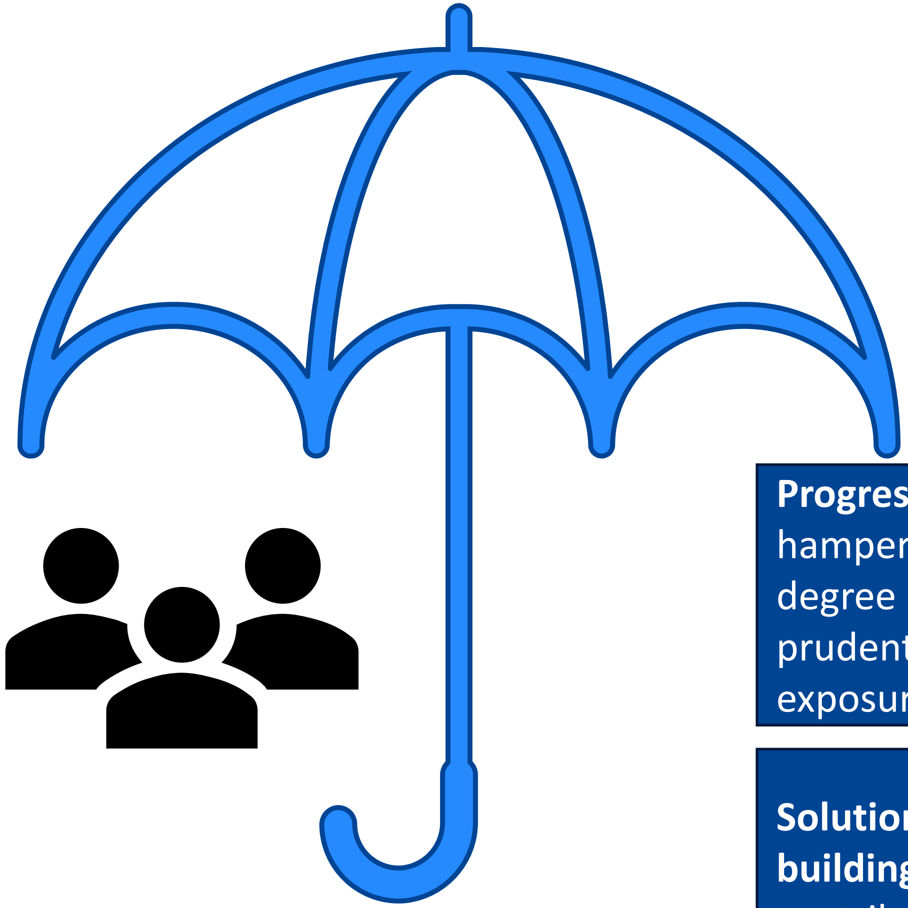
CRISIS MANAGEMENT AND DEPOSIT INSURANCE FRAMEWORK: CMDI REFORM

Gaps in the current CMDI framework	CMDI reform
Access to the SRF is difficult for medium banks, high burden sharing requirement: 8% bail-in may require bail-in of deposits, posing risk to financial stability.	It permits national Deposit Guarantee Scheme funds to be used as a "top-up" to meet the 8% requirement for banks to be resolved under transfer strategy.
Small and Medium banks managed outside the resolution framework, often resulting in protracted piece-meal liquidation, which generates significant value destruction	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.
Unpredictability of the Public Interest Assessment (PIA) : inconsistency across resolution cases with respect to the outcome of the PIA due to different interpretations.	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.
Early intervention measures (EIMs): some EIMs overlap with the supervisory actions and have been rarely used .	The proposal removes the overlaps and provides a clearer legal basis for the ECB to use such measures.
Preparation for resolution: 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.	The proposal provides additional details on cooperation in the run-up to resolution, concerning the type of information that should be exchanged.

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

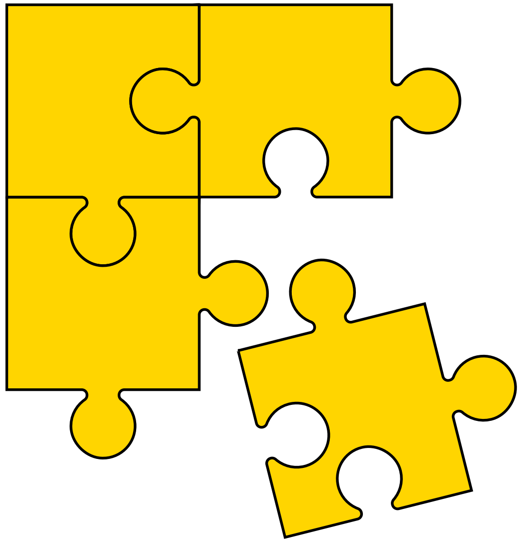
Mutualisation of DGSs: a bigger and more solid insurance framework which would strengthen financial stability in the euro area



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?

Q & A

ANNEX

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

- **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 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)

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.

European Stability Mechanism

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