BRUEGEL POLICY CONTRIBUTION

ISSUE 2013/18
DECEMBER 2013

ENDING UNCERTAINTY: RECAPITALISATION UNDER EUROPEAN CENTRAL BANK SUPERVISION

SILVIA MERLER AND GUNTRAM B. WOLFF

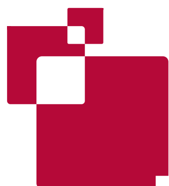
Highlights

- Estimates of the recapitalisation needs of the euro-area banking system vary between €50 and €600 billion. The range shows the considerable uncertainty about the quality of banks' balance sheets and about the parameters of the forthcoming European Central Bank stress tests, including the treatment of sovereign debt and systemic risk. Uncertainty also prevails about the rules and discretion that will apply to bank recapitalisation, bank restructuring and bank resolution in 2014 and beyond.
- The ECB should communicate the relevant parameters of its exercise early and in detail to give time to the private sector to find solutions. The ECB should establish itself as a tough supervisor and force non-viable banks into restructuring. This could lead to short-term financial volatility, but it should be weighed against the cost of a durably weak banking system and the credibility risk to the ECB. The ECB may need to provide large amounts of liquidity to the financial system.
- Governments should support the ECB, accept cross-border bank mergers and substantial creditor involvement under clear bail-in rules and should be prepared to recapitalise banks. Governments should agree on the eventual creation of a single resolution mechanism with efficient and fast decision-making procedures, and which can exercise discretion where necessary. A resolution fund, even when fully built-up, needs to have a common fiscal backstop to be credible.

Silvia Merler (silvia.merler@bruegel.org) is an Affiliate Fellow of Bruegel. Guntram Wolff (guntram.wolff@bruegel.org) is Director of Bruegel. The authors thank Zsolt Darvas and other Bruegel colleagues for excellent comments and discussions, and Giuseppe Daluiso for excellent research assistance.

Telephone
+32 2 227 4210
info@bruegel.org

www.bruegel.org



ENDING UNCERTAINTY: RECAPITALISATION UNDER EUROPEAN CENTRAL BANK SUPERVISION

SILVIA MERLER AND GUNTRAM B. WOLFF, DECEMBER 2013

EXECUTIVE SUMMARY

The European financial system is plagued by two major sources of uncertainty. First, there is still mistrust over the quality of banks' balance sheets. Second (and related to the first), major uncertainty remains about the rules that will apply to bank recapitalisation, bank restructuring and bank resolution in 2014 and in years to come.

The fact that the European Central Bank is due to become the single supervisor for euro-area banks, and that it will conduct a far-reaching preliminary assessment of banks' balance sheets, has the potential to greatly reduce the first uncertainty, because a centralised assessment will make balance-sheet information more transparent, comparable and credible. The ECB has already outlined the broad structure of the exercise and some important technical elements underpinning it, such as, for example, the 8 percent threshold of core Tier 1 capital that will be used as the benchmark capital level. However, to date, important parameters remain still undecided and/or have not yet been communicated. These include in particular the treatment of sovereign debt, the magnitude of the stress test and the treatment of systemic risk. In light of the relevance of these variables for the formation of market expectations ***ex ante*** and for the credibility of the stress tests ***ex post***, it will be important for the ECB to be as transparent as possible as early as possible.

The choices that still have to be made about these elements can potentially affect the results of the exercise. Market analysts and academics have put forward numerous estimates of the recapitalisation needs that might be identified by the stress tests for the euro-area banking system. The estimates vary widely between €50 billion and €650 billion. Differences in estimates are explained by the lack of information about the balance sheets of banks, and by the uncertainty over central parameters of the exercise, in particular the way the systemic dimension of the exercise will be approached.

If a recapitalisation need is identified, decisions will need to be taken about how the capital need will be met. In the current situation, the main guiding framework is national decision-making authority. Some harmonisation is introduced via the amended state-aid framework, which is discussed in this Policy Contribution. This regime however could lead to potentially significant differences between countries and could thereby deepen financial fragmentation. The Bank Recovery and Resolution Directive (BRRD) will improve the situation significantly in terms of harmonisation, but it will not be applied in 2014 when the ECB results will be known.

The discussion about bail-in is likely to remain topical in the context of this exercise. The modified state-aid regime ***de facto*** introduces bail-in of junior debt as a precondition for accessing public funds for bank recapitalisation. The BRRD will introduce tougher requirements from 2016. The new steady-state system should be based on strict and clear rules. However ***de facto***, policy discretion will always be exercised in some exceptional cases in order to prevent major systemic fall-outs from bail-ins. Who exercises this discretion, and how they do it, are of central importance.

Finally, there is the question of how remaining recapitalisation costs should be distributed between national taxpayers and taxpayers of other European countries. While during the transition phase to the new steady state, national taxpayers will inevitably have to shoulder most of the burden, we argue that in order to credibly break the vicious circle between banks and sovereigns, a European insurance scheme for the large risks,

INTRODUCTION

The European Council's June 2012 commitment to break the vicious circle between banks and sovereigns by creating a banking union is one of the most important steps taken towards a more integrated euro area. Since then, the co-legislators have agreed on the first element of banking union, the creation of a Single Supervisory Mechanism (SSM). Discussions on the single resolution mechanism (SRM) are still ongoing at the time of writing. There is now a political agreement on the Bank Recovery and Resolution Directive (BRRD). A central aspect of the political discussion is the rules governing the recapitalisation of banks and the important transitional arrangements on the way opposit42irsECB assesde. It93 Ttaliss' and8nomy

led E29nA0 11 365.8498 1.2 To b654[a3j-7.8112

savings to the taxpayer were rather subdued[3]. This opposition was mainly rooted in the concern – justified or not – that forcing losses on private investors would have had disruptive consequences for the stability of the financial system of the countries concerned, and of the euro area as a whole[4].

The general approach changed – although slowly – when it became evident that the strategy of total bailouts was costly and could have major systemic consequences. The channels are well known by now: high costs associated to bank recapitalisation cast doubts on the sustainability of public finances, initiating a 'vicious circle'[5] between sovereigns' and banks' misfortunes, which has been a characteristic feature of this crisis. Faced with the high cost of public bank rescues, European policymakers started to talk more openly about the possibility of private-sector participation. This started to be seen as a way to both reduce the cost for the taxpayer and to foster the right incentives, by allocating responsibilities to those that took risks in the first place. The Cyprus episode marked a jump to the extreme, leading to considerable confusion about the applicable framework for bank recapitalisation[6]. Since then, all in all, the EU has shifted from a framework in which private participation was abhorred to one where it will become the norm, but the transition is tricky and the timing is challenging especially in relation to the ECB's forthcoming comprehensive assessment of banks.

Against this background, we start by discussing estimates of potential recapitalisation needs that could result from the ECB's assessment of banks. This highlights that important choices, which will influence the outcome of the exercise, have not yet been made. It also highlights the fact that the ECB assessment will be ***de facto*** an assessment of the banking system and not just individual banks – which is necessary to restore trust but which is delicate, in view of the potentially substantial recapitalisation needs that it could imply. We then review the new rules on bank

1. See Constâncio (2013) on the way the SSM will further harmonisation.

2. This is what Bruegel scholar Nicolas Véron has called the 'Sanio doctrine' referring to the first large bail-out of the crisis that happened in Germany at the insistence of the BaFin president Jochen Sanio, with reference to the systemic nature of the affected bank and the Pfandbrief market.

3. Pisani-Ferry, Sapir and Wolff (2013) estimate the figure for Ireland to be about €5-10 billion.

4. See, for example, Asmussen (2012).

5. Gerlach, Schulz and Wolff (2010) empirically demonstrate that larger banking sectors and less-capitalised banking sectors can potentially constitute a significant burden on taxpayers and are therefore positively correlated with sovereign risk, in particular when risk aversion is increasing.

6. During the negotiations of the financial assistance programme for Cyprus, the Eurogroup initially agreed to also bail-in insured depositors. The resulting bank run led to a change in the decision and the safeguarding of insured depositors, but in the following weeks, concern arose in the market about whether Cyprus should be considered a 'template' for the application of bail-in in the near future.

recapitalisation and note that there is still considerable uncertainty, which should be removed before the ECB takes over as supervisor.

1 BANK RECAPITALISATION NEEDS, WHAT TO EXPECT

1.1 Elements of uncertainty in the design

The ECB will assume its new supervisory tasks in November 2014. Before that, together with national competent authorities (NCAs), the ECB will conduct a comprehensive assessment of the banking system, to be concluded in October 2014. This exercise will involve all banks that will in the future be directly supervised by the ECB, ie about 130 banks in 18 euro-area countries, accounting for approximately 85 percent of total euro-area bank assets. The comprehensive assessment is to be undertaken by the ECB based on the transitional arrangements laid out in Article 33.4 of the SSM regulation[7]; national authorities and the credit institutions concerned will supply the necessary information as requested. According to the ECB, the assessment has three elements[8]:

- A supervisory risk assessment, addressing key risks in the banks' balance sheets, including liquidity, leverage and funding.
- An asset quality review, examining the asset side of banks' balance sheets as of 31 December 2013. All asset classes, including non-performing loans, restructured loans and sovereign exposures, will be covered.
- A stress test, building on and complementing the asset quality review by providing a forward-looking view of banks' shock-absorption capacity under stress.

The ECB will set capital thresholds as a benchmark for the outcomes of the exercise amounting to 8 percent Common Equity Tier 1 (CET 1). The threshold is decomposed to 4.5 percent, which is the ratio that will be legally mandatory as of 1 January 2014 according to Capital Requirement Directive (CRD IV) and the Capital Requirement Regulation (CRR), a capital conservation buffer of 2.5 percent, and an add-on of 1 percent to take into account the systemic relevance of banks. The capital ratios make reference to the new regime that will phase in with the Capital Requirement IV Directive. The 4.5 percent is the minimum CET 1 capital ratio required under CRD IV (up from 2 percent) whereas the capital conservation buffer is a new prudential tool introduced by the Basel III standard on bank capital adequacy, stress testing and market liquidity risk, and implemented by the CRD IV, which sets it at 2.5 percent of Risk Weighted Assets (RWAs). The capital conservation buffer will however only start to phase in gradually as of 2016. CRD IV includes also a mandatory systemic risk buffer of between 1 and 3.5 percent CET 1 of RWAs for banks that are identified by the relevant authority as globally systemically important. Moreover, CRD IV also gives the supervisor an option to set a buffer on 'other' systemically important institutions, including domestically-important institutions and EU-important institutions. The decision by the ECB to introduce an additional systemic buffer echoes a choice previously made by the Federal Reserve

7. Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions.

8. ECB Note, Comprehensive Assessment October 2013, http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf.

9. See ***Comprehensive Capital Analysis and Review 2014 Summary Instructions and Guidance***, 1 November 2013, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131101a2.pdf, and ***2014 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule***, 1 November 2013, http://www.federalreserve.gov/bankinforeg/bcreg20131101a1.pdf.

10. CRD IV establishes five new capital buffers: the capital conservation buffer, the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer. In addition, supervisors may add extra capital to cover for other risks following a supervisory review, and institutions may also decide to hold an additional amount of capital. See http://europa.eu/rapid/press-release_MEMO-13-690_en.htm.

11. The CRR follows Basel III and sets 13 criteria that any instrument would have to meet to qualify as CET 1. The criteria are listed in Article 28(5) of Regulation (EU) No 575/2013.

12. The transition period is established to ensure that before the new capital requirements apply in full, banks are given time to adapt in order to avoid nega-

it has neither been communicated what would happen with banks falling below the 4.5 percent threshold in the comprehensive assessment, nor it is clear how tough the ECB will be with banks above 4.5 percent but below 8 percent[14].

The ECB has signalled that it will publish further details about the comprehensive assessment by the end of January 2014.

1.2 Market expectations

Researchers and bank analysts have expressed their hope that the exercise will be a central element in the strategy to restore trust in Europe's banking system. One big difference between the current exercise and previous European Banking Authority exercises is that the ECB will actually become the competent supervisor. It will therefore have far-reaching powers and it will also be able to make sure that banks' internal risk models will be harmonised. This should contribute substantially to restoring trust in Europe's banking system.

Currently, market-based valuations of banks in Europe suggest that investors still do not trust entirely the quality of banks' balance sheets. Figure 1 shows that the market-to-book value of major banks in five selected euro-area countries

tive consequences for their activity of lending to the economy. In particular the phase out of capital instruments that will not meet the new and stricter eligibility criteria is to last eight years from 2014.

13. The guidelines state that ***'the capital definition of 1 January 2014 will apply for the asset quality review, whereas the definition that is valid at the end of the horizon will be used for the stress test'***. With the horizon of a stress test normally being around 3 years, the ***'definition valid at the end of the horizon'*** could include part of the transition period before the implementation of the stricter capital definition that would apply under CRD IV/CRR. But the ECB would be using (and stressing) underlying balance sheet data at end-2013, ie before the transition to the new capital definition comes into effect, which could create a problematic mismatch.

14. Current legislation only foresees the 4.5 percent threshold for existing bank balance sheets. Once the transition phase for capital conversion buffers is over, the law would also require banks that do not hold the full 2.5 percent capital conversion buffer to refrain from certain practices, such as payments of dividends. However, these rules are formally not applicable in 2014.

to more than 5 per cent of euro-area GDP"[15]

policy decisions have been taken that will allow the assessment of the capital shortfalls. The most important policy choices concern GDP projections, the treatment of sovereign debt and the extent to which systemic risk is taken into account in the tests. The ECB has therefore clearly communicated that no intermediate results can be published[22]. The fact that capital levels have increased in recent years does certainly not preclude the potential for further recapitalisation needs being detected.

To establish its credibility as a supervisor, the ECB should not only be tough in its assessment. It should also not shy away from forcing banks to raise new capital and in ***ultima ratio*** forcing banks into restructuring and resolution. The result may be temporary volatility on the financial market, which should be weighed against the cost of a lasting weak and dysfunctional banking system and the credibility of the ECB as a supervisor and also as a monetary authority. In the period of possible financial instability, the ECB should stand ready to provide large amounts of liquidity to the banking system. Governments should be supportive of this policy, even if the liquidity provision would result in a rise in Target2 balances.

Against this background, the next section discusses principles and practices of bank recapitalisation. Particular emphasis is put on the existing rules, which are the state aid rules, on the BRRD and on the principles that should govern the SRM.

2 BANK RECAPITALISATION: HOW AND WHEN

The comprehensive assessment of Europe's banking system in 2014 will start the phase of single bank supervision in Europe. The exercise is of fundamental importance for the ECB, because it will be the basis of its reputation as supervisor. Some market participants seem to have doubts about the fact that the exercise will be a game-changer. A recent investor survey run by Morgan Stanley[23] showed that the majority of investors interviewed did not see the AQR/stress tests as likely to have a meaningful impact on boosting lending. To avoid episodes like Dexia – which jeopardised the reputation of the EBA's stress tests in 2011 – ensuring credibility is crucial, and statements from ECB officials suggest it will be biting. ECB President Draghi has stated[24] that if banks ***'do have to fail, they have to fail. There is no doubt about that'***. This consideration has led to animated discussions at the political level across Europe about how to deal with the shortfalls that will possibly be discovered. More specifically, a key point in the debate surrounding the ECB's exercise is the optimal degree of private versus public contribution to the recapitalisation, in the case of banks that were not able or willing to raise all (or part) of the needed capital on the market.

A number of issues should be carefully considered when deciding on the how and when of bank recapitalisation.

Who should decide on whether a bank needs to

'To establish its credibility as a supervisor, the ECB should not only be tough in its assessment. It should also not shy away from forcing non-viable banks into restructuring and resolution, though the result may be temporary volatility on the financial market.'

stances, the ECB will as the relevant supervisor ask the bank to raise its capital levels.

If a bank cannot or does not want to raise private capital, under current legislation, state aid rules would determine how public resources would be used. In July 2013, the European Commission issued a new communication that amends the

sufficient number of large banks to provide a meaningful number to diversify risks. However, to be fully credible, such a fund would need to have a credit line to the European taxpayer, which could, for example, be based on the ESM. In the steady state, it will also be important to keep national taxpayers on the hook. As long as numerous national policies influence the likelihood of bank failures, the continuing exposure of national taxpayers alongside the common insurance fund is justified.

For the transition, the main principle should be that the European insurance fund should be only used for large risks that endanger national public solvency. National budgets can take care of small public recapitalisation needs. For somewhat larger risks, a programme similar to the Spanish programme is advisable in order to avoid the risk of a country's government being priced out of the market. In some cases of very large capital needs, direct bank recapitalisation from the ESM, combined with national taxpayer contributions, is advisable to take care of the legacy problems. This can be motivated not only by the fact that government solvency problems should be prevented. Equally important is the fact that some of banking problems are not the responsibility of faulty national supervision, but have arisen for euro-area financial stability concerns[32]. In such circumstances, the case for burden sharing is strong. It is impossible to agree ***ex ante*** on precise thresholds at which direct bank recapitalisation should be carried out. Certainly, when banking rescue costs are high, a debt sustainability analysis should be undertaken. There may also be instances in which government solvency is in any case endangered undermining the logic of direct bank recapitalisation. During the transition, policy discretion will remain a defining element of providing support. However, it is important to limit this discretion as much as possible so that the same conditions pertain for all countries. Furthermore, it is important that the ECOFIN clearly signals its intention to find the best European solution for the recapitalisation and restructuring during the transition, and that it commits to a clear roadmap towards a European resolution authority that will eventually take such decisions with qualified majority voting and based on a single backstop[33].

CONCLUSIONS

The euro area has embarked on a process of creating a banking union, which is of critical importance to the stability of the common currency c2ea. Angesn t(u)02uvaluthe singlgesn tact JT*. beker.0061

Barisitz, Stephan (2013) 'Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions', ***Focus on European Economic Integration*** 2013, 1: 28-47, National Bank of Austria

Constâncio, Vitor (2013) 'Banking union and the future of banking', speech at the IIEA Conference on ***The Future of Banking in Europe***, Dublin, 2 December, available at http://www.ecb.europa.eu/press/key/date/2013/html/sp131202.en.html

Darvas, Zsolt (2013) 'To bail-in or not to bail-in, that is the question for Cyprus', ***Bruegel Blog*** 14 March, available at http://www.bruegel.org/nc/blog/detail/article/1043-to-bail-in-or-not-to-bail-in-that-is-the-question-now-for-cyprus/

Dor, E. (2013) 'The recapitalisation needs of European banks if a new financial crisis occurs', ***Working paper*** 2013-ECO-19, IESEG School of Management, available at http://www.ieseg.fr/wp-content/uploads/2013-ECO-19_Dor.pdf

Gerlach, Stefan, Alexander Schulz and Guntram B. Wolff (2010) 'Banking and sovereign risk in the euro area', ***Discussion Paper***, Series 1: Economic Studies 09/2010, Deutsche Bundesbank, available at http://econstor.eu/bitstream/10419/32799/1/627499228.pdf

Pisani-Ferry, Jean, André Sapir and Guntram B. Wolff (2013) ***EU-IMF assistance to euro area countries: an early assessment***, Blueprint 19, Bruegel

Pisani-Ferry, Jean and Guntram B. Wolff (2012) 'The fiscal implications of banking union', ***Policy Brief*** 2012/02, Bruegel

Sapir, André and Guntram B. Wolff (2013) 'The neglected side of banking union: reshaping Europe's financial system', contribution to informal ECOFIN, 14 September, Bruegel, available at http://www.bruegel.org/publications/publication-detail/publication/792-the-neglected-side-of-banking-union-reshaping-europes-financial-system/

Schweitzer, Frank (2009) 'Mechanisms of Systemic Risk: Contagion, Reinforcement, Redistribution', presentation to ZIF Workshop, Bielefeld, Germany, 1-11 September, available at http://www.sg.ethz.ch/media/talk_slides/zif-schweitzer-presentation.pdf

Véron, Nicolas (2013) 'A realistic bridge towards European banking union', ***Policy Contribution*** 2013/09, Bruegel

Véron, Nicolas and Guntram B. Wolff (2013) 'From supervision to resolution, next steps on the road to European Banking Union', ***Policy Contribution*** 2013/04, Bruegel

Xin Huang, Hao Zhou and Haibin Zhu (2011) 'Systemic Risk Contributions', ***Finance and Economics Discussion Series*** 2011-08, Federal Reserve Board, Washington DC, available at http://www.federalreserve.gov/pubs/feds/2011/201108/201108pap.pdf