NEXT STEPS FOR THE COMPLETION OF BANKING UNION AND THE REDUCTION OF NON-PERFORMING LOANS

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Conference on Completing the Banking Union, Ljubljana, 14 February 2018

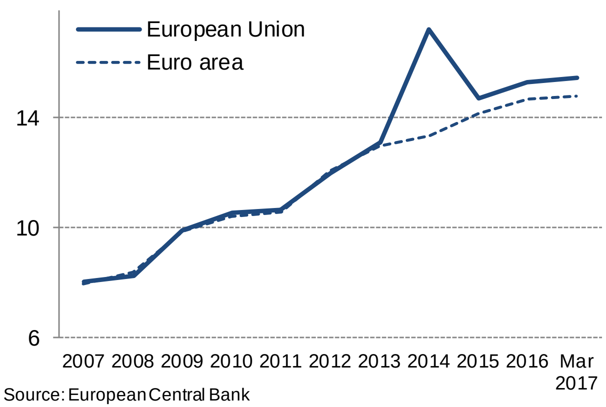
European Commission

Banking and finance

13/02/2018

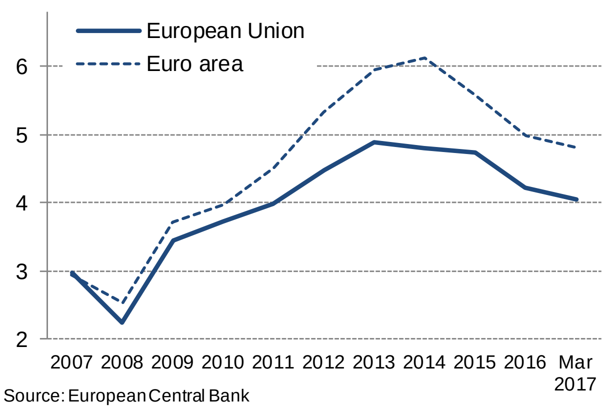
Since the financial crisis, European banks have more capital, higher asset quality, more stable funding structures

Banks' equity: Tier 1 ratio (%)



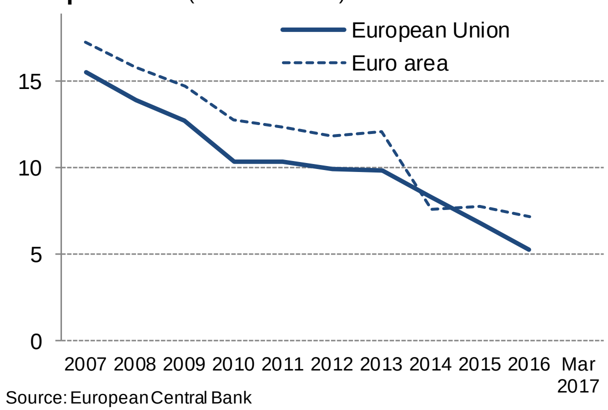
Source: European Central Bank

Gross non-performing debt instruments
(in % of total gross debt instruments, end-of-period values)



Source: European Central Bank

Banks' funding structure: Interbank market dependence (% of total assets)



Source: European Central Bank

Yet, problems remain in banks and Banking Union:

Institutions

- **Banks' profitability: cyclical and structural challenges**
- **Still high amounts of non-performing loans in some Member States / institutions (→ ECOFIN Action Plan, July 2017)**
- **Home bias of assets: misallocation of risk**
- **….**

European framework

- **Banking Union is not completed (in particular, a common deposit insurance (→ EDIS) and a backstop are still missing).**

The broader picture: EMU Package

Announced in the 2017 State of the Union Address, it builds on the Five Presidents' Report of June 2015 and the Reflection Paper on the deepening of EMU of May 2017.

Support the principles of unity, efficiency and democratic accountability

It encompasses:

- *Communication on further steps towards completing Europe's Economic and Monetary Union;*
- *Communication on the European Minister of Economy and Finance*
- *Regulation for the integration of the ESM as the EMF*
- *Directive for the integration of the TSCG (fiscal compact) into EU law*
- *Communication on budgetary instruments*
- *Amendment of the Common Provisions Regulation*
- *Amendment to the Structural Reform Support Programme*

Completing the Banking Union

2017 State of the Union Address

Banking Union should be completed by the end of 2018, if it is to deliver its full potential as part of a strong Economic and Monetary Union (EMU)

State of play: Single rulebook, Single Supervisory Mechanism and Single Resolution Mechanism are in place

→ *Last October the Commission issued a* ***Communication on completing the Banking Union***

Aim of the Communication: set out an ambitious but realistic path in order to achieve political agreement and put in place the missing pieces (EDIS, backstop)

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The content of the BU Communication

- ***Risk reduction measures proposed in 2016***
- ***EDIS***
- ***Backstop***
- ***Non-Performing Loans (NPLs)***
- ***Sovereign Bonds Back Securities (SBBSs)***

=> To be completed by 2018

Risk reduction through the November 2016 Banking Package

The November 2016 Banking Package fulfils most of the objectives set out in the 2016 Council Roadmap in terms of further risk reduction in the banking sector.

In particular with the implementation of *Total Loss-Absorbing Capacity (TLAC) /MREL, creditor hierarchy, moratorium powers and remaining Basel reforms (including NSFR and leverage ratio).*

What the BU Communication proposes:

=> With a view to swift progress and reach an as rapid adoption as possible, EP and Council are encouraged to maintain the clearly defined scope of the package.

Moving forward towards a European Deposit Guarantee Scheme (EDIS)

Increased resilience of the Banking Union through strong and uniform insurance coverage for all depositors in the Banking Union

Negotiations on the Commission's proposal have stalled

What the BU Communication proposes:

=> Sets out proposals to help facilitate a compromise on EDIS and allow political agreement in 2018

Main features of the 2015 legislative proposal

- EDIS is introduced in 3 phases (reinsurance, coinsurance, full insurance).
- In all 3 phases both liquidity shortfalls and losses are covered but to a limited extent in the first two phases.
- The transition from one phase to another is automatic when reaching the date set (2020 starts co-insurance and 2024 starts full insurance).

Main suggestions for EDIS (of 2017)

Introduce EDIS in a more gradual manner, commensurate to progress on risk reduction and the tackling of legacy issues:

- *Two phases (re-insurance and co-insurance)*
- *Only liquidity coverage up to 100% by 2022*
- *Loss coverage subject to <u>conditions</u> starting at 30% in 2022*
- *Such conditions could include a targeted AQR to address NPLs and Level III assets issues.*

→ Commission proposal of 2015 is still on the table, as well as the ambition to have at the end a fully-fledged EDIS.

→ details of such ideas to be specified and negotiated by the co- legislators.

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HOW WOULD THE REVISED EDIS PROPOSAL WORK?

PHASE 1
Reinsurance

	2019	2020	2021
EDIS covers liquidity shotfall after national Deposit Guarantee Systems (DGS) exhausted, repayable	30%	60%	90%
EDIS does not cover losses	0%	0%	0%

TRANSITION CONDITIONAL ON

- ✓ targeted asset quality review on legacy risks, incl. NPLs
- ✓ banks address legacy risks with clearly defined targets
- ✓ actual reduction of NPLs
- ✓ monitoring by Single Supervisory Mechanism

TO BE CONFIRMED BY COMMISSION

PHASE 2
Coinsurance

EDIS covers all liquidity needs from first euro and increasingly covers losses.

2019 · 2020 · 2021 → indicatively **2021**

Completing a Backstop to the Banking Union

A common fiscal backstop would reinforce the overall credibility of the bank resolution framework within the Banking Union and instil confidence in the Single Resolution Mechanism

MS agreed in 2013 on the development of a common backstop

Criteria for the backstop identified in 2017 EMU Reflection Paper

What the BU Communication proposes:

=> Operationalize as rapidly as possible and to be articulated with December proposal for transforming the European Stability Mechanism (ESM) into a European Monetary Fund

Actions announced to address NPLs

The aim is to further reduce the high levels of NPLs that hinder banks from providing new credit to the real economy, and limit economic growth.

Since mid-2014, The EU NPL ratio has decreased from 6.7% to 4.5%. But progress is slow where it is needed the most. Measures are also needed to prevent a future NPL build-up.

Therefore the Commission is currently working to implement and accelerate the Council's Action Plan on NPLs adopted in July.

The Commission will present a package of concrete measures in spring 2018.

Package of NPL measures in spring 2018

1) Blueprint for Asset Management Company (AMC)

2) Measures to develop secondary markets for NPLs

3) Measures to enhance the protection of secured creditors

4) Statutory prudential backstops to avoid under provisioning of NPLs

The Commission is also undertaking a benchmarking exercise of loan enforcement regimes

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Focus on Blueprint: Council Mandate

The "Action Plan To Tackle Non-Performing Loans In Europe" invited the Commission to develop (in cooperation with other relevant institutions), by the end of 2017, a "Blueprint" for the potential set-up of national asset management companies (AMCs).

Such a Blueprint for national AMCs was and continues to be widely cited as a key tool to speedily address legacy NPL stocks.
Measures to warehouse NPLs would allow for reconciling the need for immediate removal of NPLs from banks' balance sheets with the "slow-burning" nature of many of the proposed reforms (cfr. insolvency).

Scope of the Blueprint: Centralised AMCs

- There are many different measures than can be effective and efficient in handling NPLs. Their utility depends on the specific situation, including
  - ✓ the size of the NPL-problem,
  - ✓ the concerned asset classes and
  - ✓ banks' own capacity to manage and work out NPLs.
- This Blueprint focuses on centralised AMCs at national level, that can acquire assets from many banks.
- Centralised AMCs can be fully private or state-sponsored without State aid, if the State can be considered to act as any other economic agent. Setting up an AMC with State aid should therefore not be seen as the default option.
- However, the Blueprint clarifies, in detail, key success factors and the permissible design for such state-sponsored AMCs, consistent with the EU legislative framework.

Conditions for asset transfer to an AMC

In the case of a publicly supported AMC, consistency/compliance with the EU legal framework needs to be ensured, i.e. state-aid rules, the BRRD and the SRMR:

A number of scenarios are possible in which a bank transfers NPLs to a publicly supported AMC:

- No involvement of State aid;
- Resolution;
- Insolvency proceedings under national law;
- Precautionary recapitalisation (in exceptional cases).

If the assets are bought at a price exceeding the estimated market value (EMV), then the transaction involves State aid, which amounts to the difference between the actual transfer price and the EMV. The transaction then has to be approved by the Commission before it can be implemented

The transfer price cannot exceed the assets' real economic value (REV).

An enabling framework for Sovereign Bond-Backed Securities (SBBS)

Need to reduce risks to financial stability through diversification of banks' sovereign portfolios and weakening banks' home bias in their sovereign exposures

SBBS could contribute to more geographical portfolio diversification

What the BU Communication proposes:

=> In light of the upcoming report of the European Systemic Risk Board (ESRB), the Commission would consider putting forward legislative proposal for an enabling framework for the development of SBBS (2018)

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Thank you for your attention