Reform of the EU Banking Framework: Progress and Challenges

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Challenges of the EU Banking System

- What has been achieved so far
- Completing the Banking Union
  - TLAC/MREL
  - EDIS
- Dealing with NPLs
What has been achieved so far
European banks' capital levels

EU Tier 1 ratio [%]
Eu, domestic banking groups and stand-alone banks

Source: ECB, IMF (for US)
European banks' leverage ratio

Source: ECB, IMF (for US)
European banks' funding: more stable

Liquidity Coverage Ratio

Net Stable Funding Ratio

Source: EBA QIS data (June 2016)

Group 1 banks are banks with Tier 1 capital in excess of EUR 3 billion and which are internationally active. All other banks are categorised as Group 2 banks. This report has classified Group 2 banks into sub-groups: large Group 2 banks.
A Croatian perspective

• Croatian economy in slow recovery from a long recession

• Croatian banks remain highly capitalized

• NPLs slowly beginning to decline, but still among highest in EU

• Economy is highly euroized

• Economic vs. prudential considerations
Completing the Banking Union
Key elements of the Banking Union

- Single Supervisory Mechanism
- Single Resolution Mechanism
- European Deposit Insurance Scheme
- Single Rule Book (CRR/CRD IV, BRRD, DGSD)
Roadmap for completing Banking Union

Risk Reduction
- CRR/CRD IV, BRRD, DGSD, SSM, SRM
- COM Banking Package

Risk Sharing
- SRF
- EDIS SRF Backstop
Completing the Banking Union

TLAC/MREL
TLAC/MREL

• MREL already introduced by EU under BRRD on a firm-specific basis

• TLAC agreed at G20 level for G-SIBs, will come into force in 2019

• Commission proposes to integrate TLAC minimum requirement into existing MREL rules

• Minimum TLAC requirement (Pillar 1) through amendments to CRR

• Firm-specific add-ons for G-SIBs/non-G-SIBs through targeted amendment to BRRD
Completing the Banking Union

EDIS
Commission proposal for EDIS

Phase 1: Re-insurance
2017-2019

Phase 2: Coinsurance
2020-2023

Phase 3: Full insurance
2024
Why we need EDIS

National deposit guarantee schemes remain vulnerable to large, national shocks. By contrast, EDIS will

• Enhance resilience against future crises

• Align incentives across all pillars of the Banking Union

• Reinforce depositor confidence and promote financial stability

• Enhance free movement of capital – due to equal treatment of deposits across countries

• Reduce moral hazard by adding European dimension
EDIS: the roadmap

**Commission proposal**
November 2015

Follow-up to Five Presidents' Report
Aims to give Banking Union the 3rd pillar

**EP draft report**
(De Lange)
November 2016

Only two stages of implementation and move to full insurance conditional

**Council discussions**

Still at an early stage
Dealing with NPLs
NPL ratio by Member State

Gross non-performing debt instruments [\% of total gross debt instruments]
Domestic banking groups and stand-alone banks
NPL level by Member State

EUR Bn

Total NPLs: $1.2 Tn

Source: ECB
NPL coverage ratio by Member State

Total accumulated impairment [% of total gross non-performing debt instruments]
Domestic banking groups and stand-alone banks

2016Q3 (UK 2016Q1)

Source: ECB
Croatia: Financial CSRs and NPLs

- **2016:** Facilitate the resolution of non-performing loans, in particular by improving the tax treatment of the resolution of non-performing loans.

- **2015:** Reinforce the pre-insolvency and insolvency frameworks for businesses in order to facilitate debt restructuring and put in place a personal insolvency procedure. Strengthen the capacity of the financial sector to support the recovery in view of challenges from high non-performing loans.

- **2014:** Complement the 2014 European Central Bank's asset quality reviews and stress test exercises, undertake a comprehensive portfolio screening exercise designed specifically for the Croatian financial sector.
NFC NPLs and investment

NPL build-up

NPL work-out
Investment and GDP growth
Towards a virtuous cycle of NPLs

1st quadrant:
High NPLs
High level of impaired loans, low coverage ratio

2nd quadrant:
High NPLs
High level of impaired loans, increased coverage ratio

3rd quadrant:
Low NPLs
Decreased level of impaired loans with still a high coverage ratio

4th quadrant:
Low NPLs
Low level of impaired loans with a low / sustainable coverage ratio

Low coverage ratio

High coverage ratio

Increasing coverage ratios to reduce differences between transaction prices and net book values

Incentive to dispose of impaired loans and to higher levels of recovery (increased coverage ratios leading to smaller differences between transaction prices and net book values)

Further disposals and recovery of loans with mainly high coverage ratios
NPL disposal: what strategy?

**Long term**
- Reform of insolvency & enforcement regimes
- Increasing the capacity of the judiciary
- Removing impediments to secondary markets
- AMCs
  - Precautionary recapitalization
  - Securitization schemes
- Increased transparency & accounting requirements
- System-wide stress testing
- Further enhanced supervision
- Strengthened prudential framework for banks

**Short term**
- Avoiding a future build-up of NPLs
- Resolving the legacy stock of NPLs
- National actions can benefit from coordination at EU level

**National level**

**EU level**

Avoiding a future build-up of NPLs
Resolving the legacy stock of NPLs

National actions can benefit from coordination at EU level
AMCs as precautionary recap

• It seems conceivable to provide a bank with aid in the form of precautionary recap to finance an AMC

• All the conditions in Article 32 BRRD/18 SRMR as well as in the State Aid framework must be complied with
Making it possible

- Supervisory Guidance on NPL management (SSM-NCAs)
- (Internal/External) NPL Capacity Management (Banks)
- Transparency on asset quality (SSM-NCAs)
- Insolvency, foreclosure and judicial frameworks (MS)
- Secondary markets and AMC
- State-aid: viability, burden sharing*, competition
- Precautionary Recap: state-aid in BRRD without resolution

(*) To address already incurred losses and losses to be incurred in the near future
### Table 1 - Number of closed and open bad loan positions
(annual data; number of positions and per cent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Num. of closed positions</th>
<th>Num. of new positions</th>
<th>Num. of positions outstanding in each year</th>
<th>Num. of closed/outstanding positions at the start of the year (%)</th>
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</thead>
<tbody>
<tr>
<td>2006</td>
<td>198,588</td>
<td>158,713</td>
<td>547,175</td>
<td>36.3</td>
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<tr>
<td>2007</td>
<td>161,209</td>
<td>189,720</td>
<td>575,686</td>
<td>28.0</td>
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<tr>
<td>2008</td>
<td>123,615</td>
<td>176,769</td>
<td>628,840</td>
<td>19.7</td>
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<tr>
<td>2009</td>
<td>133,976</td>
<td>183,033</td>
<td>677,897</td>
<td>19.8</td>
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<tr>
<td>2010</td>
<td>128,168</td>
<td>233,966</td>
<td>783,695</td>
<td>16.4</td>
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<td>2011</td>
<td>145,538</td>
<td>199,196</td>
<td>837,353</td>
<td>17.4</td>
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<tr>
<td>2012</td>
<td>128,653</td>
<td>230,694</td>
<td>939,394</td>
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<td>2013</td>
<td>112,331</td>
<td>228,153</td>
<td>1,055,216</td>
<td>10.6</td>
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<td>2014</td>
<td>287,685</td>
<td>341,271</td>
<td>1,108,802</td>
<td>25.9</td>
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<td>2015</td>
<td>257,965</td>
<td>325,488</td>
<td>1,176,325</td>
<td>21.9</td>
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<tr>
<td>TOTAL</td>
<td>1,677,728</td>
<td>2,267,003</td>
<td>833,038</td>
<td>21.0</td>
</tr>
</tbody>
</table>

**Media**

- 167,773
- 226,700
- 833,038
- 21.0
Conclusions

• We are much better off than we were before

• But we still need to work on remaining challenges:

  • *system-wide*: complete the Banking Union
  • *idiosyncratic* (bank-by-bank): deal with NPLs