

Andrea Enria Speech at Finest
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Speech by Andrea Enria, Chairperson of the EBA Milan, 30 November 2017

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

“Restoring asset quality and building loss absorbing capacity”

It is a great pleasure for me to take part in the 2017 FINEST Winter Workshop and I would like to thank Professor Petrella for inviting me. One of the few positive side effects of the financial crisis is the stronger connection between academic research and regulatory debates on banking matters. I feel a great responsibility in delivering the closing speech in your workshop and will interpret my role by focusing my remarks on two key challenges for the regulatory repair process in EU banking: restoring asset quality and building loss absorbing capacity.

In recent years, significant progress has been achieved in the repair of bank balance sheets. But the job is not yet complete.

On the assets side, a common definition of non-performing loans (NPLs) and wide-ranging asset quality reviews (AQR) allowed identifying the scale and distribution of asset quality problems. The actual cleansing of banks' balance sheets is however still work in progress: we recently saw an

acceleration in the decrease of the NPLs ratio, but we are still well above pre-crisis levels. The ECB has increased supervisory pressure on banks and the Council approved in July this year a comprehensive action plan on NPLs, which now needs to be followed up with concrete policy measures.

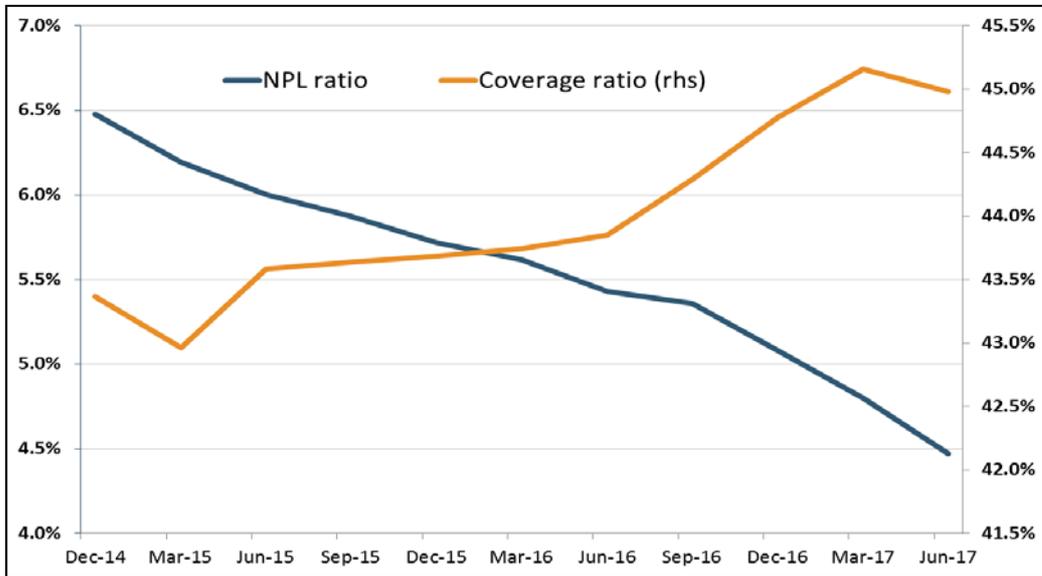
On the liabilities side, banks have significantly strengthened their capital position, adjusting to the more demanding regulatory requirements and responding to the policy pressure exercised via EU-wide stress test exercises. But loss absorbing capacity – including equity and other debt instruments that could be converted into equity or written down if a bank is failing or likely to fail – has not yet achieved levels that would ensure a smooth exit from the market in future crises. The fast-tracked approval of the legislative proposals to harmonise the hierarchy of creditors and the efforts of resolution authorities to set clear targets for the minimum requirements for own funds and eligible liabilities (MREL) should favour a faster build-up of loss absorbing capacity in the months to come.

Restoring asset quality and building up loss absorbing capacity should progress in parallel, as they are the twin components of the overall strategy for risk reduction after the financial crisis. Both the European Commission and the ECB recently reminded that progress of the risk reduction agenda is an important condition for the completion of the Banking Union, with the implementation of risk sharing arrangements.

Restoring asset quality

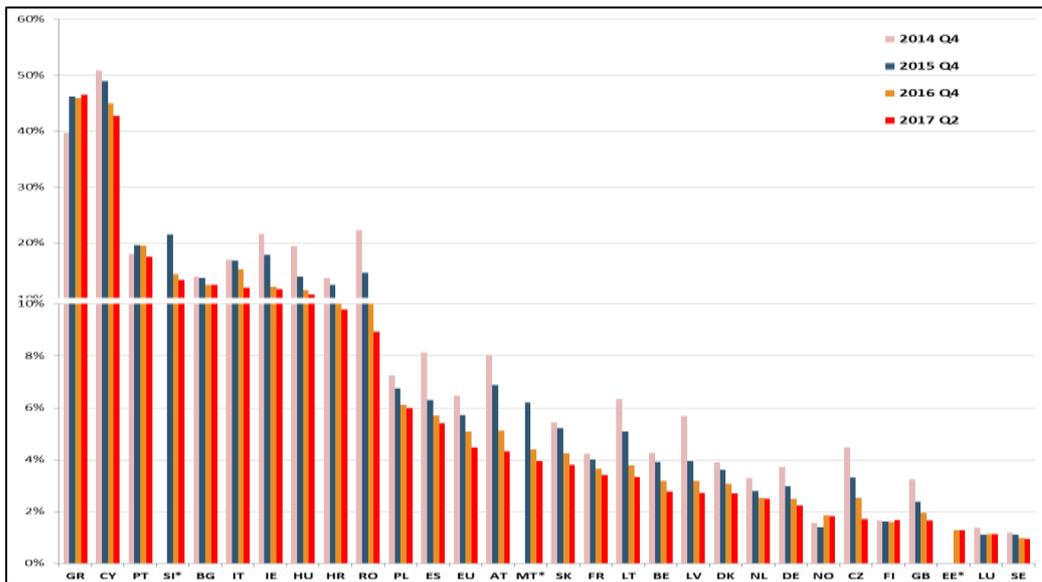
Cleansing the EU banking sector's balance sheet and resolving non-performing loans (NPLs) remain a challenge. Notwithstanding an improving trend, the stock of NPLs is still high in the EU, at about EUR 900 billion. As of June 2017, the weighted average NPL ratio was down to approximately 4.5%, whereas the coverage ratio reached 45% (see Figure 1). The EU average is still above the pre-crisis level, but below the threshold identified by the IMF as critically impairing bank profitability and lending capacity. Still, in 8 Member States the NPL ratio was above – in few cases well above – 10% in June 2017 (see Figure 2). The progress in the recognition and disposal of NPLs has been supported by some high profile operations and needs to broaden in scope (see Figure 3).

Figure 1: NPL ratio vs coverage ratio (weighted average)



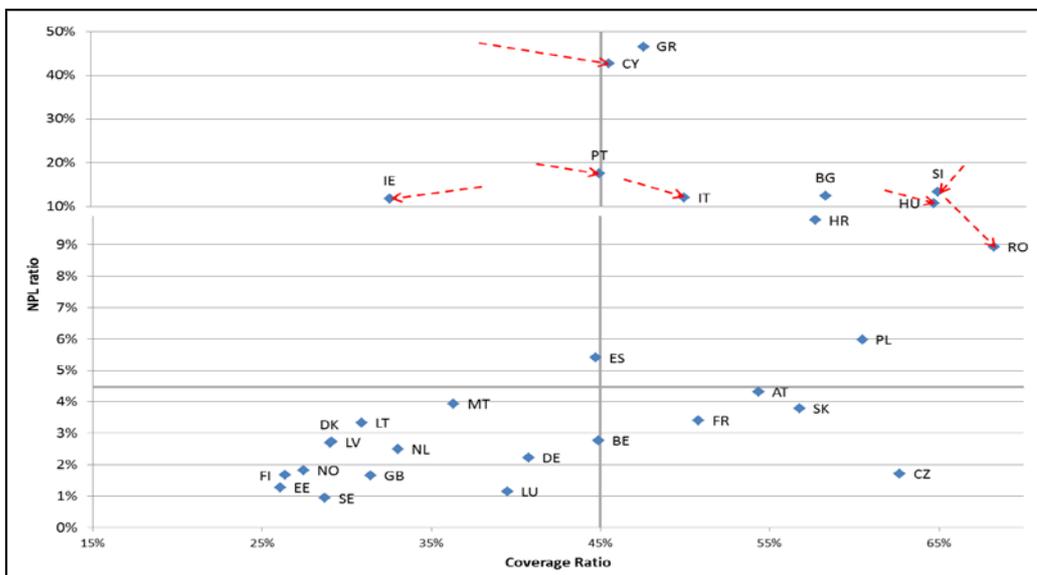
Sources: EBA supervisory reporting

Figure 2: NPL ratios (weighted average by country)



Sources: EBA supervisory reporting

Figure 3: NPL recognition and disposal – major migrations Q2-2016 to Q2-2017



Sources: EBA supervisory reporting

The management of NPLs is a priority for two reasons. A comprehensive strategy is needed to: i) erode the legacy stock at a faster pace; and ii) avoid the future build-up of NPLs. Achieving these two objectives requires tackling the numerous structural inefficiencies and market failures that hinder the NPL recognition and transfer process. The conclusions of the July 2017 Council reflect the fact that a set of complementary measures is needed. I will take this opportunity to go through what I believe are the major issues at stake, highlighting the action points foreseen at EU level to tackle them and the contributions the EBA plans to make.

Supervision of NPLs must be strengthened

Supervisory pressure on banks to pro-actively tackle NPLs is a prerequisite for any further actions. Banks have to develop a strategy for dealing with NPLs, strengthen their internal procedures, improve their arrears management, and more generally make NPL management active, efficient and informed.

Adopting conservative provisioning policies is becoming a very sensitive and debated topic. But let me remind that EU banks' impairments against asset deterioration were often perceived as insufficient, in certain jurisdictions more than in others. The incurred loss model – along with the excessive optimism on the evolution of credit quality in some cases – led to the 'too little, too late' problem. Banks were recognising losses only at a late stage, and not enough for bridging the gap

between book and market values of assets. Other things being equal, insufficient coverage widens the bid-ask spread, increasing the profit & loss hit that banks suffer when transferring the loans and may act as negative signalling towards investors. The IFRS 9 reform package recently fast-tracked by the co-legislators will contribute to address these problems.

Additional supervisory and regulatory measures are however necessary. The Council's action plan requires the Single Supervisory Mechanism to extend the scope of its NPL guidance to less significant institutions and mandates the EBA to produce similar guidance for all the institutions in the EU. Our guidelines will cover the management of arrears, the valuation of collateral and the work-out of losses. Banks will have to address asset deterioration with the appropriate governance structure, including by means of independent work-out units, robust collateral valuation policies and procedures and the establishment of adequate qualitative and quantitative risk management targets. Collateral valuation is one of the major hurdles in the NPL recognition and transfer process in that inadequate valuation processes are among the drivers of under-provisioning and are among the most important value adjustments that investors deem necessary when pricing NPLs. The work is ongoing and we are planning to start the consultation next year.

Under the same roadmap, the Commission has issued a consultation paper that discusses possible options for introducing a prudential backstop to the coverage of NPLs, in order to ensure that provisions on newly-originated loans turned non-performing are sufficiently conservative and time-bound. The draft proposal is that any shortfall between a minimum coverage requirement and the bank's actual coverage would have to be deducted from CET1 capital, within a specific maximum time lag that differs across the secured and unsecured portions of the NPL. The EBA was tasked with assessing the impact of such a proposal, with a view to testing different technical specifications, potential scope, and solutions to alleviate any cliff-edge effects. It is my view that the proposal has merits and a legislative initiative should be seriously considered. IFRS 9 will bring positive changes in provisioning practices across the EU, but in light of the wide variety of practices currently prevailing it is likely that differences will remain, which are not justifiable from a prudential point of view. Comparing recent experiences – from the Nordic and Japanese crises in the 1990s to the US and EU responses to the recent financial crisis – a clear lesson emerges: an early and conservative assessment of potential losses, coupled with appropriate increases in capital coverage, has been effective in restoring banks' lending capacity and profitability, with positive effects on the speed of the recovery. By contrast, the delayed recognition of losses, or outright forbearance policies, lead to the build-up of asset quality problems that impair the transmission

mechanism of monetary policy and delay the recovery from the crisis. A common backstop – if properly calibrated – could be valuable in preventing future problems and could also provide incentives for banks to adopt more conservative provisioning policies.

Lastly, let me mention that the Council also tasked the EBA to issue Guidelines on banks' loan origination, monitoring and internal governance. Assessing – among other things – the affordability of a loan before it is granted to a customer is a broader necessary step to ensure that – going forward – loans will be less and less likely to turn non-performing.

Measures to ensure well-functioning secondary markets

The transfer of NPLs suffers from asymmetries of information between sellers and buyers. When purchasing NPL portfolios investors are not in a position to determine whether banks are revealing the full set of information on a loan-by-loan basis. Investors generally claim that the lack of sufficient and accurate information on NPLs entails a very time consuming, skill-intensive and costly due diligence process. The due diligence costs associated to poor investor disclosure, together with an asymmetry of information premium that investors may charge in the pricing, contribute to widening the bid-ask price gap in NPL transactions.

The due-diligence costs and complexity may also represent a barrier to the entry of new players into the NPL investor base. In this vein, the asymmetry of information may reduce the competitive structure of the market. In an environment with a too limited investor base, buyers' market power may end up being reflected in the bid-ask spread.

In order to improve the quantity and quality of disclosure on asset quality, the Council mandated the EBA to develop loan-level data templates for NPLs. We are carrying out this work with the aim of facilitating investors' due diligence, initial portfolio screening and portfolio valuation in an NPL transaction, but also with a view to bolster market disclosure and facilitate price discovery. We have published in November draft templates – which are not intended to be a mandatory reporting standard, but rather a contribution to the start of an efficient secondary market – for an informal discussion with market participants. They leverage to the extent possible on existing definitions and concepts in order to reduce the burden for banks.

With the aim of further exploiting economies of scale and standardisation of processes, the Council asked the EBA, in cooperation with the ECB and the Commission, to put forward proposals for NPL transaction platforms and data infrastructures. Transaction and data platforms may be effective in

pooling NPLs from different regions and across asset classes, in order to achieve critical masses, building portfolios and attracting a wider and cross-border investor base. In some cases, the platforms could also take care of NPL servicing, allowing a more effective management and greater potential for restructuring of exposures.

Lastly, the Commission is working on a European blueprint for national asset management companies (AMCs). AMCs may address, in a comprehensive manner, the numerous factors that determine the NPL inter-temporal pricing problem, i.e. the resurgence of a gap between the market value and the real economic value of NPLs. Recent experience has shown that AMCs could be very effective in addressing systemic asset quality problems and in ‘buying time’ during which the inter-temporal gap could be tackled. Their effectiveness is maximised when public funds are leveraged to initially bridge the pricing gap. The work coordinated by the Commission would be particularly valuable in clarifying how this public support element could be structured so as to be compliant with the EU State Aid rules and the Bank Recovery and Resolution Directive.

This would be a positive achievement. However, I remain convinced that in completing the institutional architecture for the Banking Union the establishment of a pan-European AMC should be reconsidered, as national vehicles address the restructuring process from a domestic perspective – e.g., via purely national M&As – rather than in a truly European dimension.

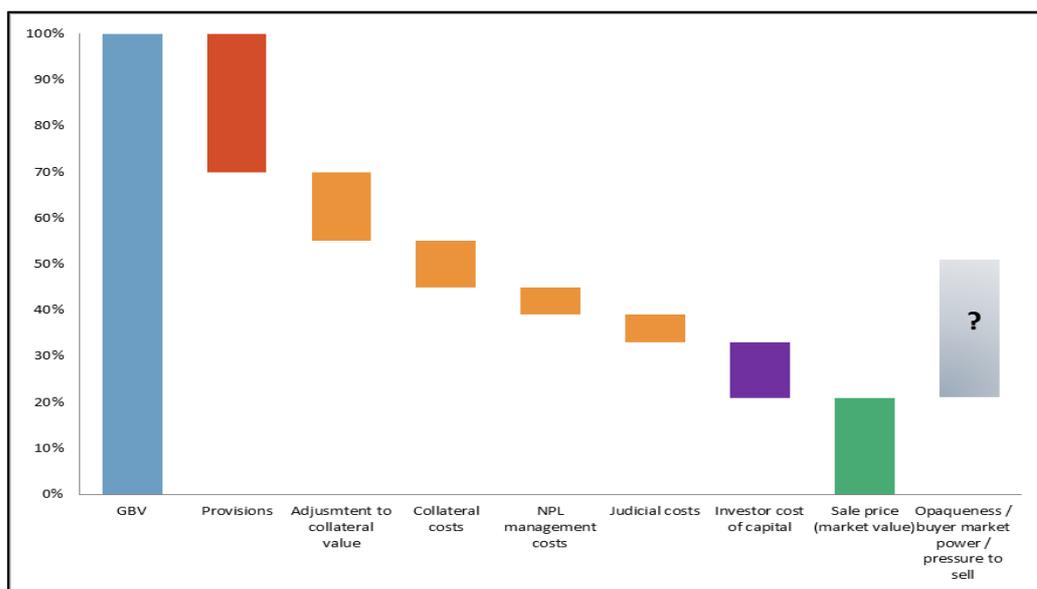
Reforms are needed to address structural inefficiencies

Inefficiencies of legal, administrative and judicial nature can affect the length and cost of enforcement procedures and recovery processes. The more burdensome the recovery process, the wider may be the bid ask spread of the NPL transaction, with an adverse effect on banks’ incentives to transfer NPLs. Material differences in the efficiency of insolvency procedures may also deter investors from entering specific jurisdictions, hence depressing the cross-border potential of NPL investments.

The Council action plan foresees that Member States will carry out peer-reviews on insolvency regimes across the EU and the Commission will publish the results of a benchmarking exercise on the efficiency of national loan enforcement regimes. This is an area of intervention that goes beyond the remit of the supervisors, but that we believe is pivotal for the success of the NPL strategy

In fact, firm supervisory actions, initiatives for restarting the secondary market and structural reforms should complement each other to facilitate the disposal of NPLs, by reducing what can be defined the NPL ‘price walk’, i.e. the distance that separates the NPL net book value from its market price (see Figure 4).

Figure 4: The NPL ‘price walk’



Sources: EBA

Building loss absorbing capacity

Turning now to the adjustment on the liabilities side, let me start with the significant progress in strengthening banks’ capital positions. Also as a result of significant supervisory pressure coordinated by the EBA through stress test and recapitalization exercises, banks’ Common Equity Tier 1 (CET1) ratios have steadily increased from 9.2% at the end of 2011 to reach 14.3% in June 2017, in the same ballpark as banks in other major jurisdictions, including the US. The average leverage ratio – i.e., the ratio of Tier 1 capital to total assets – reached 5.1%.

Is this enough? While the industry has been complaining that the harsher requirements on the quality and quantity of capital are unduly constraining lending and growth, a significant body of academic literature has argued that banks remain way too leveraged and much tighter rules should be applied. According to some, the leverage ratio requirement should be brought into double digit, ideally even above 20%, to prevent the future need to resort to taxpayers’ money.

Indeed, in many countries, during the crisis, a considerable onus has been placed on public finances to support ailing banks, which ran their business on a very thin layer of equity capital. The financial crisis showed that broad and unconditional public guarantees on banks' liabilities are neither fair nor sustainable. Implicit or explicit public support triggered a vicious link between the stability of banks and that of the respective Member States. The bank-sovereign feedback loop is a hallmark of the financial crisis that unfolded, with deep and long-lasting implications. In some Member States, the size of the banking system relative to GDP called into question the fiscal sustainability of systemic crises, in the absence of cross-border crisis management tools and funding. This was particularly relevant for those countries with high government debt and/or a particularly large banking sector. A recent piece of analysis shows that in five EU countries the cost of public interventions to recapitalise banks amounted to more than 15% of GDP, with one of these reaching 40%.

The decision taken at the international level, and implemented in the EU with the Bank Recovery and Resolution Directive (BRRD), did not follow the suggestion to impose a significantly higher leverage ratio, acknowledging that the latter is not the only measure to protect public budgets from banks' bail-outs. Instead, the concept of *bail-in* was introduced: resolution authorities had to be empowered to apportion losses not only to equity holders, but also to eligible debtholders, whose claims could be converted into equity or written down. For systemically important banks, capital requirements have been coupled with defined thresholds on overall loss absorbing capacity.

Bail-in, together with the other resolution tools included in the BRRD to manage banking crises, were designed with a view to minimizing the impact of banks' failures on: (i) the parties directly affected; (ii) banks' critical functions to the financial system and the economy at large; and (iii) the Government budget and ultimately taxpayers. The aim of resolution is to ensure an orderly and less disruptive restructuring of a bank, safeguarding the continuity of critical functions. This process cannot however leave creditors without any skin in the game. This is why the involvement of private investors is important to internalise the losses associated with the failure of an institution. This is a crucial step in the resolution process to ensure the sharing of losses is proportionate to the risks undertaken – as well as to the returns enjoyed – by the different categories of investors, as well as to limit any form of public support, including from the resolution fund.

The introduction of the BRRD determines a regime shift in the way we look at banks' funding and liability structures. In order for this reform to successfully reduce risks and strengthen resolvability,

public authorities and institutions must – collectively – increase their efforts for a speedy and efficient implementation of the framework. This entails, in my view, i) a commitment by resolution authorities to the timely determination of bank-specific MREL targets; ii) increased effort by institutions to build their MREL buffers; iii) a joint effort by institutions and authorities to address the challenge to resolvability that arises when a significant amount of instruments are allocated to retail customers.

Speeding-up on the quantum and quality of loss absorbing capacity

The data currently available to the EBA provides a concerning picture in two main respects: i) first, insufficient progress is being made, to date, in building up MREL capacity; ii) second, the fact that significant amounts of loss absorbing instruments are held by retail customers may hinder banks' resolvability and requires prompt action as well as a systematic fix.

The EBA is about to publish an updated quantitative analysis on the MREL requirement, following the publication of its December 2016 Final MREL Report. A like-for-like analysis on a consistent sample of 100 EU banks shows that during 2016 almost no progress was made in the issuance of MREL eligible instruments. Total MREL liabilities increased by EUR 4.5 billion during 2016, which amounts to only 0.1% of the end-2015 value (see Table 1). The breakdown of our analysis unveils that while there was an increase of MREL capacity for global systemically important institutions (G-SIIs) (+2.1%), MREL capacity actually decreased for non-G-SIIs (-1.8%). Our data show only a slight improvement in the degree of subordination in 2016 (+1.9%), but evidence collected and commented by analysts show a more marked shift from senior unsecured issuances to junior or senior non-preferred ones in the course of 2017, especially after the summer.

Thus far banks do not seem to have taken enough advantage of the exceptional benign conditions prevailing in funding markets. The extraordinary measures of monetary policy have kept interest rates very low for a prolonged period of time. The liquidity and funding conditions for European banks in recent weeks tells the story of an unprecedented compression in yields, involving a wide spectrum of securities in Europe. Also Additional Tier 1 (AT1) yields have followed a tightening trend since the beginning of 2017, with yield to call now below the cash yields on equities.

Table 1: Change in MREL eligible stack (in EUR billion - consistent sample 100 institutions)

MREL eligible(total)	December 2016		Δ	%Δ	December 2015
G-SII	1,629.5	↗	33.2	2.1%	1,596.2

Non G-SII:	1,540.1	↘	- 28.7	-1.8%	1,568.9
Of which: O-SII*	1,208.1	↑	261.7	27.7%	946.4
Of which: Other*	332.1	↓	- 290.4	-46.7%	622.5
Total	3,169.6	→	4.5	0.1%	3,165.1

MREL eligible (subordinated)	December 2016		Δ	%Δ	December 2015
G-SII	943.1	↗	13.2	1.4%	929.9
Non G-SII:	846.7	↗	19.7	2.4%	826.9
Of which: O-SII*	610.9	↑	102.3	20.1%	508.6
Of which: Other*	235.8	↓	- 82.6	-25.9%	318.3
Total	1,789.8	↗	32.9	1.9%	1,756.8

Sources: EBA

*The aggregate figures across the sub-samples of O-SIIs and other banks (non G-SIIs and non O-SIIs) have been affected by reclassification of banks' systemic importance between 2015 and 2016.

I understand that banks are waiting that resolution authorities formally communicate to them the bank-specific MREL targets and the transitional path. Also, market activity has been affected by the lack of legal clarity, for both issuers and investors. Indeed, it is essential that resolution authorities clarify their approach and determine the MREL requirements, including for midsize banks and subsidiaries. Important steps in this direction have been accomplished. The EU co-legislators agreement on the hierarchy of creditors, last month, represents a major step forward towards legal clarity. However, it will take more time before all Member States adapt their bank insolvency frameworks to pave the way for the issuance of 'senior non-preferred' new instruments of debt.

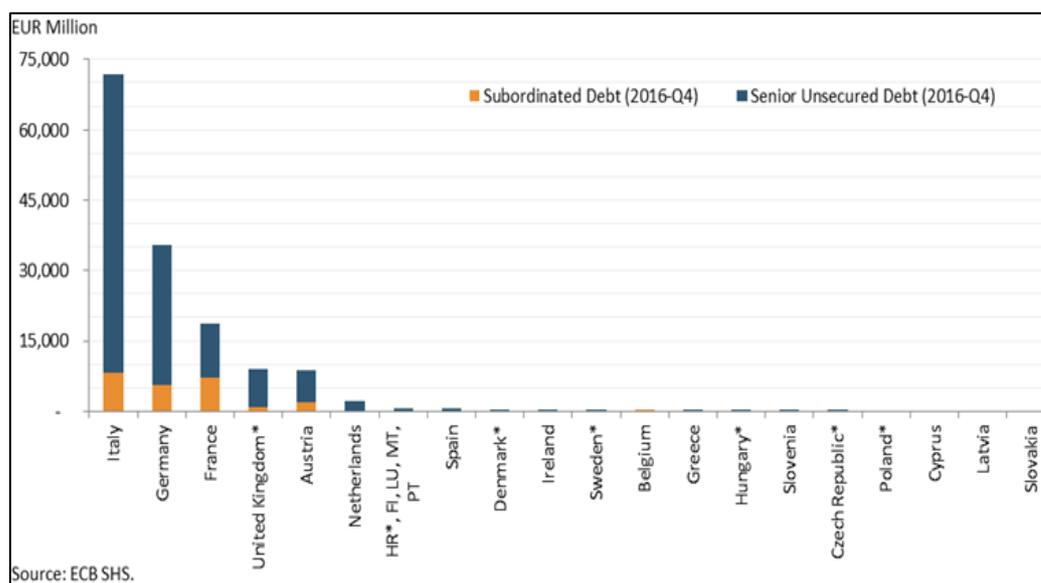
This notwithstanding, I believe that banks could and should have done more efforts in pre-funding MREL-eligible stack, even in the absence of established regulatory targets. A well-planned pre-funding strategy, at this juncture, would mitigate the implications of future potential episodes of idiosyncratic or market-wide funding stress and, at the same time, would alleviate the concerns of market absorbability of high issuance volumes in the months and years to come.

Working on the quantum of the MREL requirement may not be sufficient. The common practice of placing eligible debt with retail investors may pose serious challenges to the reliability and effectiveness of the bail-in procedure. This is what I call the 'retail challenge' to banks' resolvability. The bail-in of retail debt instruments can generate investor protection issues, legal challenges, financial instability episodes such as bank runs, as well as broader political backlash and social unrest. Ultimately, significant amounts of eligible debt placed with retail investors may undermine the effective loss absorption capacity of the MREL stack, endangering the resolution process. The

implications on the resolution outcome can be even more serious when bail-in-able debt is self-placed with the issuer’s own retail clients. Bailing-in those clients damages the customer base and reputation of the institution, making more challenging for resolution authorities to restore the franchise value and business viability of the institution post-resolution. Recent experience shows that retail distribution has taken place in the absence of appropriate levels of disclosure and with the possible violation of relevant investor protection requirements, resulting in the emergence of widespread episodes of mis-selling, amplifying political opposition towards the bail-in tool.

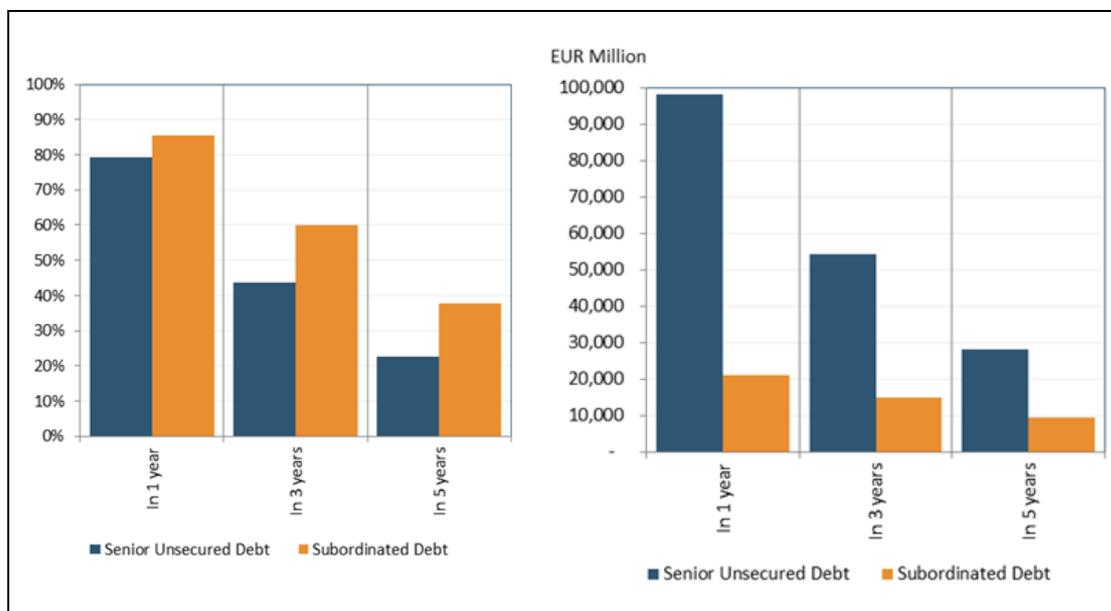
The retail challenge is not a theoretical concern. Data available for the euro area confirms that retail investors still hold an important share of EU debt securities issued by financial institutions, with high concentration of retail debt holdings in specific Member States. At the end of 2016, the distribution of retail debt was concentrated in five Member States and very low in all the other jurisdictions (see Figure 5). Issuers in Italy leads with the largest nominal amount of euro area retail holdings (EUR 71.9 billion) followed by Germany (EUR 35.5 billion) and France (EUR 18.6 billion).

Figure 5: EU banks’ debt securities held by Euro area retail investors (by country of issuance - As of Q4 2016)



Based on debt residual maturity, if we were to assume that banks stop placing debt with retail investors now, by the end 2019 euro area retail investors would still hold 44% of the senior unsecured bank debt and 60% of the subordinated bank debt that is currently in their portfolios. By 2021 the current stock of retail holdings would be reduced to one third of its current level (see Figure 6). In a nutshell, the amortisation profile of the existing stock is such that the retail challenge is bound to last for a while.

Figure 6: EU banks' debt securities held by Euro Area retail investors - amortisation profile assuming no further placement with retail investors (Left chart: in % of total – Right chart: nominal amount)



Sources: ECB SHS and EBA calculations

In my view, the legacy of debt retail holdings and banks' new issuances need to be addressed separately. As regards the stock, it is important that retail investors who bought debt securities before the implementation of the BRRD fully understand the risks inherent in their investments and are provided with complete and updated information on the potential treatment of such investments in resolution or insolvency. I believe institutions should be required to convey this information to existing clients by means of ad-hoc, clear and proper written information.

In addition, where the legacy stocks are sizeable and with a relatively long-term maturity profile, banks should consider a more pro-active approach to reduce those stocks, for example through voluntary liability management exercises proposing to retail investors the conversion of their holdings into savings deposits.

As regards more systematic solutions on new issuance, the option to ban the distribution of complex capital instruments to retail investors is being discussed in some jurisdictions. Such a solution has been adopted in some countries for AT1 instruments, featuring particularly complex mechanisms for the suspension of coupon payments, conversion and write down. My view is that, as retail investors are entitled to purchase bank equity, they should also be allowed to invest in subordinated or senior non-preferred debt, as long as they are adequately informed of the potential risks attached to such financial instruments and the institution recommending the instruments has assessed the suitability of the investment for the clients. In this regard, it will be

crucial to properly implement and enforce the strengthened investor protection framework of the forthcoming MiFID II regime, which will also include the requirement to identify the target market for the financial instruments distributed to clients.

Where there is a material presence of retail investors as holders of debt liabilities of an institution subject to resolution, it will be crucial that the resolution and market authorities open a dialogue and share relevant information, for example in terms of the assessment by the market supervisors of the degree of compliance of the institution with the investor protection framework. A positive supervisory assessment could be considered, in fact, an important determinant to overcome or reduce potential issues arising from the bail-in of debt held by retail investors.

Where the presence of retail investors is material, if resolution authorities identify potential challenges to bail-in, they should explicitly address such challenges to resolvability into their planning. This may entail adjusting the quantum of the MREL requirement and/or imposing that the requirement be met with a minimum percentage of instruments that are subordinated to senior debt liabilities. Even if not eliminating the challenges to resolvability that may derive from extensive involvement of retail investors, subordination will materially mitigate such risk.

As I already mentioned, the EU political agreement on the harmonised hierarchy of creditors and the introduction of the new class of senior non-preferred debt is a major step forward. It reassures me that once Member States have adapted the legislation and banks make progress with the issuance of such instruments the retail challenge to banks' resolvability will be contained, without jeopardising the no creditor worse off principle.

Conclusions

Ten years after the start of the crisis we could be satisfied with the progress achieved in designing and implementing regulatory reforms and repairing EU bank balance sheets. Still, we need to avoid losing momentum. Market conditions are extraordinarily favourable. The investors' search for yield in a low interest rate environment creates an environment much more favourable to NPLs sales, also via securitisation programmes. In order to take full advantage of the positive market conditions it is important that the "push" effect generated by supervisory pressure is accompanied by a "pull" factor, where public policies focus on addressing the opaqueness and illiquidity of the secondary market for NPLs. The efforts of the EBA in standardising the information templates and enhancing the public disclosure are intended to support this process, by reducing information asymmetries

and potentially attracting new investors to this market segment. The structural reforms to remove impediments to the disposal of NPLs should act as the “lubricant” of the process and are an essential, often neglected, component of a comprehensive policy strategy.

The risk appetite of investors is also favouring a jump ahead in reshaping banks’ liabilities structures, with a decisive shift towards longer term liabilities, clearly characterised by an enhanced capacity to absorb losses, ideally subordinated to other senior unsecured liabilities and uninsured deposits. Banks must also make sure that retail investors are fully aware of the risks entailed by different category of instruments and issuers follow closely the investor protection requirements, especially when they place own liabilities to their retail depositors.

There are two important reasons to accelerate the efforts on asset quality and loss absorbing capacity. First, the current market conditions will not last forever. If the adjustment process is not completed when interest rates start rising, or a macroeconomic shock hits our economy, supervisors could be forced to continue tightening the belt and inflict considerably greater pain under adverse market conditions. Second, decisive progress in the risk reduction agenda is essential to put the whole institutional architecture on a stronger footing, with a fully integrated safety net, at least for the Banking Union. This would be extremely important to cut once and for all the sovereign-bank loop and restore an integrated market for financial services, which could help in addressing idiosyncratic shocks and give more stability to the whole area.

Thank you very much for your attention.