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A Reconfiguration of Europe - the CEE Perspective

Deleveraging and segmentation of the Single Market

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Dear President Belka, honourable Prime Minister, dear colleagues,

Today I would like to share with you some thoughts on the path followed so far in the deleveraging process by the European banks and the disruptive effects this is having on the Single Market.

Let me stress that deleveraging is not a swearword: it is something necessary, and even healthy, to restore a viable financial system and the orderly financing of the economic activity. Any financial crisis - and especially those generated by credit or real estate bubbles – is followed by a deleveraging process, which brings indebtedness of banks and their borrowers down to sustainable levels. At the end of the adjustment process, we will have a banking sector with more capital, less debt and a more balanced liability structure, with lower reliance on flighty sources of funding. This is indeed a policy objective that the G20 leaders indicated already in

2009, in the aftermath of the Lehman crisis. The key issue confronting policy makers is how to accompany a smooth transition to the new equilibrium - or, said differently, how to avoid that the deleveraging process causes unwarranted damage to our economies.

The first policy hurdle is to avoid a deleveraging process that leads to significant reductions in lending to the real economy and to fire sales of assets. In the aftermath of a crisis, banks are naturally reluctant to tap equity markets, as valuations are depressed and investors are particularly risk-averse. They could, therefore, be tempted to perform the adjustment predominantly through a squeeze in lending and a hasty sale of good quality liquid assets, which could depress prices and trigger self-fulfilling negative spirals. Supervisory authorities have, therefore, to put in place efforts to counteract these tendencies and to push for measures aimed at increasing capital. This is what the EBA has done with the recapitalisation exercise that was completed in June. Banks were asked to strengthen their capital position so as to achieve a Core Tier 1 ratio of 9%, after a prudent valuation of sovereign exposures. Only a limited set of measures were allowed, which led to curtailing asset levels. In particular, reduction in lending were allowed only when requested by competent authorities, especially within the framework of European measures aimed at containing State aid. Furthermore, sales of assets were conducted under strict supervisory control, mostly in areas outside the European Union, for exposures that were suffering from the drying up of US dollar funding.

Between September 2011 and June 2012, the banks involved in the exercise strengthened their capital position by more than EUR 200 bn, the bulk of it through direct capital measures. In order to capture the relevance of the results achieved, we have to consider that if this correction in the capital position were to be achieved only through a reduction in risk weighted assets, the amount of deleveraging would be a stunning EUR 2.2 trillion.

It is interesting to notice that the International Monetary Fund, in its recent Global Financial Stability Report, estimates that a deleveraging of $2.8 trillion (at the current exchange rate, somewhat short of EUR 2.2 trillion) would be needed from September 2011 to December 2013 under the baseline scenario, while a much higher $4.5

trillion would be necessary only in case of the “weak policies”, i.e. if already agreed measures for the Banking Union were not implemented and commitments for structural reforms were not respected. Our exercise, therefore, brought European banks quite a long way down the necessary deleveraging path, increasing capital levels and minimising the impact on lending to the real economy.

But increasing capital levels is not enough. The second policy challenge concerns the pace of the adjustment, especially the prompt recognition of losses on the exposures carried at book value. Also in this case, banks might face an incentive to postpone the recognition of losses, in the hope that assets will increase in value as the recovery takes place and that a replenishment of capital could eventually be avoided. However, what could be seen as a rational policy for an individual lender would lead to a suboptimal outcome for the system as a whole. If investors maintain a sceptical view on the quality of bank assets, funding costs remain high and hamper the recovery in lending. Moreover, if assets remain mispriced, the overall allocation of credit is distorted and prevents credit from flowing to profitable investment opportunities, with a negative effect on growth and employment. The deleveraging accounted for by reviewed and more accurate valuation of assets does not hurt the real economy. Quite the contrary, it is a necessary condition to kick-start lending activity again. It is important to acknowledge that also in this area progress has been made. Independent asset quality reviews have been conducted in a number of countries, especially in those that had experienced major real estate bubbles. Further supervisory efforts in asset quality review are needed, to restore market participants’ confidence in the accuracy of bank valuations and contribute to a re-opening of funding markets, especially the interbank market.

Let me now move to the third and last challenge, the need to ensure that the deleveraging process does not adversely affect the integration of the Single Market. The leveraging up of the banking sector in the run up to the crisis has surely been characterised by serious mispricing of risks, in domestic as well as cross-border lending. The run of banks to achieve a greater size, more suitable to compete in a larger and more integrated European market, has surely led to hyper-inflated balance sheets and excessive complexity. At the same time, the development of integrated

cross-border banking groups has also contributed to a greater flow of savings to finance economic activity in countries with genuine investment opportunities, to greater market integration in the EU. An effective deleveraging process will have to be realised with a serious review of the business models, with a refocusing on core activities and markets. But recent developments show that we risk throwing the baby away with the bath water: the deleveraging process is indeed occurring with a substantial repatriation of assets and is leading us back to a banking market segmented along national lines.

Cross-border business has experienced a sharp downward trend since 2009, and has significantly accelerated since the burst of the sovereign debt crisis. This is particularly visible in wholesale markets, with the cross-border share of interbank assets back to levels close to those prevailing before the introduction of the euro. But it is affecting also other areas of banking business, with the decision of some banks to pull out from some foreign markets and, especially, to achieve a greater matching of assets and liabilities on a country-by-country basis.

If left unchecked, this process could have negative repercussions on Central Eastern European (CEE) countries. The loan to deposit ratio of many cross-border groups present in the area is fairly high, reflecting the use of wholesale funding raised by the parent entity to finance business in host countries. Data collected by the BIS and the IMF show that since mid-2011, cross-border deleveraging in CEE countries has been significant.

The EBA is making serious efforts to bring together relevant policy makers, home and host authorities, and to ensure that joint discussions are held, and joint decisions taken, to see to that the deleveraging process occurs without an undue home bias. In the course of the recapitalisation exercise, and in close agreement with the Polish Presidency of the Ecofin Council, we ensured that all the bank plans were discussed and agreed in colleges of supervisors, in line with the spirit of the Vienna initiative.

We are also aware that a number of measures have been taken by competent national authorities, which could have the effect of contributing to the segmentation of the Single Market. Host authorities tend to react to stressed market conditions putting pressure on local subsidiaries and branches to ensure greater resilience, *de facto*

trapping capital and liquidity in local markets. Home authorities, on the other hand, strongly encourage a de-risking process which also entails lower exposures to counterparts in other more fragile or stressed Member States. An interesting study by Barclays' analysts indicates that in a framework of "balkanised" capital ratios imposed in an uncoordinated fashion on each establishment of a cross-border group, the pressure on capital is going to be substantial and could affect the cost and availability of credit. The impact of segmented pools of liquid assets is likely to be even more significant, dividing funding markets along national lines. According to the data disclosed in our recapitalisation exercise, also the sovereign portfolio has been significantly repatriated through the selling of bonds issued by other Member States to increase investment in domestic sovereign paper. There is a serious risk that if this market environment crystallises, the business model of cross-border groups is not viable anymore. This development could have an impact on the integration of the Single Market; retail borrowers, households and corporates, would loose access to a wider area-wide pool of financial resources; the benefits of the Single Market for growth and employment would be dissipated.

The EBA is making all possible efforts to spur discussions between home and host authorities. Exchange of information and supervisory cooperation and coordination have increased substantially thanks to the establishment of colleges. The EBA will continue to encourage improving cooperation, and acts as a facilitator where there is disagreement between national supervisory authorities. In some cases, these discussions have brought a reconsideration of measures having an impact in other Member States. We also recently endorsed a code of conduct, which is expected to guide more intense and satisfactory cooperation and information sharing between home and host supervisors, and with the EBA, in particular in stressed situations.

I would also like to highlight the EBA's formal role as mediator and watchdog for the compliance with EU law. So far, no national competent authority has triggered a mediation process at our table, and also market participants that have complained about some supervisory decisions have not flagged the issue to our attention. But we stand ready to activate our mediation role at any moment. We are also continuously

monitoring whether any of the measures taken by national authorities could violate key principles of European legislation and stand ready to investigate breaches of Union law, in case we found evidence pointing in that direction.

It is fair to say, however, that the core issue driving the segmentation of the Single Market is the segmentation in the safety net. As long as the safety net, including prudential supervision, resolution tools and deposit guarantee scheme, remains national, investors will continue differentiating the credit quality of banks according to the standing of the sovereign providing them with the ultimate backstop in case of crisis. This has been the main driver of the interconnection between banks and their sovereign. The Single Supervisory Mechanism and the other steps towards a complete Banking Union contained in the package proposed by the Commission in September are the only possible way forward.

I understand that a delicate point is the role of and possible impact on Member States that are not yet participating in the monetary union. I would like to stress two points, which I believe are crucial.

First, we have to devote close attention to the governance of the arrangements for rule-making and supervision. A lot of emphasis is being put on the need to find delicate and complex balances in weighing the votes of Member States' representatives at the relevant tables, both at the EBA and the ECB. I would invite to think out of the box and consider also decision making mechanisms that are less based on country representation and more on technical skills and accountability frameworks. We need the best people we have in Europe to design high quality rules and implement effective supervision, in the common interest of savers in the whole area; and we need mechanisms to ensure that their decisions do not unduly penalise any actor in the Single Market. More reliance on independent decision making bodies, composed of experts selected on the basis of their technical skills, would put all countries, in and outside the euro area, on the same footing. It would ensure that decisions are taken in the best European interest, not as a compromise amongst different national positions. Monitoring mechanisms could then ensure appropriate representation of all the Member States, high quality and unbiased processes, and

the possibility to call back decisions that are not considered of an appropriate standard.

Second, as not all Member States will join the Banking Union, we will require a true leap forward towards single rules and common supervisory methodologies for the whole Single Market. This is the condition to have a level playing field and ensure that the segmentation of the Single Market is put in reverse gear, not only for the countries participating in the currency union. It will not be an easy task: the legislative texts currently being discussed by the European Parliament and the Council still leave a rather large room to national discretionary decisions, and supervisory methodologies are still very different. But it is a unique opportunity, which we should not miss.

Thank you very much indeed for your attention.