EUROPEAN PARLIAMENT

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Re-capitalisation of banks

NOTE

Abstract

The comprehensive assessment is an important step in anticipation of the Single Supervisory Mechanism. It is expected that the outcome will suggest that some banks will need to be re-capitalised. We argue that the assessment by the ECB should be done by the ECB behind closed doors and without interference or scrutiny of market participants or politicians. This should allow the ECB to carry out the comprehensive assessment without restraint. However, we do feel that the plan for this assessment, the methodology, the scenarios and the capital thresholds should be communicated in advance. We also stress that the fact that the bail-in tool is to be implemented in 2018 creates some uncertainty. To be effective it should be clear how capital shortfalls are going to be dealt with. This means that a backstop has to be in place. We feel that this issue should be addressed more explicitly before the results of the comprehensive assessment will be communicated.

IP/A/ECON/NT/2013-09 December 2013

Part of the compilation PE 492.456 for the Monetary Dialogue EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHOR

Sylvester C.W. EIJFFINGER, CentER and EBC, Tilburg University and CEPR
with research assistance performed by Louis Raes, Tilburg University

RESPONSIBLE ADMINISTRATOR

Dario PATERNOSTER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@europarl.europa.eu

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its newsletter please write to:
Poldep-Economy-Science@europarl.europa.eu

Manuscript completed in December 2013.

This document is available on the Internet at:
http://www.europarl.europa.eu/studies

DISCLAIMER

CONTENTS

BACKGROUND

In the formation of a Banking Union, 2014 will prove to be another milestone. In the first quarter of 2014 the Asset Quality Review and balance sheet assessment by the European Central Bank (ECB) is planned. This audit by the ECB is intended to assess the health and resilience of the largest European Banks. In September 2014 these banks will be supervised by the ECB under the Single Supervisory Mechanism (SSM).

The assessment by the ECB may result in the need for (further) re-capitalisation of some of the banks under scrutiny. Re-capitalizing banks may have important implications. This briefing paper discusses how we feel that this re-capitalisation should be carried out as well as related aspects. In particular we start by emphasizing the implications of transparency when assessing the health of financial institutions. Subsequently we discuss the steps which may be taken in case of a need for re-capitalisation. We argue that all the procedures for re-capitalisation of banks as well as for the resolution of troubled banks should be laid out as soon as possible. Transparency has in this cost important ramifications as well. We stress that sufficient transparency is need to allow financial markets to adequately price the risks related to debt instruments of individual institutions.

1. THE ROLE OF THE ECB

One of the new roles for the ECB in the ongoing establishment of a Banking Union, is micro-prudential policy. This role is given by the Single Supervisory System (SSM) which should be operational in the fall of 2014. As a refresher we show the distribution of tasks delegated to the ECB in Figure 1. This Figure was taken from our Briefing Paper of September 2013.[1] It shows current and already decided tasks along with proposed and hypothetical tasks.

The Figure illustrates that the ECB is directly responsible for monetary policy and micro-prudential supervision (under SSM). The dotted line stresses that the ECB is also connected to macro-prudential supervision. While macro-prudential supervision falls under an independent body, the European Systemic Risk Board (ESRB), it is intimately related to the ECB as it is hosted by the ECB and the ECB president chairs the ESRB. To the right we see the Single Resolution Mechanism (SRM). We discussed our views on the SRM previously.[2] Recently the ECB voiced an opinion on the SRM. [3] Importantly, the ECB stressed the idea that a resolution should be distinct but recommends at the same time that it could participate in the executive as well as plenary sessions of the Single Resolution Board as an observer. [4] The dashed line suggests that a final decision has not been taken but that in our view there will be some connection between the SRM and the ECB. Finally, we have put the Deposit Guarantee System as well in this Figure. We outlined a vision on a common Deposit Guarantee System in our briefing paper of July 2013.[5] As it currently stands, it is unlikely that we see much progress with respect to the Deposit Guarantee System in the near future. Nonetheless we keep this part in the Figure to stress that we believe that this is a key ingredient of a fully fledged Banking Union.

The task of banking oversight will fall under the wings of the ECB from September 2014 onwards. Before that the ECB has been given the responsibility to assess the resilience and health of the banks. In particular the ECB needs to undertake a comprehensive assessment (see also next section). The idea is that the ECB gauges which banks are in need for additional re-capitalisation and to what extent.

At this point it is commonly assumed that a proper assessment will find that some banks are in need for additional capitalisation.[6]

It is our opinion that the ECB is well equipped for this role and we have confidence that the ECB is perfectly able to fulfill this duty. However, the complexity of this task should not be

---

1 Eijffinger, Sylvester C.W. (2013), The *various roles of the ECB in the new EMU archictecture*, Briefing Paper for the Monetary Dialogue of September 2013

2 Eijffinger, Sylvester C.W. (2013), *Single Resolution Mechanism.* Briefing Paper for the Monetary Dialogue of February 2013

3 European Central Bank (2013), *8 November 2013 – ECB publishes its opinion on the Single Resolution Mechanism (SRM)* http://www.ecb.europa.eu/press/pr/date/2013/html/pr131108.en.html

4 European Central Bank (2013), *8 November 2013 – ECB publishes its opinion on the Single Resolution Mechanism (SRM)* http://www.ecb.europa.eu/press/pr/date/2013/html/pr131108.en.html

5 Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013

6 OECD (2013), Focus: Strengthening euro area banks, 10 january 2013 http://www.oecd.org/eco/economicoutlookanalysisandforecasts/strengtheningeuroareabanks.htm

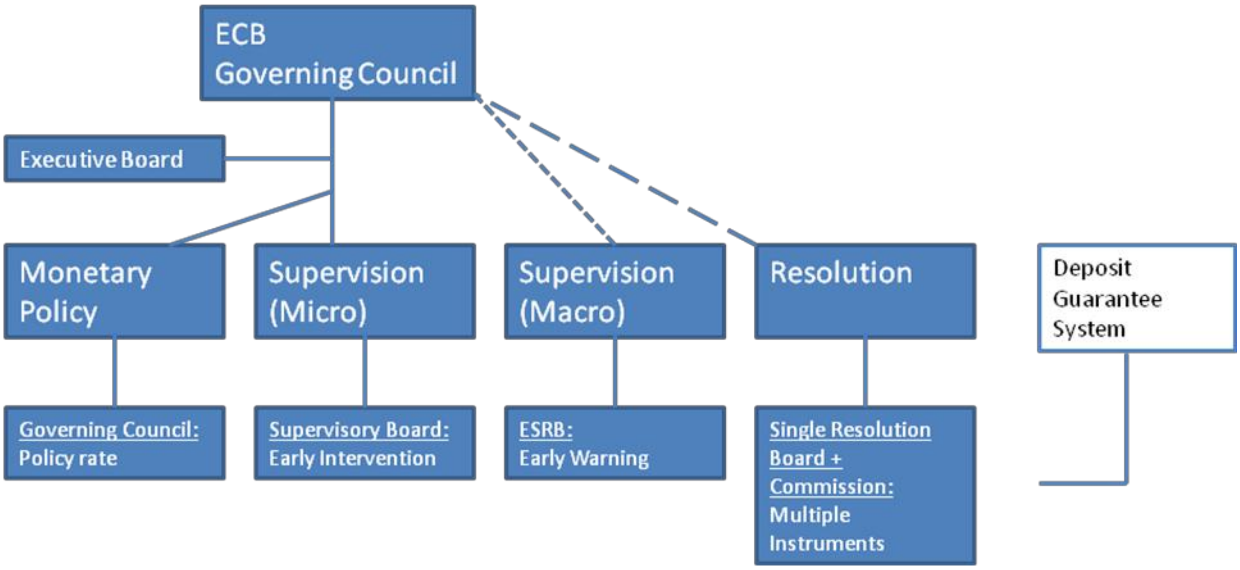
underestimated. For example, in 2011 Dexia passed a stress test by European regulators only to see it collapse subsequently.

In this briefing paper we would like to underline that proper assessment of bank risks, be it the Asset Quality Review, balance sheet assessment or future stress tests, are best carried out behind closed doors. While we in general favour transparency, this is one instance where transparency may prove to be costly. What one really wants is a deep and thorough assessment where the ECB delves as deep as it wants and brings up all risks. Pointing out risks, risks potentially largely unknown to the public and other financial market participants, may ignite problems. The ECB may feel pressure not to create problems for (undercapitalised) banks by pointing out to hidden risks. This pressure does not need to be explicit. It may be the case that the level of transparency is just too high to justify an in-depth assessment. If the ECB is trusted with the evaluation of bank capital than it makes sense to let the ECB do their job. This means that the ECB should do the job behind closed doors and with minimal presence of outsiders.

It is clear that such an approach is only feasible and justifiable if the assessment or stress test follows a plan which has been outlined in advance and which makes clear that afterwards a transparent yet detailed reconstruction is feasible. At the same time the ECB is fully accountable for the results from their assessments.

We feel that such an approach which allows for a thorough assessment *in the dark* with explicitly outlined procedures and a fully transparent evaluation afterwards should be used in all further Asset Quality Reviews, balance sheets assessments or stress tests.

Figure 1: Distribution of tasks: current, future, proposed and hypothetical.



Source: Eijffinger, Sylvester C.W. (2013), *The various roles of the ECB in the new EMU architecture*, Briefing Paper for the Monetary Dialogue of September 2013

2. COMPREHENSIVE ASSESSMENT

The comprehensive assessment may reinforce (or reinstall) confidence in European banks at large.[7] If investors believe that the assessment was adequate (sufficiently strict) than this assessment by an independent, third parties should raise confidence. This increased confidence could translate in lower financing costs for financial institutions which in itself may enlarge the possibilities for strengthening the balance sheets.

The certification by the ECB of the health of European banks provides additional insight to financial markets into the situation of European banks. The experiences with the *Supervisory Capital Assessment Program (SCAP)* in 2009 learned that even in difficult market conditions banks can raise capital. Most banks which were deemed to raise additional capital were able to do so through private investors.[8]

As stressed by other observers,[9] a necessary condition for the comprehensive assessment to succeed is a financial backstop (under strict conditions and as a last resort). The reason is that the publication of deficiencies could trigger problems and potentially even bank runs. For a similar reason we argued in the previous section that the ECB should be able to do its assessments and stress tests behind closed doors. However, that does not preclude the necessity of a financial backstop. The backstop in this case would be provided by the European Stability Mechanism (ESM) which could only be used when national governments are unable to do so and after a bail-in. Strict and severe conditions for the use of the backstop should provide incentives for banks to find private sector solutions for their capitalisation needs. After the SCAP less than 3% of the capitalisation needs were addressed by the US government, in part due to strict conditions.[10]

The comprehensive assessment itself comprises three elements: a supervisory risk assessment, an Asset Quality Review and a stress test. An overview is given in Figure 2.

The supervisory risk assessment is an exercise in determining the intrinsic risk profile of the bank. By addressing key risks in the balance sheet of banks, using backward– and forward looking information the ECB and the national competent authorities want to assess the position of each individual bank relative to its peers and its vulnerability to exogenous factors. This assessment tool will be used in the future SSM as well.[11]

The Asset Quality Review is an examination of the asset side of the individual banks balance sheets. This examination will take a broad view, cover all asset classes (including non-performing loans, restructured loans, sovereign exposures) and deal with on and off-balance sheet positions.

The final element is a stress test which extends the Asset Quality Review by examining how well banks can absorb shocks. The ECB and European Banking Authority (EBA) will perform the next EU-wide stress testing in close cooperation. As it stands the details on

---

[7] European Central Bank (2013), *Note Comprehensive Assessment October 2013* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

[8] De Nederlandsche bank (2013), *Overzicht financiele stabiliteit, najaar 2013*

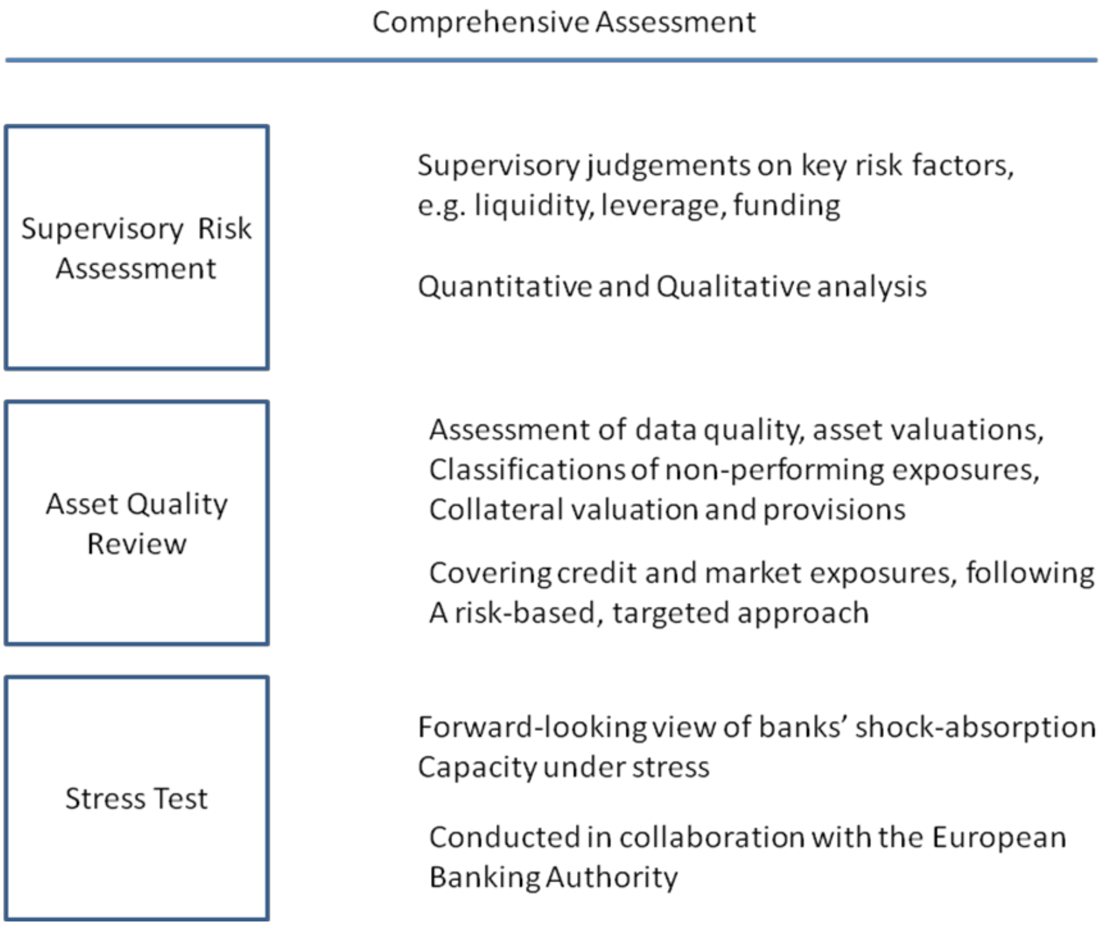
[9] De Nederlandsche bank (2013), *Overzicht financiele stabiliteit, najaar 2013*

[10] De Nederlandsche bank (2013), *Overzicht financiele stabiliteit, najaar 2013*

[11] European Central Bank (2013), *Note Comprehensive Assessment October 2013* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

methodology are not yet communicated. [12] We feel that is important that details on the methodology of the stress test(s) are communicated timely and in sufficient detail. This should ensure that financial market participants are sufficiently aware of how the stress tests will be conducted and allow the markets to price the expectations on these stress tests. Stress tests will be performed on a returning basis under the SSM. Over time there may be changes to the stress tests in terms of scope and scenarios. It is important that the changes and the underlying rationale are communicated in all cases before the tests take place.

Figure 2: Overview of the Comprehensive Assessment



Source: European Central Bank (2013), Note Comprehensive Assessment October 2013

[12] European Central Bank (2013), *Note Comprehensive Assessment October 2013* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

3. BAIL-IN

As mentioned in the previous section, the ESM or any other form of burden sharing should only be addressed after a bail-in and possibly an intervention by the national government. A *credible* bail-in regime is important to signal the envisioned disconnect between governments and banks.

As ECB Executive Board Member Jörg Asmussen recently stated: *Bail-out is out, bail-in is in*. [13] In the context of bank resolution, the Council general approach stipulates that banks can only be recapitalised with resolution agreements after a minimal bail-in (8% of the total liabilities in the proposal). As it stands the bail-in tool is to be implemented from January 1st 2018 onwards, but some, including ECB President Mario Draghi, have suggested that a earlier implementation is warranted. [14] Until the bail-in arrangements are implemented, in the proposed or altered form, there is some uncertainty on what measures are going to be taken. While we do not envisage nor hope that problems of such an extent will arise that additional banks in the Eurozone will have to be resolved, we feel that this possibility should not be dismissed. The comprehensive assessment could, at least in principle, expose problems which are such that bail-in becomes a real possibility. It would be beneficial if the arrangements in such a case are specified in advance. The ECB points out in its opinion on the current proposal for the SRM and Single Bank Resolution fund, that between 2015 and 2018 "*there will be uncertainty to whether senior debt can be bailed in since Member States are free to decide whether they should anticipate the introduction of a bail-in framework.*"[15] It is our opinion that it would be beneficial if such an uncertainty is eliminated as soon as possible, ideally before the ECB finishes its comprehensive assessment.

The ECB notes in the aforementioned opinion that bail-in is already priced in to a large extent and the impact on funding of implementing bail-in earlier should be minimal. [16] The important advantage of an agreement on using the bail-in tool earlier is that it would contribute to legal certainty and consistency and avoid ad hoc solutions.

[13] Asmussen, Jörg (2013), *Building Banking Union,* Speech at the Atlantic Council, London 9 July 2013 http://www.ecb.europa.eu/press/key/date/2013/html/sp130709.en.html

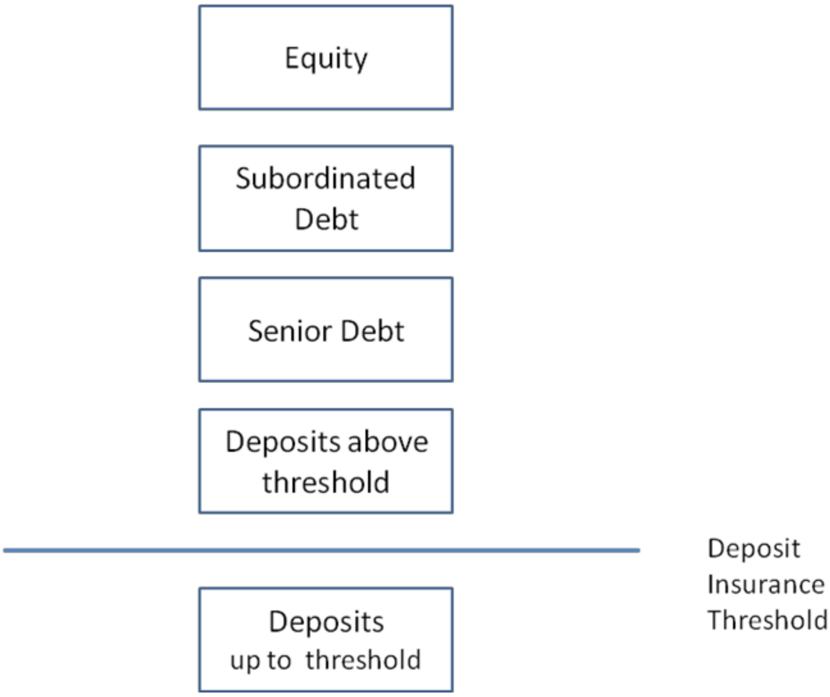
[14] Draghi, Mario (2013), *The future of Europe,* Opening Speech at the european Banking Congress, Frankfurt am Main 22 November 2013 http://www.ecb.europa.eu/press/key/date/2013/html/sp131122.en.html

[15] European Central Bank (2013), Opinion of the European Central Bank of November 6 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76) http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html

[16] European Central Bank (2013), Opinion of the European Central Bank of November 6 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76) http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html

It appears to be the case that the priority of claims in insolvency is not identical to the provisions of the forthcoming Bank Recovery and Resolution Directive (BRRD). [17] In an earlier briefing paper we discussed our view on the bail-in tool. [18] In Figure 3 we show a Figure from that briefing paper. What it shows is our preferred hierarchy. Equity holders should be the first to be approached in case of a bail-in. Then the debt holders and a distinction between debt holders can be made according to seniority of the debt. Finally, deposit holders could be considered as long as there is an absolute protection of the deposits which fall below the deposit insurance threshold (currently € 100.000,-).

Figure 3: Bail-in Order



Source: European Central Bank (2013), Note Comprehensive Assessment October 2013

At this point there is no clear plan for banks which run into trouble before the bail-in tool is implemented. In our opinion it would be wise to implement this sooner rather than later. The costs of re-capitalisation after the comprehensive assessment are hard to predict. We do not think that these estimates are useful other than that they give a sense of the order of magnitude. We have heard estimates in a wide range including numbers above 100 billion euro. The re-capitalisation will be a massive undertaking and even if everything goes

[17] European Central Bank (2013), Opinion of the European Central Bank of November 6 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76) http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html

[18] Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013 http://www.europarl.europa.eu/document/activities/cont/201307/20130705ATT69284/20130705ATT69284EN.pdf

smoothly, it is thinkable that some banks will be in need for support by their governments. Having a game plan and communicating that in advance is our preferred choice.

4. CONCLUSION

In this briefing paper we have argued that the comprehensive assessment by the ECB as well as future risk assessments and stress tests are best carried out behind closed doors. Too much transparency during the assessment process may induce the ECB to hold back. This is undesirable. We prefer an assessment which digs deep without close scrutiny of financial market participants. The ECB is responsible for the assessment and should be held accountable. After the assessment is finished the ECB would be transparent about the assessment process and the results.

However, while the assessment process should be held behind closed doors, we feel that the tools and methodology should be clear before the assessment. As it currently stands, the methodology of the stress test which is part of the comprehensive assessment is not yet communicated.

At the same time it should be clear what the game plan is after the comprehensive assessment. It is clear that some banks will need to be re-capitalised. Bank re-capitalisation in the U.S. after the *Supervisory Capital Assessment Program (SCAP)* in 2009 is sometimes quoted as an example of relatively successful re-capitalisation in a difficult context. However it seems wise to prepare for the case that the re-capitalisation among European banks will be more troublesome. This brings us to the bail-in tool. As it currently stands, the bail-in tool will only be implemented in 2018. We feel that an earlier implementation is desirable. A clear communication on how troubled banks are going to be dealt with may resolve any existing uncertainty.

The comprehensive assessment and need for re-capitalisation are important steps in anticipation of the SSM. We feel that it would be wise to make all methodological issues clear in advance and to be explicit about how troubled banks will be dealt with before 2018. The comprehensive assessment itself, as well as future stress tests, should be done without any restraint. One way to achieve this is to let the ECB do its job without much interference. We trust that they are up to the job.

REFERENCES

- Asmussen, Jörg (2013), *Building Banking Union,* Speech at the Atlantic Council, London 9 July 2013 http://www.ecb.europa.eu/press/key/date/2013/html/sp130709.en.html
- De Nederlandsche bank (2013), *Overzicht financiele stabiliteit, najaar 2013*
- Draghi, Mario (2013), *The future of Europe,* Opening Speech at the european Banking Congress, Frankfurt am Main 22 November 2013 http://www.ecb.europa.eu/press/key/date/2013/html/sp131122.en.html
- Eijffinger, Sylvester C.W. (2013), *Single Resolution Mechanism*, Briefing Paper for the Monetary Dialogue of February 2013; http://www.europarl.europa.eu/document/activities/cont/201302/20130214ATT61105/20130214ATT61105EN.pdf
- Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013; http://www.europarl.europa.eu/document/activities/cont/201307/20130705ATT69284/20130705ATT69284EN.pdf
- Eijffinger, Sylvester C.W. (2013), *The various roles of the ECB in the new EMU architecture*, Briefing Paper for the Monetary Dialogue of September 2013, http://www.europarl.europa.eu/document/activities/cont/201309/20130923ATT71742/20130923ATT71742EN.pdf
- European Central Bank (2013), *Note Comprehensive Assessment October 2013* http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf
- European Central Bank (2013), *8 November 2013 – ECB publishes its opinion on the Single Resolution Mechanism (SRM)* http://www.ecb.europa.eu/press/pr/date/2013/html/pr131108.en.html
- European Central Bank (2013), Opinion of the European Central Bank of November 6 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76) http://www.ecb.europa.eu/ecb/legal/opinions/html/act_12873_amend.en.html
- OECD (2013), Focus: Strengthening euro area banks, 10 january 2013 http://www.oecd.org/eco/economicoutlookanalysisandforecasts/strengtheningeuroareabanks.htm