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How Well Are the European Banking Regulations Working? Evidence from Recent Events in Spain and Italy

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In an April 14, 2016 PWP Global Macro Insights paper on Eurozone banks, we discussed the vulnerabilities of the European Banks and the overhauled Eurozone Banking System whose Single Resolution Mechanism (SRM) went into full effect in January 2016. At that time, the regulatory framework was incomplete and untested. A year and a half later, it remains incomplete, but no longer untested, warranting a close look at the evidence that has emerged.

One of the crucial elements of the new European banking legislation is the bail-in provision – the requirement that existing stakeholders absorb losses equal to 8% of the bank's assets before any state aid becomes available. Recent events in the banking sectors of Spain and Italy tested this provision and revealed the defining factors for its application. In particular, faced with failing banks in the two countries, Spain chose to apply the bail-in rule while Italy opted to bail out its banks. Why were these two different approaches chosen and what do these recent experiences mean for the viability and credibility of the new European banking regulations? The rest of this paper provides some answers to these questions.

The Case of Spain

On June 6th the European Central Bank's Single Supervisory Mechanism (SSM) declared Spain's Banco Popular "failing or likely to fail." This set in motion the EU's Single Resolution Board (SRB) which, in collaboration with the Spanish regulators, restructured the bank and engineered its takeover by Santander. This was a key test of two of the critical components of the European Banking Union, the SSM and the SRB. In addition, it provided a real life test of Europe's wide-spread reliance on contingent convertible debt (CoCos). The restructuring involved wiping out the existing equity and some junior debt, triggering the conversion of the contingent debt to equity which was then handed to Santander for 1 euro. Senior debt holders and depositors were not impaired and, most importantly, as prescribed by the regulations, taxpayers' money was not involved.

In the case of Spain's Banco Popular, the bail-in provision of the Resolution Mechanism worked as intended and no bail out was necessary. While the Spanish test of the regulatory framework led to some initial euphoria regarding the achievement of an orderly resolution, the enthusiasm was short-lived. A month later the Italian government stepped in to provide state aid to some of its failing banks, with the approval of the ECB, without first applying the bail-in provision.

The Case of Italy

Faced with the distress of the Italian lender Monte dei Paschi Di Sienna (MPS) and the failing regional banks Banco Popolare di Vicenza and Veneto Banca, the Italian government got permission from the ECB and the European Union to inject at least 20 billion euros into the Italian banking system.

MPS has been hovering on the brink of default for several years. Plans for its rescue were finalized a few weeks ago with the arranged sale of a portfolio of bad loans from the bank's balance sheet for the equivalent of about 20 cents to the dollar. The bad loans are being transferred to a special vehicle. At the same time, a plan was approved to close Banco Popolare di Vicenza and Veneto Banca. The shareholders and junior debt holders of these banks would be wiped out and the healthy remains would be acquired by Intesa Sanpaolo. To incentivize Intesa to assume the healthy assets of those two regional banks, the Italian government would provide billions of euros to Intesa so that after its acquisition of these assets, it would not be worse off than before it acquired them. In addition, the government would bail out investors who bought the senior unsecured debt of the defunct banks. In other words, the Italian government bailed out those banks and avoided applying the bail-in provision of the new European banking regulations.

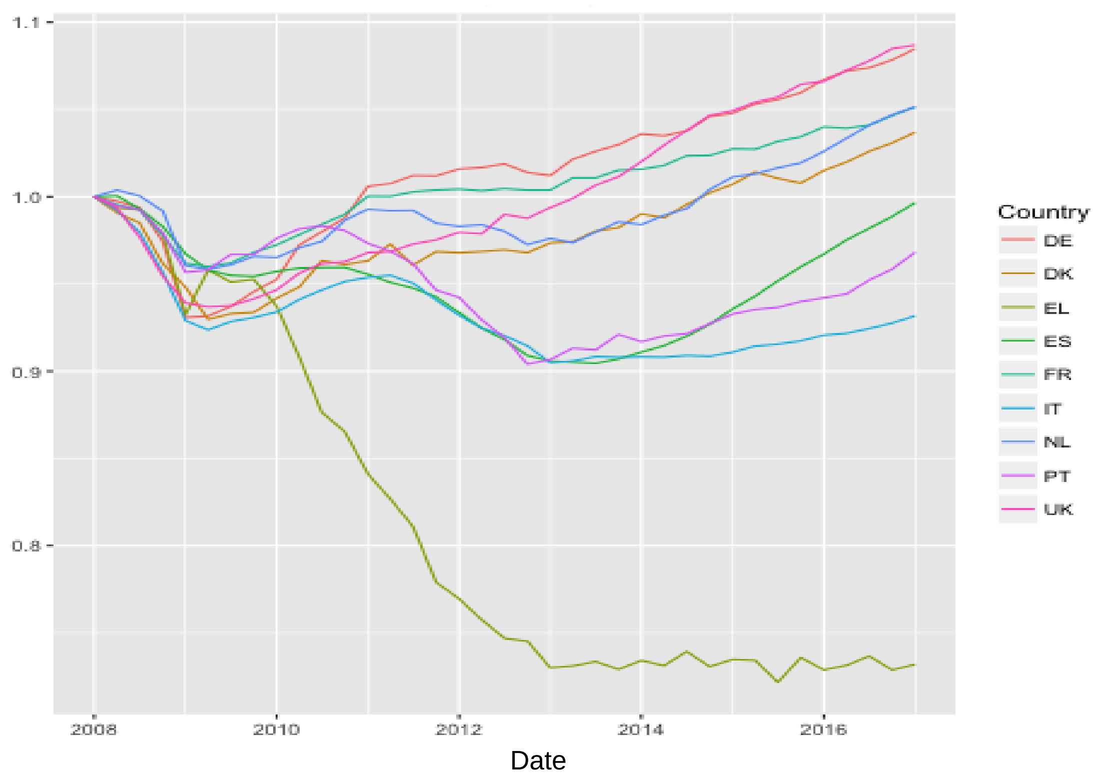
Why did Spain bail-in and Italy bail-out?

In the case of Spain, it was deemed that applying the bail-in provision would not lead to contagion, and it did not. In the case of Italy, however, the Italian authorities reached the opposite assessment. The specific conditions surrounding the Italian banking sector and those banks in particular, made them susceptible of setting in motion a contagion in the Italian banking system. The Italian government has been determined to avoid that.

One of the reasons the Italian government stepped in to rescue its banks is that the banks sold much of their contingent convertible debt to their own retail customers, offering them higher returns without warning them of the risks. A default by some of these institutions could lead investors of contingent convertible debt from other banks to dump the debt, unleashing contagion across the Italian banking system and impairing the ability of the economy to function.

The health of the economies of the two countries has also played a role. Figure 1 shows that Italy and Spain have diverged in recent years in terms of their economic growth trajectories. While growth has significantly accelerated in Spain since 2014, it remains largely stagnant in Italy. Furthermore, Italy suffered a deeper recession than Spain following the financial and European crises that left scars on the country's economy. The recent pickup in growth in Italy and across the region is a positive and welcome development, but it does little to reduce the prolonged economic divergence of the Eurozone economies.

FIGURE 1: REAL GDP – CHAIN-LINKED 2005 (€ MILLIONS)



Source: Eurostat.

Some of those scars manifest themselves through the high percentage of Non-Performing Loans (NPLs) that Italian banks carry on their balance sheets. The figure stands at 14.8% of total loans in Italy, the third highest percentage in Europe after Greece and Portugal, whereas in Spain 5.5% of total loans are deemed non-performing. The percentages of NPLs for a number of European countries are provided in Table 1 below.

TABLE 1: PERCENT OF NON-PERFORMING LOANS

Greece	Italy	Portugal	Spain	France	Germany	U.K.	Ireland
46.2	14.8	18.5	5.5	3.5	2.4	1.8	12.5

Source: European Banking Authority Risk Dashboard.

High percentages of NPLs imply that a significant part of the banks' capital is not deployed in productive activities, reducing the banks' profitability and its ability to extend credit to the healthy sectors of the economy. The resulting credit contraction weighs on the ability of the country to generate growth, especially given the heavy reliance of most European countries on bank credit to finance economic activity.

The comparison between the Spanish and Italian cases reveal that the banks' "pre-existing conditions" have a lot to do with the viability of the bail-in mechanism that has been the cornerstone of the European resolution plan. Therefore, one of the challenges for the application of this resolution plan is that these "pre-existing conditions" have not been dealt with prior to the creation of the European Banking Union. The stark differences in NPL levels across countries and their implications for economic growth in those countries seem to also impede the uniform application of the European banking regulations.

The Capital Adequacy of Eurozone Banks Remains a Problem.

The adequacy of European bank capital remains an issue. As we noted above, Banco Popolare easily passed its initial stress tests but failed a few months later. In our earlier report we presented the data on capital adequacy that is compiled and maintained by Thomas M. Hoenig, former President and CEO of the Federal Reserve Bank of Kansas City and a Director of the FDIC. Table 2 updates the leverage ratios of the European Globally Systemically Important Banks (GSIBs) with estimates from December 21, 2016.[1]

TABLE 2: TANGIBLE CAPITAL OF EUROZONE GSIBS

	Leverage Ratio %	Total Assets ($Billions)
Deutsche Bank	2.90	1,677
UniCredit	2.95	906
Banco Santander	3.56	1,412
Société Générale	3.87	1,458
BNP Paribas	4.08	2,190
BBVA	4.22	744
BPCE	4.82	1,303
Crédit Agricole	4.83	1,817
ING	5.65	891
U.S. GSIB's Avg	**6.28**	**14,012**

Source: FDIC.

High percentages of NPLs imply that a significant part of the banks' capital is not deployed in productive activities, reducing the banks' profitability and its ability to extend credit to the healthy part of the economy. The resulting credit contraction weighs on the ability of the country to generate growth, especially given the heavy reliance of most European countries on bank credit to finance economic activity.

Since our report on European Banks last year, U.S. Banks have further improved their average leverage ratio from 5.69 to 6.28 while at the same time their total assets increased from $13,856 billion to $14,012 billion. Some marginal improvement in the leverage ratios of some European GSIBs was also observed, although the big Eurozone banks remain undercapitalized relative to their U.S. counterparts. Furthermore, the improvement observed was not uniform. Notably, the leverage ratio of UniCredit fell from 3.81 to 2.95 and that of Deutsche Bank's from 3.01 to 2.9. Were one of these banks to require resolution, it is highly unlikely that the existing structure and contingent convertible debt could handle the burden without resorting to a bailout.

[1] He advocates, with good reason, looking at capital ratios (leverage ratios) based on IFRS Accounting standards rather GAAP. They give quite different results because the former do not allow the netting of derivative positions while the latter do. In a systemic event counterparty risk can be high so netting may not reflect the true risk. The leverage ratios reported are the ratio of adjusted tangible equity to adjusted tangible assets. Adjusted tangible equity and adjusted tangible assets subtract goodwill, other intangible and deferred tax assets. This provides a much clearer picture of the capital cushion of a bank.

What are the Implications for the Credibility of the European Banking Union?

Italy's bailout of its ailing banks dealt a blow to the credibility of the newly enacted banking regulations. Furthermore, the reasons behind this deviation from the rules in place suggest that the government-orchestrated rescue of Italian banks is unlikely to remain an isolated case.

In countries with high percentages of NPLs – countries that have severely hampered banking sectors – resolution with bail-in debt is difficult to implement. What worked in Spain has little chance of working in Italy, Greece or Portugal. The Italian experience also underscores that there will always be times when governments find it more prudent to intervene.

Banks in countries with high percentages of NPLs need to write off their bad loans and be recapitalized. But when banks are so severely impaired, raising capital is not an option for them. In those cases, it may be appropriate for the state government to step in and inject capital, or orchestrate a restructuring that will result in little collateral damage.

Each of the Eurozone countries has its own idiosyncrasies when it comes to their banking sector and their issues need to be dealt with on a case by case basis. Even in the case of NPLs, the sector concentration of the NPLs, the value of the collateral held against them (coverage ratio) and the forbearance of the loans can vary significantly from country to country. But until these legacy issues are fully addressed, the new European banking regulations have little chance of being uniformly applied across the region, and are unlikely to be viewed as truly binding.

Beyond the recent test of the new banking regulations in Europe, there remain many issues that can prevent the full implementation of the bail-in provision in future cases. The heavy reliance of European banks on contingent convertible securities as part their capital reserves and their continued undercapitalization relative to their U.S. counterparts are likely to complicate future bank resolutions. Weak banks with poor quality legacy assets hold back growth in the euro area. Until there is significant convergence of economic growth across the member-states of the euro area and a common deposit insurance scheme, the European Banking Union will remain an elusive concept.

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Maria Vassalou is Partner and Portfolio Manager for the PWP Global Macro strategy. Dr. Vassalou joined Perella Weinberg Partners from MIO Partners, a subsidiary of McKinsey & Company, where as a Portfolio Manager she managed a similar global macro investment strategy in a dedicated legal entity, and as Head of Asset Allocation she provided counsel on allocation for liquid assets within MIO's portfolio. Prior to joining MIO, Dr. Vassalou was a Global Macro Portfolio Manager at SAC Capital Advisors, LP. She joined SAC from Soros Fund Management where she was responsible for global quantitative research, as well as the development and management of global quantitative trading strategies. Prior to her career in asset management, Dr. Vassalou was an Associate Professor of Finance at Columbia Business School which she joined in 1995 and where she established many of the investment principles she employs today. Dr. Vassalou is a Past President of the European Finance Association and was the Chair of the 2008 European Finance Association Meetings. She has also served as a Research Affiliate of the Centre for Economic Policy Research (CEPR) in London for many years and is a past member of the Academic Advisory Board of the Vienna-based Guttmann Center of Competence in Portfolio Management. Her research focus has been on the interrelation of the macro-economy and financial markets with applications in hedge fund strategies. A frequent speaker to both academic and practitioner-oriented seminars and conferences, Dr. Vassalou has published in leading academic journals, such as the Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Journal of Business, Journal of International Money and Finance, and the Journal of Economic Dynamics and Control. While she was on the faculty of Columbia University, she also served as a consultant to many premier hedge funds and asset management institutions in the U.S. and Europe. Dr. Vassalou received a Bachelor of Arts in Economics from the University of Athens and she holds a Ph.D. in Financial Economics from London Business School.

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