Risk Reduction in the Banking Union: NPLs and Sovereign Debt Concentration

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Outline:

General theme:

Risk Reduction in the Banking Union, two key elements:

1. NPLs
2. Sovereign Debt Concentration

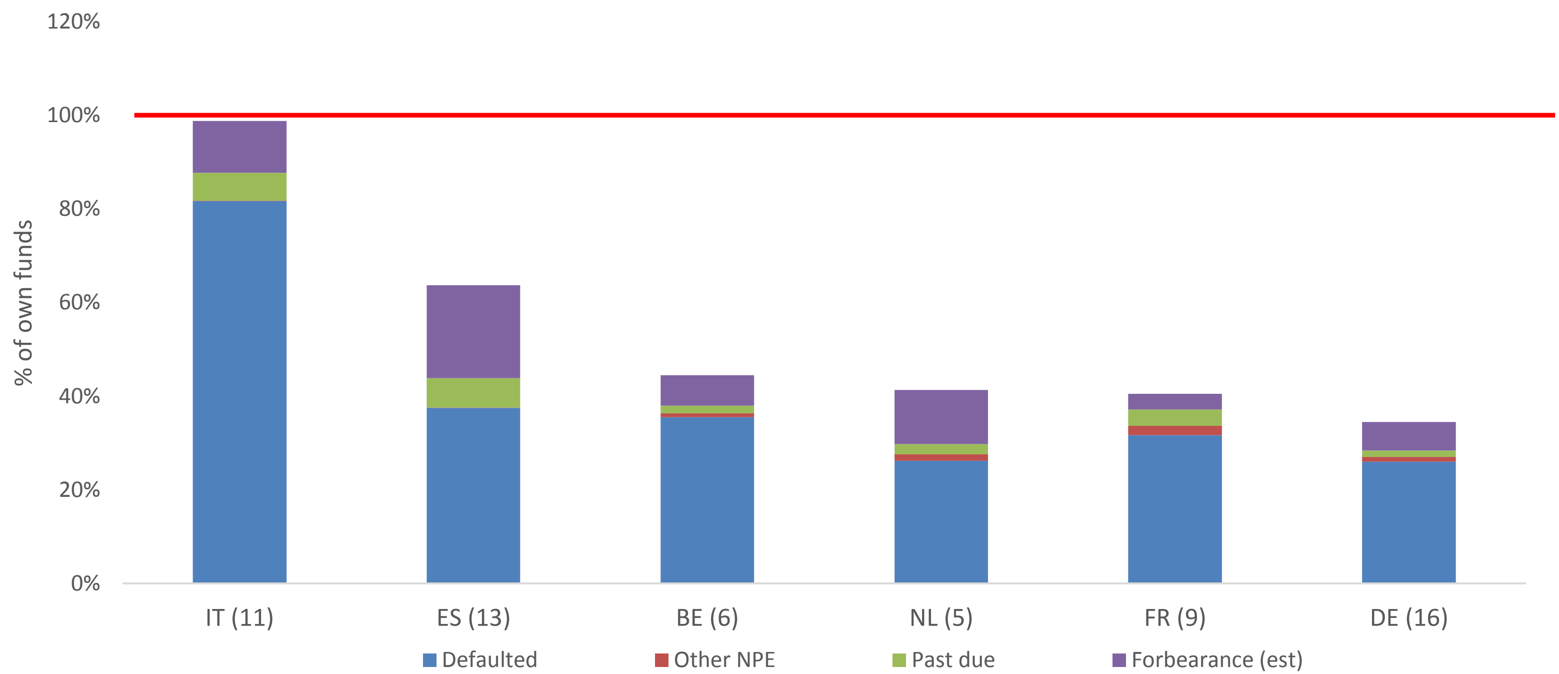
Different in nature

- NPLs much more country specific than sovereign debt holdings,
- NPLs (stock of) ‘known’ problem, seems manageable,
- Concentration of sovereign exposure very bank specific, with complex causes.

NPLs: why should we care?

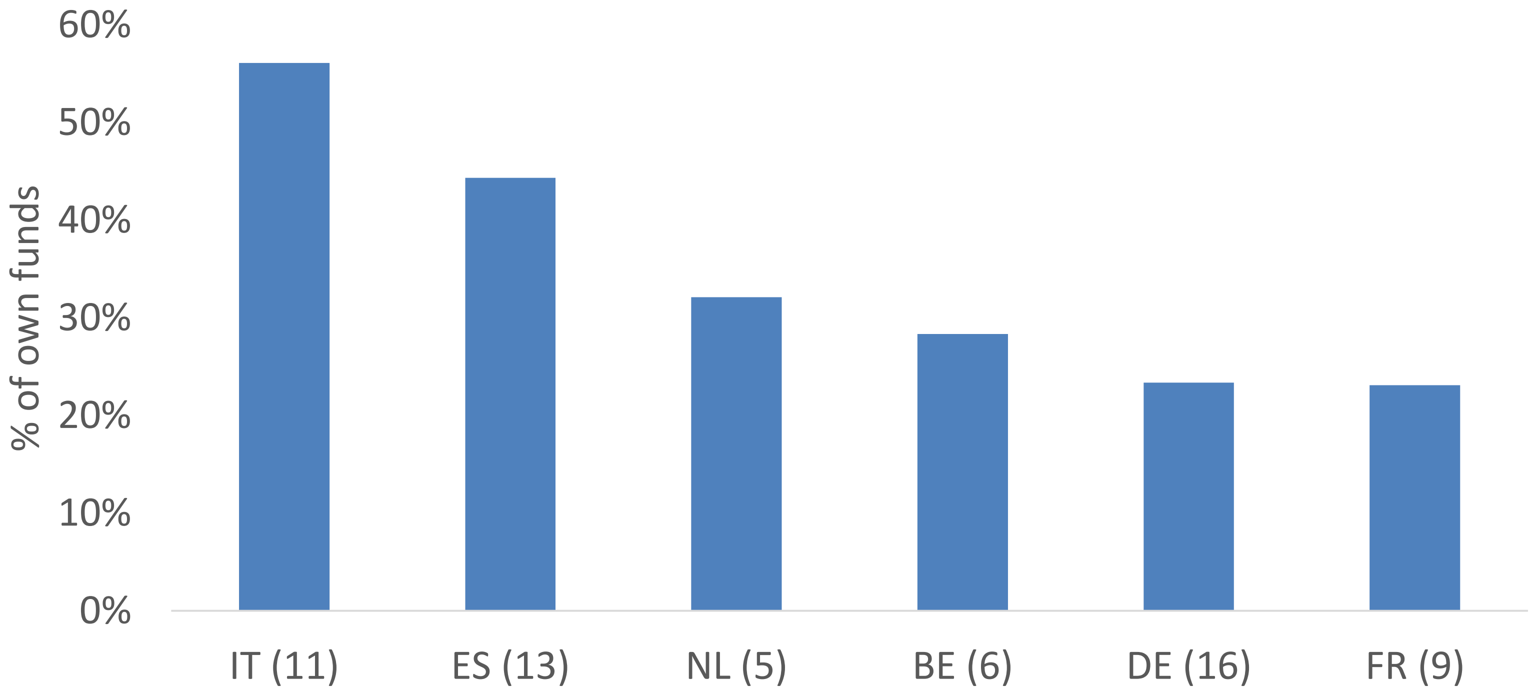
- NPLs = losses = ‘bad’,
- How big is problem?
- Nominal amount gigantic: 1 thousand billion.
- But what remains ‘at risk’?
- Forced recognition of potential further losses can transform this ‘known unknown’ into a ‘known known’ (in terms of downside risk).
- Danger for stability of system or only (temporary?) of control for existing shareholders?
- Look at problem as % of own funds.

Non-performing exposures and forbearance of systemic banks in the euro area (June-2017)



Source: Authors' elaboration based on EBA (2017)

Non-performing exposures and forbearance minus impairments and provisions (June-2017)



Source: Authors' elaboration based on EBA (2017), sample of systemic banks in the euro area

NPL problem?

From afar big problem, less from closer up.

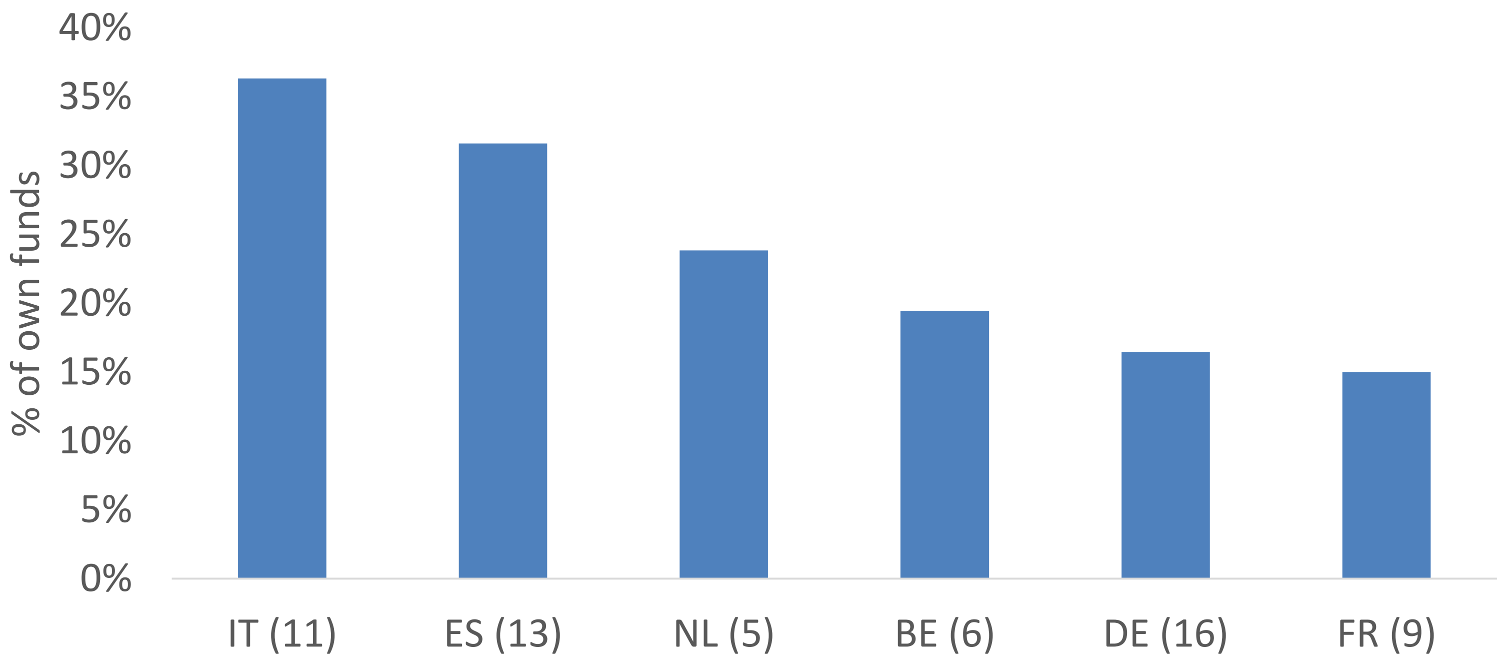
Problem partially ‘provisioned’.

Remaining problem: If value zero, would need to increase capital by 40-50 % in IT or SP.

We calculate size of remaining problem as:
Nominal exposure * 0,8 (assuming residual value is 20 % of nominal) minus provisions and impairments. Remaining loss covered by ‘bail-inable’ capital? (Key issue for deposit insurance to become relevant.)

But remaining uncertainty could have macro impact?

Non-performing exposures and forbearance minus impairments, provisions residual value of 20% (June-2017)



Source: Authors' elaboration based on EBA (2017) of systemic banks in the euro area

NPLs: why the resistance to loss recognition? (An 'efficient' market perspective)

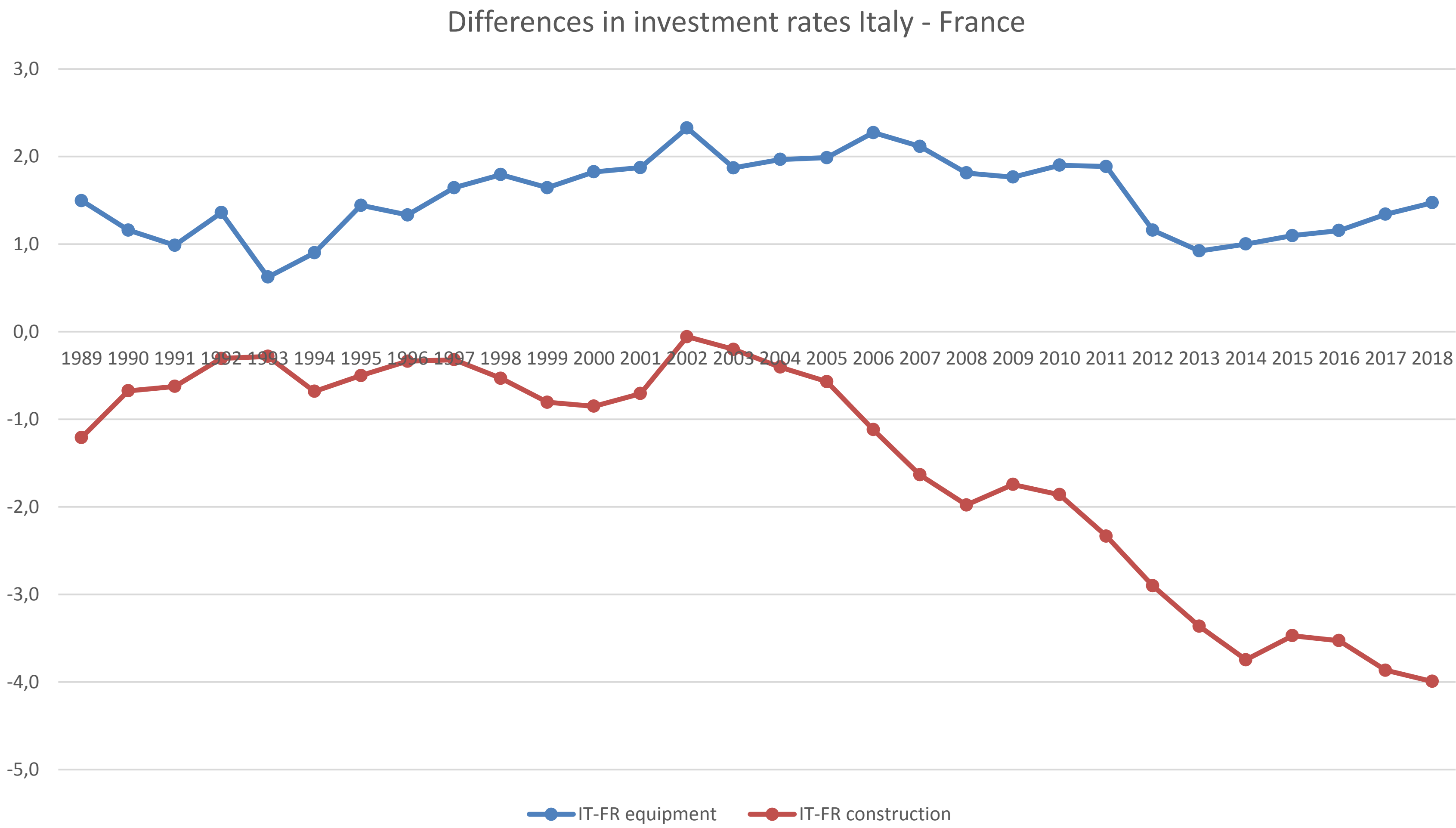
- Two approaches:

1. Force banks to sell NPLs at market value, below 'true' value (because informational asymmetries, 'market for lemons' problem) => Current shareholders shoulder losses (should have bought the NPLs).
2. NPLs remain on balance sheet, but must be written down => forced recapitalization. If new capital does not recognize the 'true' value of the NPLs it will under-value the bank. But new shareholders will make big gain when 'true' value is revealed. Why should existing shareholders not subscribe to capital increase?

NPLs: why should we care (macro aspect)

- NPLs = losses = ‘bad’
- Banks with high NPLs usually give less credit.
- Association or causation?
- Association clear: after credit boom comes the bust with little credit, but the bust also means NPLs.
- Theoretically weak banks (due to NPLs) could react by gambling on resurrection (increase credit) or hunker down to avoid new losses,
- Empirically little evidence for causality at macro level (e.g. Italy (high NPLs) vs. France (low NPLs).

Little impact on investment



Sovereign exposure = bonds + credit, n.b. Sovereign = general government in our data.

Sovereign exposure very variable across banks, more variable across banks than across countries(?)

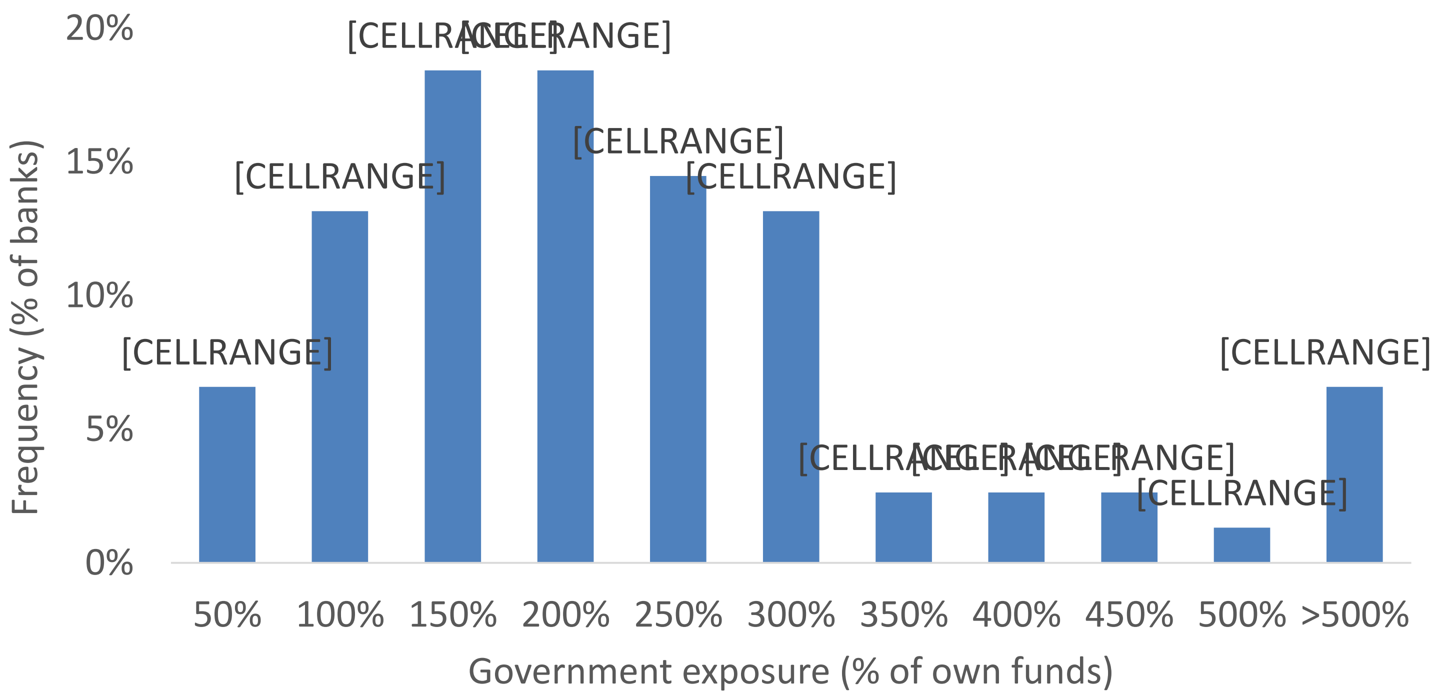
No clear relationship broad business model with sovereign exposure.

But some banks specialize in lending to sub national governments and agencies.

Data from banking group consolidate subsidiaries => parent will appear with little 'home bias' if all subsidiaries have strong 'home bias'. (E.g. Unicredit subsidiary in Germany (ex HVB only invests in German bonds.)

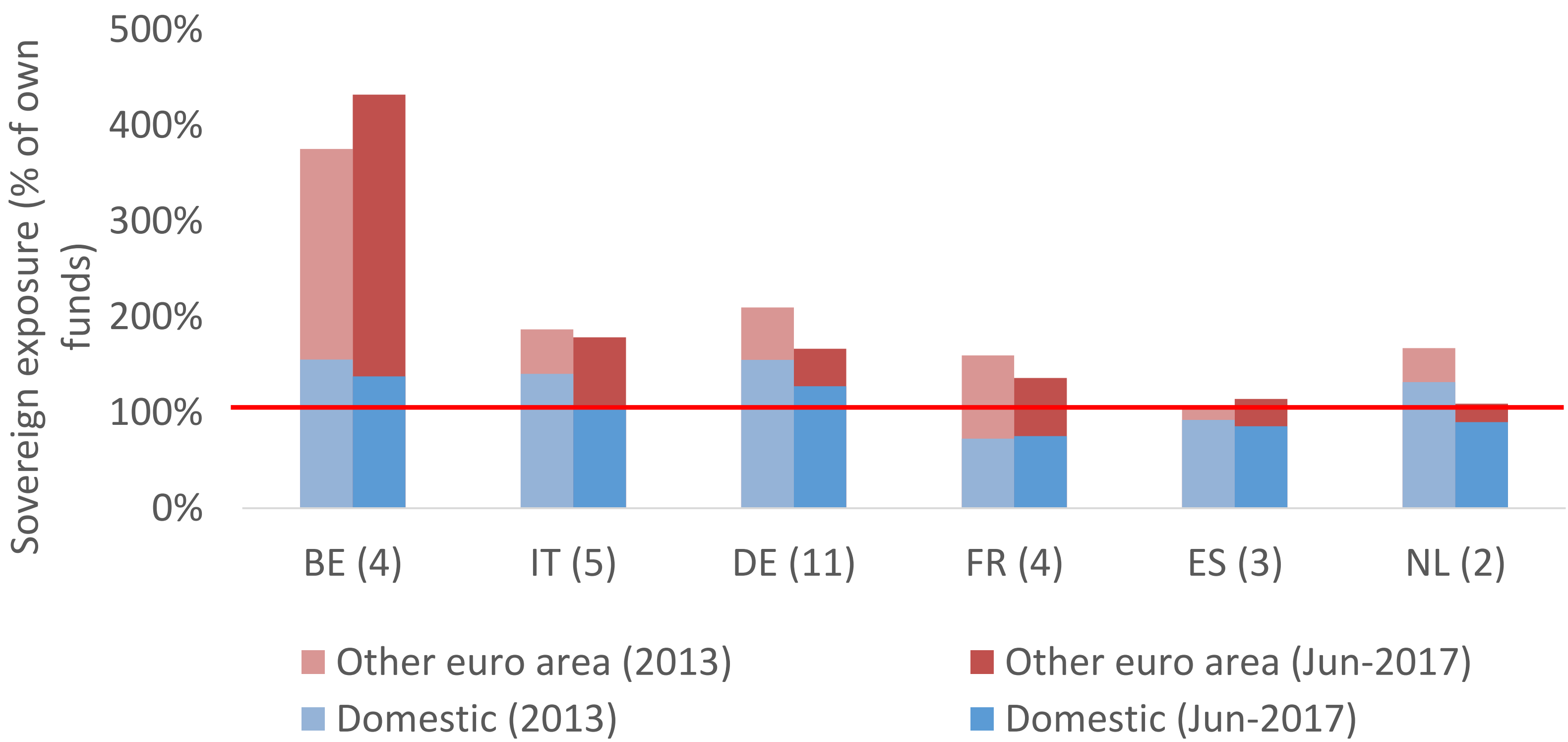
Most of the significant banks have important subsidiaries abroad.

Distribution of government exposure across euro area systemic banks (June-2017)



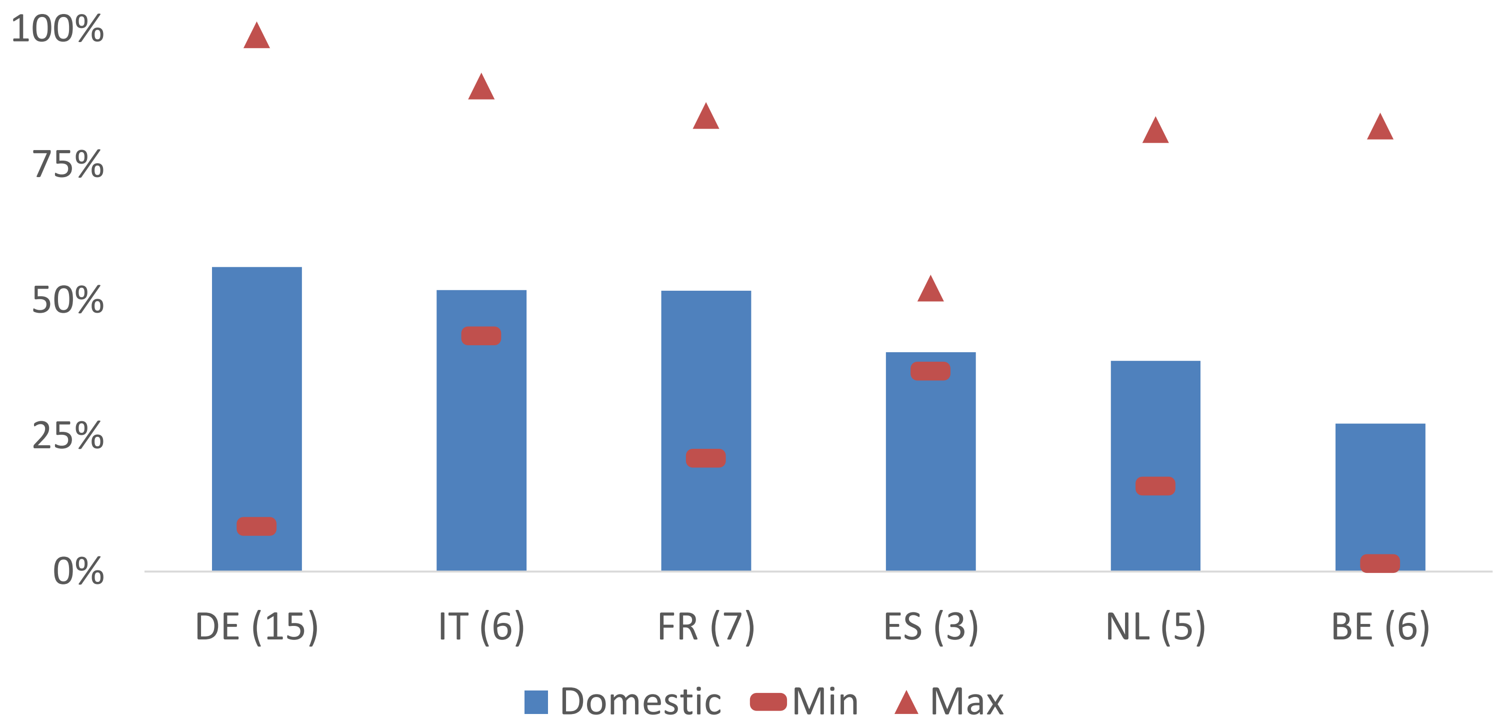
Source: Authors' elaboration based on EBA (2017)

Government-debt exposure of systemic banks in the euro area (2013-17)



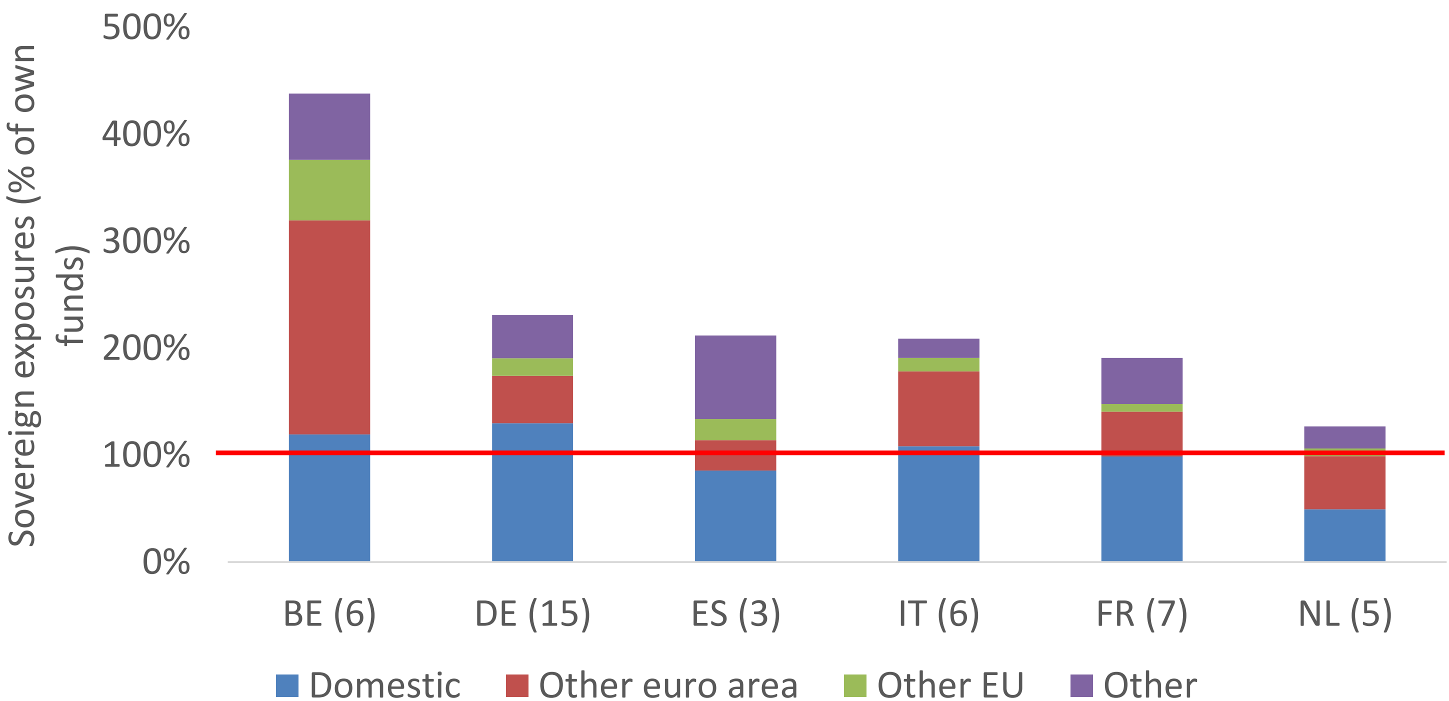
Source: Authors' elaboration based on EBA (2014-17)

Min-Max in home bias in government-debt exposure (June-2017)



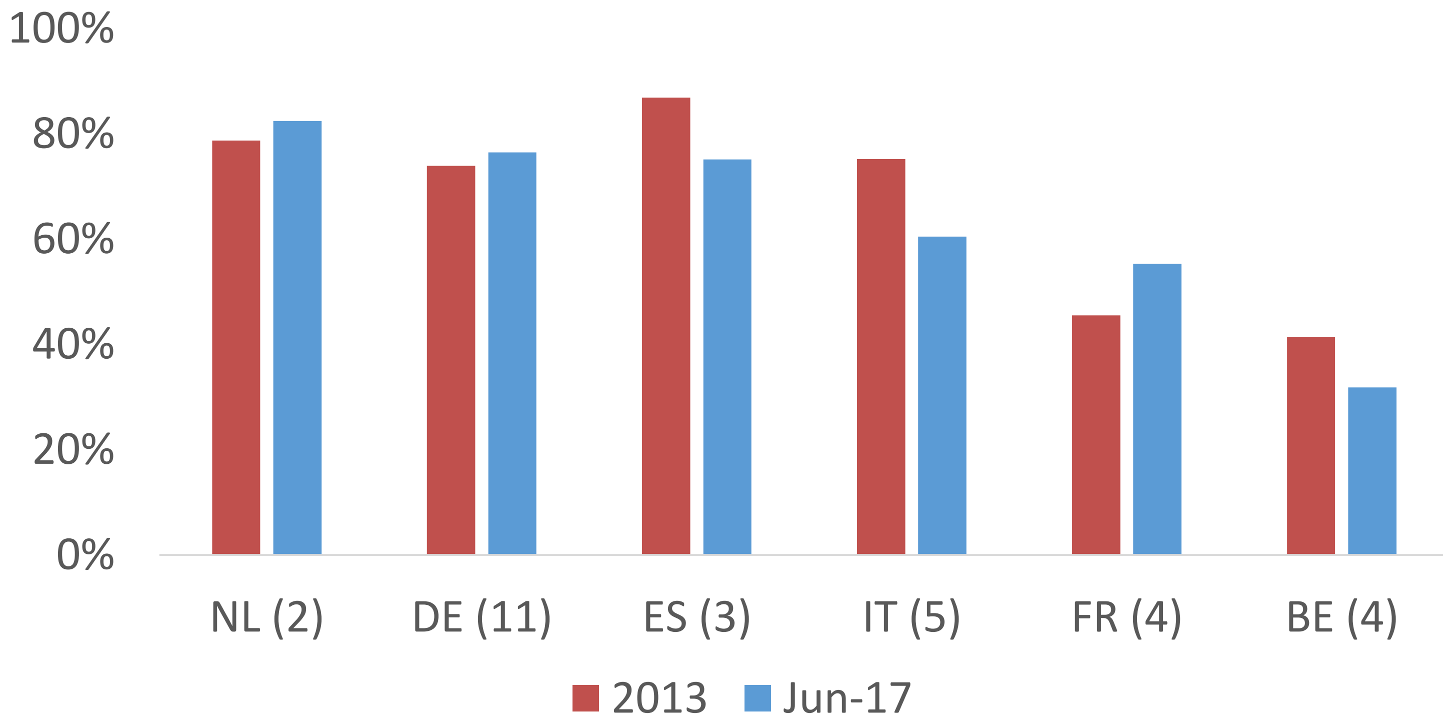
Source: Authors' elaboration based on EBA (2017), sample of systemic banks in the euro area.

Home bias in government-debt exposure of systemic banks in the euro area (June-2017)



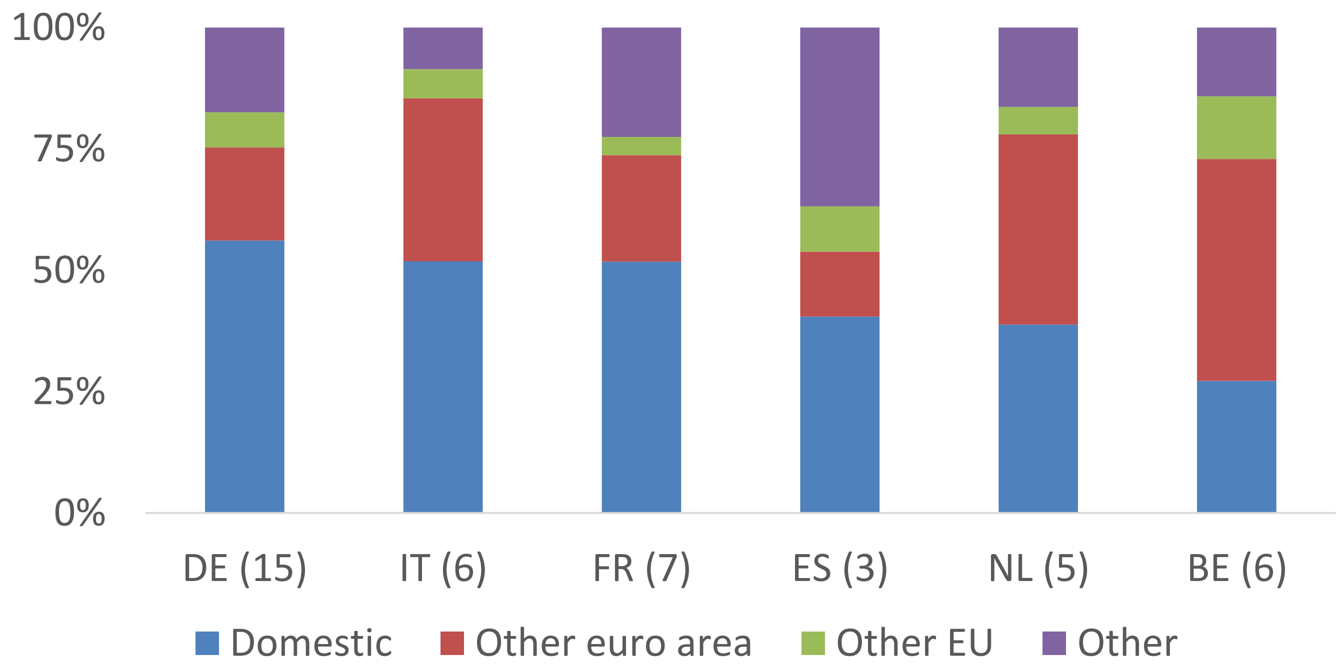
Source: Authors' elaboration based on EBA (2017)

Change in home bias in government-debt exposure? (2013-17)



Source: Authors' elaboration based on EBA (2014-17), sample of systemic banks in the euro area

Home bias in government-debt exposure of systemic banks in the euro area (June-2017)



Source: Authors' elaboration based on EBA (2017)

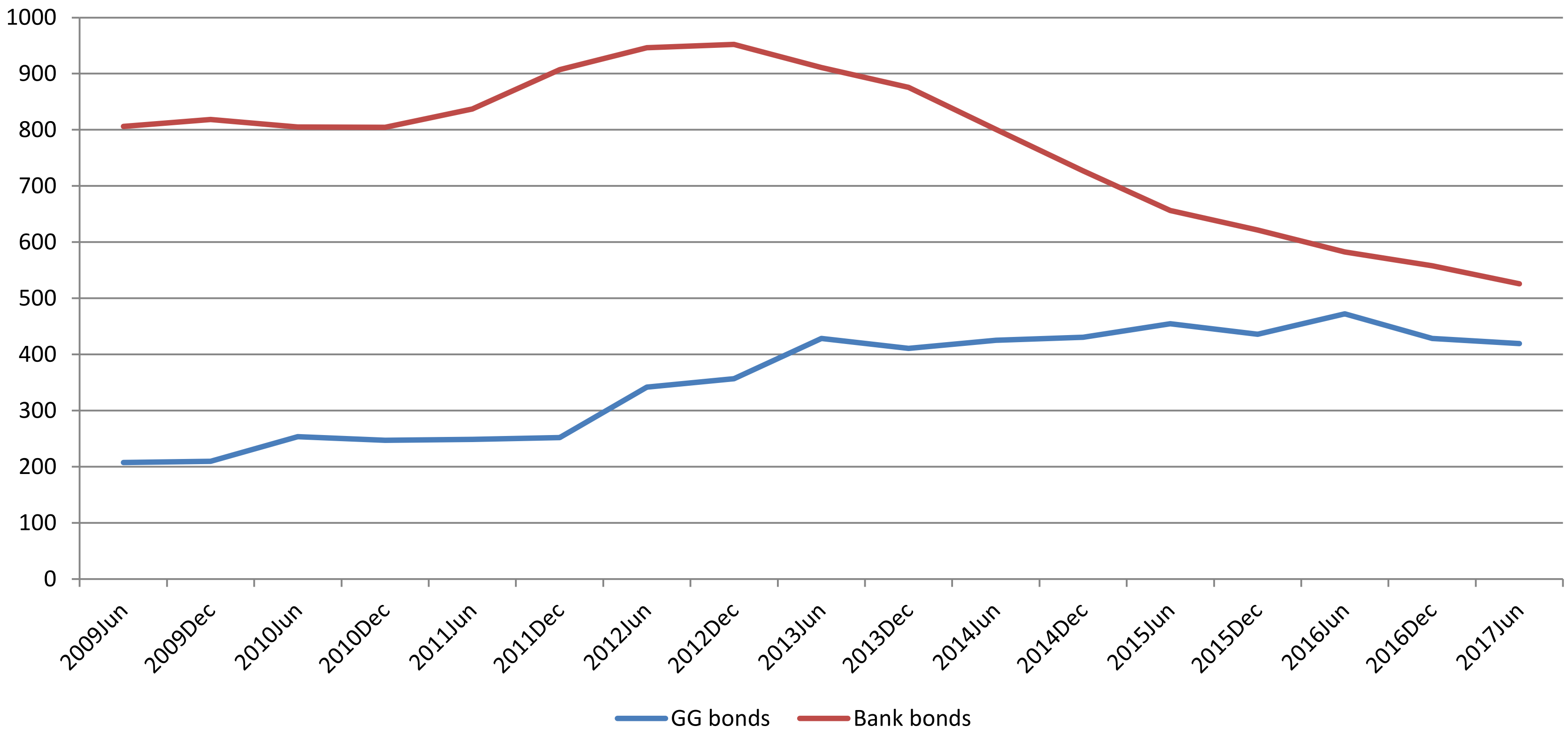
Banks buying (holding?) sovereign bonds => stabilizes market?

Two ‘real life’ examples: Greece and Italy

Greece: Banks held large amount of government bonds. Hair cut was formally applied but ESM needed to lend the Greek government money to recapitalize banks. => If Greek banks had been diversified in their government holdings Greek government debt lower today (% hair cut lower). Crisis a bit more manageable?

Italy: Banks made profits on buying BTPs at distressed prices (and lost, on average, on domestic lending). Excellent bargain, stabilized market.

Italy: banks holdings of government bonds and bank bonds issues

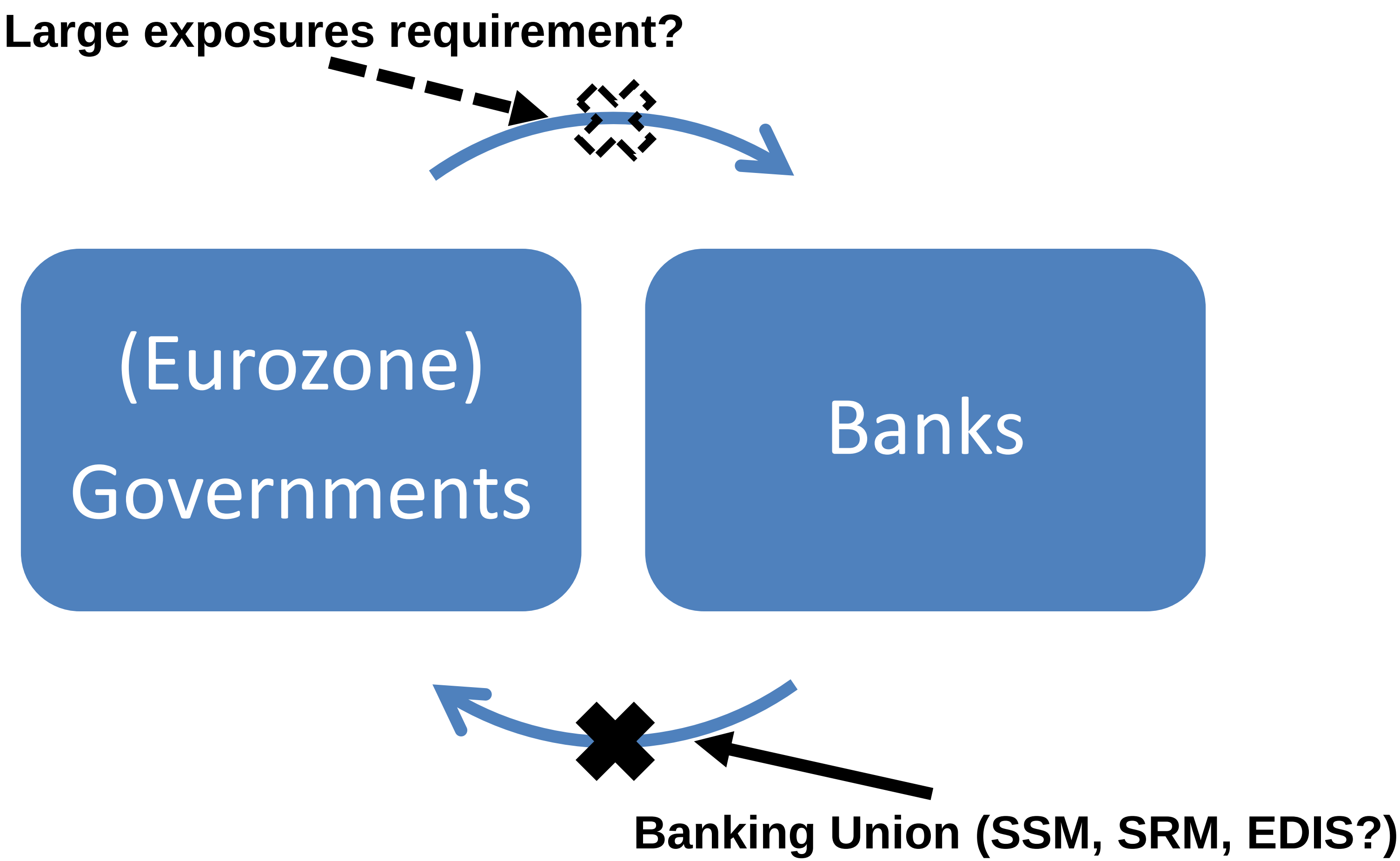


Banks buying (holding?) sovereign bonds => stabilizes market?

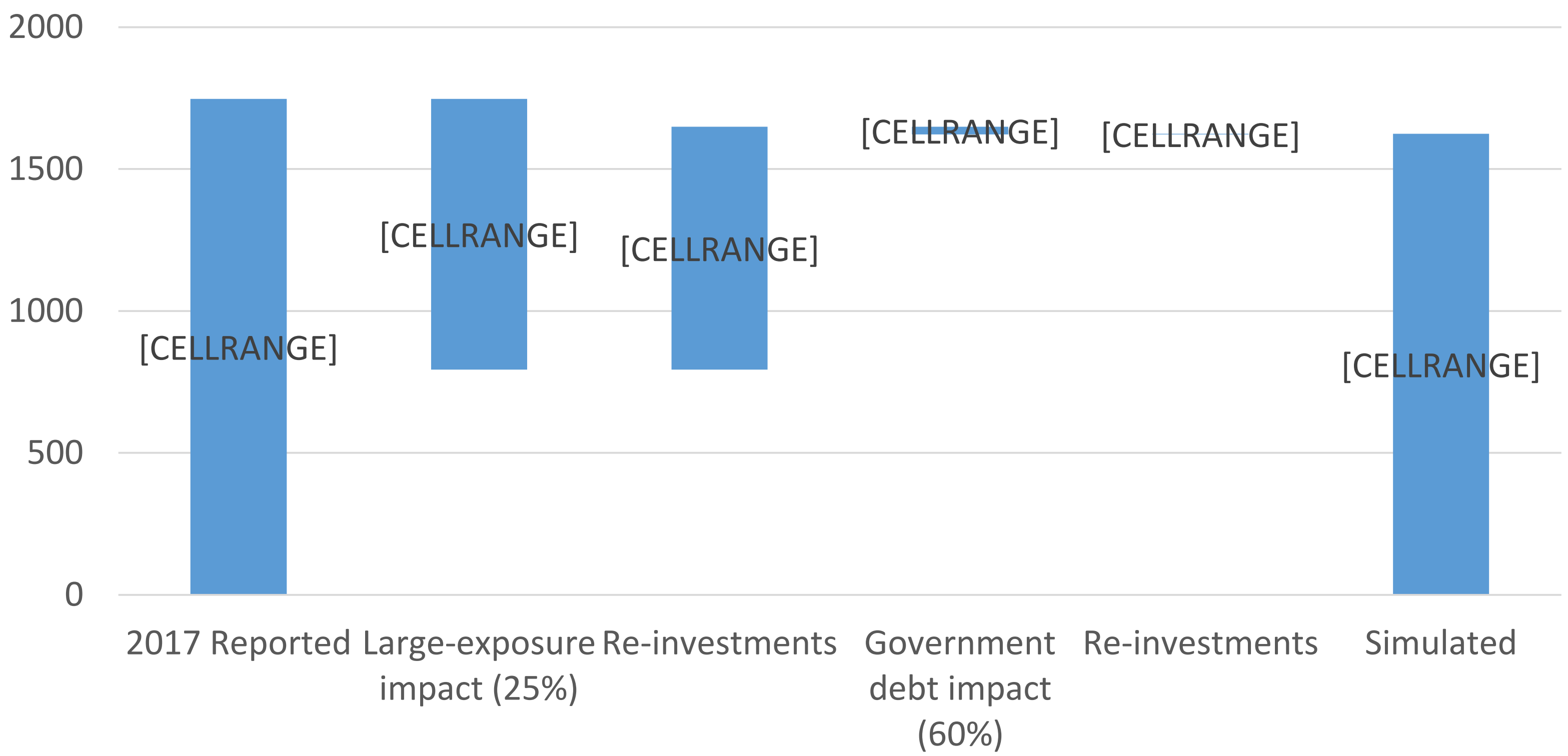
Need to look at financing of bond purchases.
Presumably counterpart to holdings of medium to long term government bonds is medium term financing, i.e. bank bonds. But cost of bank bonds usually > return on government debt (for similar maturity).

=> Holding large amounts of government bonds and having large amounts of bank bonds as liabilities implies a negative ‘carry’ and thus weakens banks. (Example Italy)

Stress tests focus on asset side, but structure of liability side also important.


Large exposures requirement?
(Eurozone) Governments
Banks
Banking Union (SSM, SRM, EDIS?)

Simulation of the impact of the application of max 25% large-exposure requirement to government debt (% of euro area government debt)



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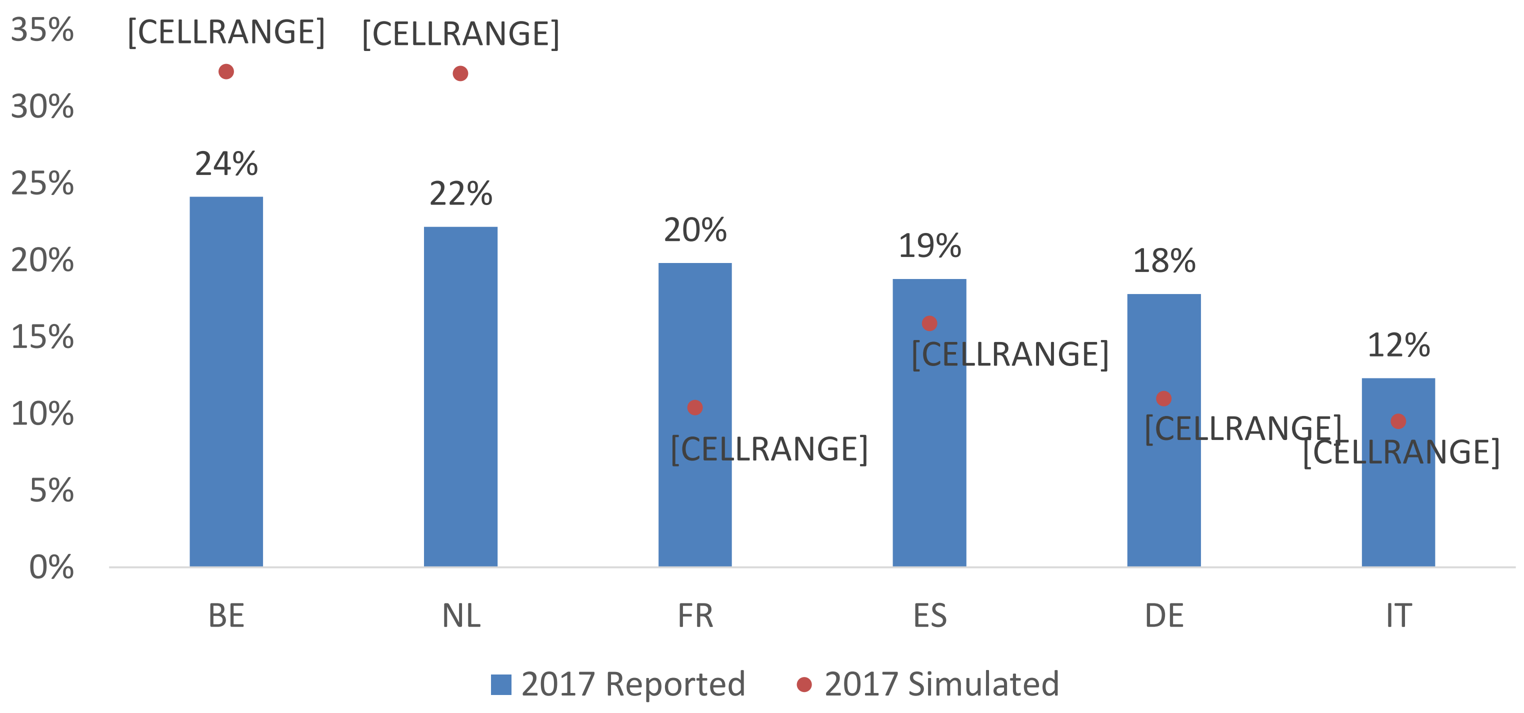

Source: Authors' elaboration based on EBA (2017)

Conclusions:

1. Existing stock of NPLs should not be viewed as obstacle to finishing the banking union (gradually).
2. Impact of NPLs on lending a priori unclear, little macroeconomic evidence.
3. Home bias in sovereign exposure likely to exacerbate sovereign- bank ‘doom loop’.
4. Banks buying government bonds might weaken the banks themselves.

Conclusions II: what to do?

1. NPLs: might be useful to eliminate residual risk by forcing pace of loss recognition/sales on the market.
2. Home bias in sovereign exposure: overall reduce government reliance on banks by disintermediating them (selling bonds directly to households). Impose exposure limits for new purchases, perhaps with ‘escape clause’ for financial stability reason to ECB.