Rector: HE Prof. D.Sc.(Econ) **Statty Stattev**

Increasing Challenges for the European Banking Industry

The Impact of shift of Markets and Supervision on Business Models

by Hans Unterdorfer

Sofia, March 2015

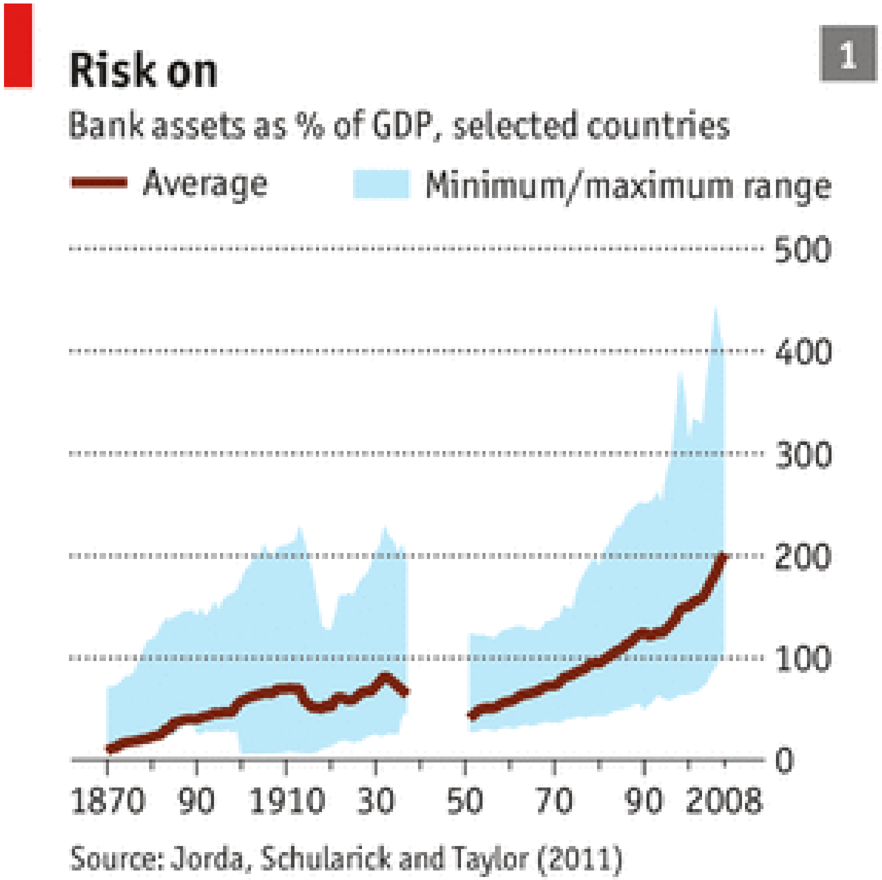
Content

- Financial crisis 2008 – brief context
- European Banking Industry
- Path to the European Banking Union
- Impact that matters – regulatory pressure
- Conclusions

FINANCIAL CRISIS 2008 – BRIEF CONTEXT

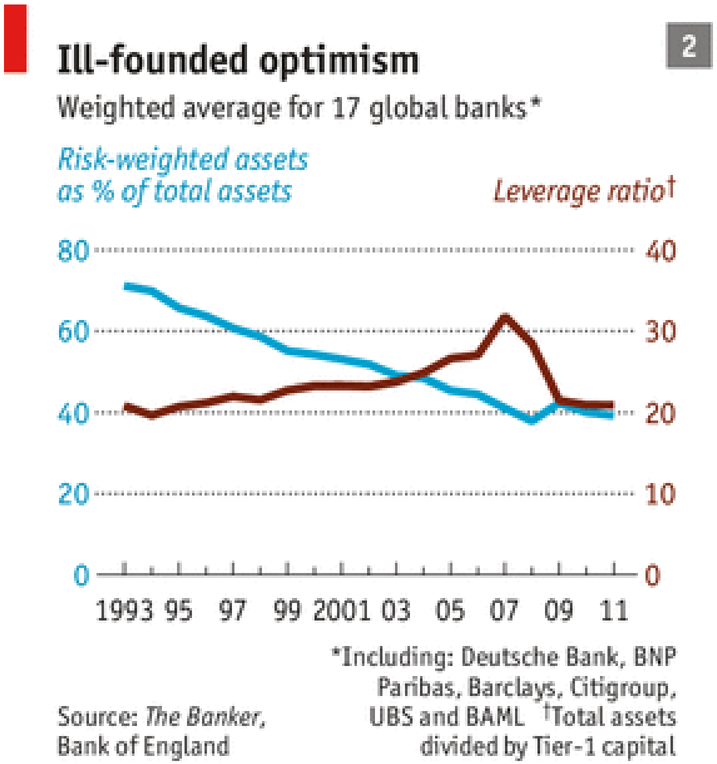
Financial crisis – short history

- THE collapse of Lehman Brothers, a sprawling global bank, in September 2008 almost brought down the world’s financial system
- worst recession in 80 years



The whole system was revealed to have been built on **flimsy foundations**: banks had allowed their balance-sheets to bloat (see chart 1), but set aside too little capital to absorb losses. In effect they had bet on themselves with borrowed money, a gamble that had paid off in good times but proved catastrophic in bad.

http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article



Under pressure from shareholders to increase returns, banks operated with minimal equity, leaving them vulnerable if things went wrong. And from the mid-1990s they were allowed more and more to use their own internal models to assess risk—in effect setting their own capital requirements. Predictably, they judged their assets to be ever safer, allowing balance-sheets to balloon without a commensurate rise in capital (see chart 2).

Main Triggers

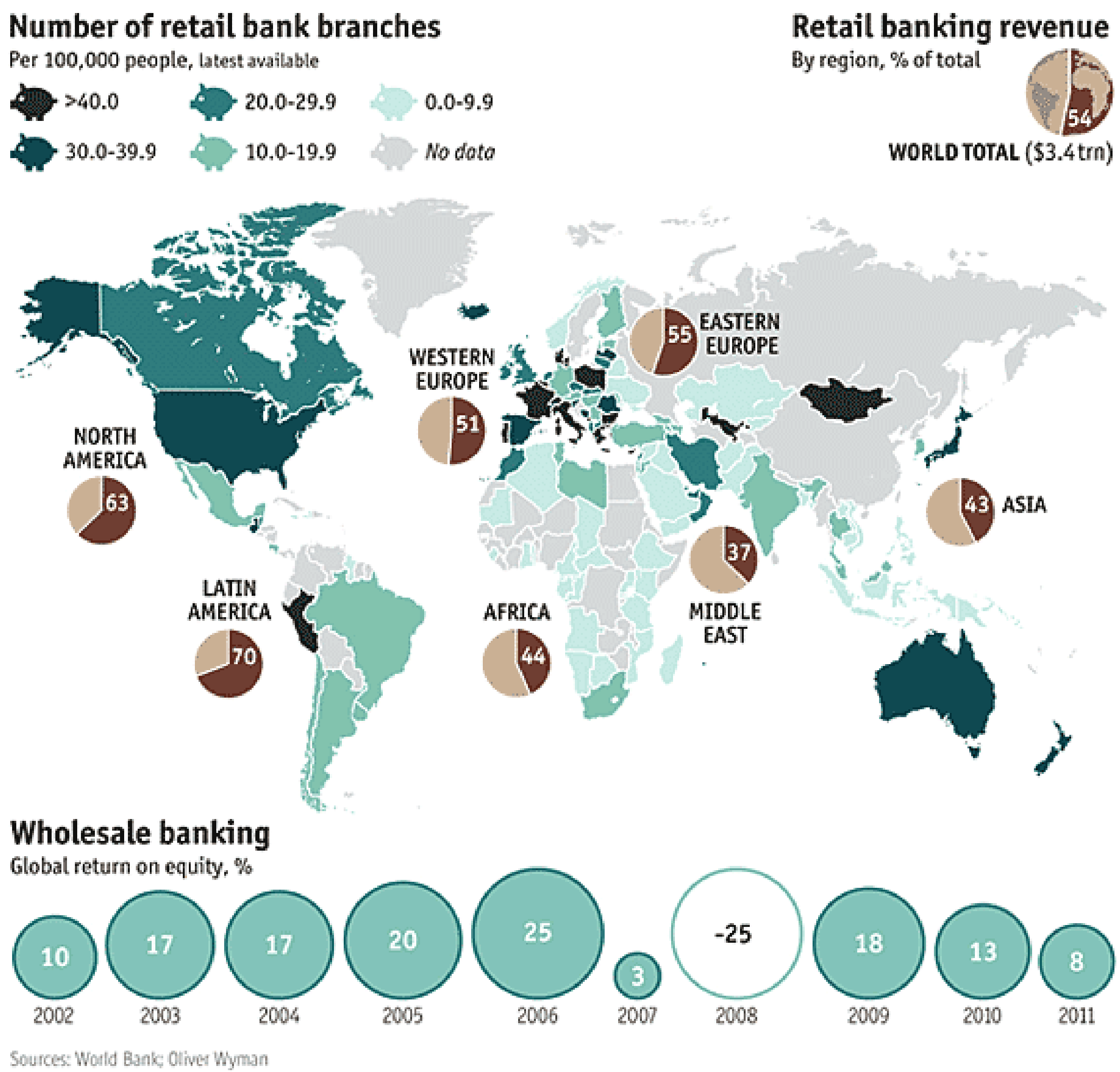
- collateralised debt obligations (CDOs)
- safer tranches because they trusted the triple-A credit ratings
- Lehman Brothers go bankrupt
- decision to stand back and allow Lehman to go bankrupt resulted in more government intervention

EUROPEAN BANKING INDUSTRY

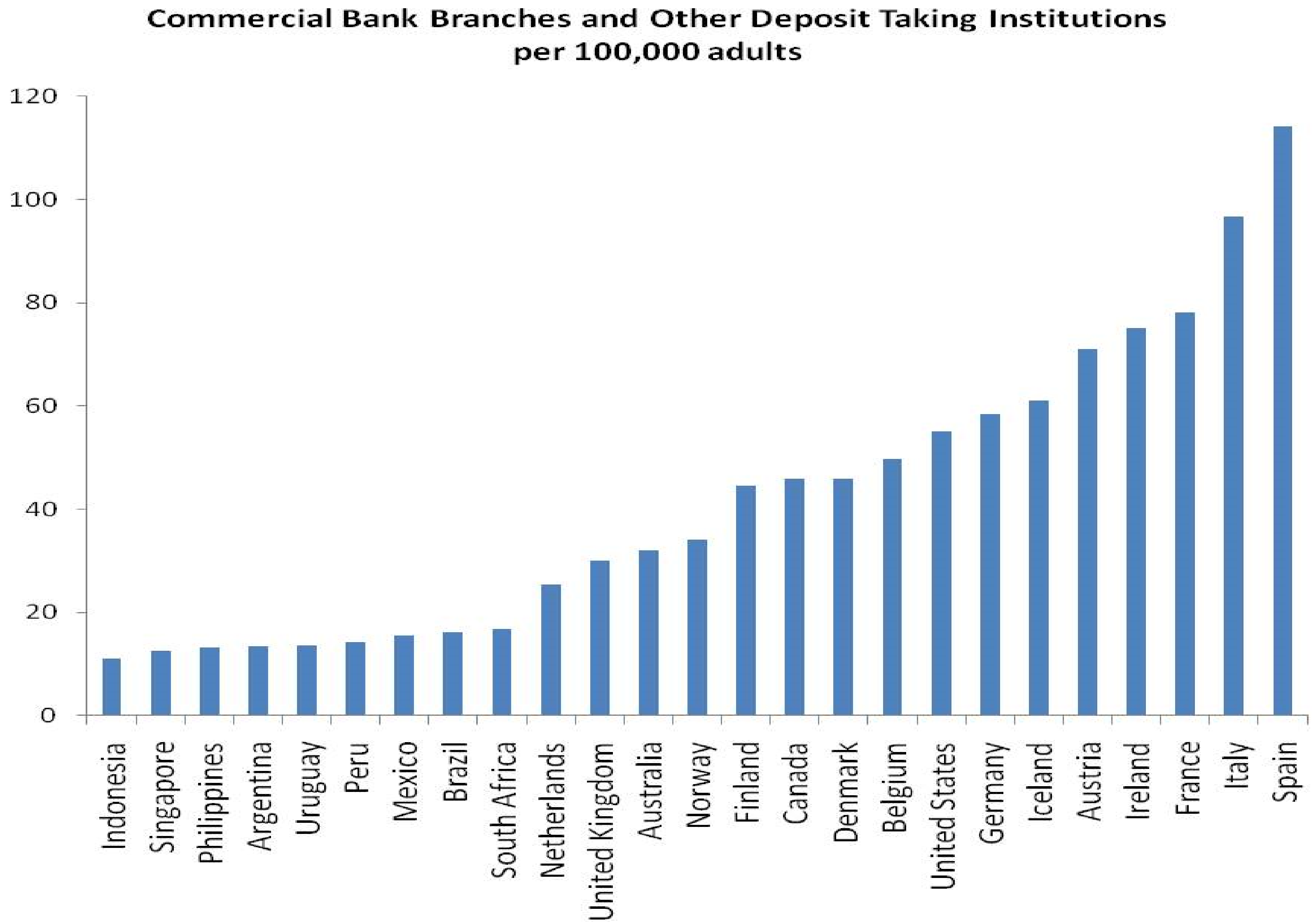
The European Banking Industry

- High density of branches
- Public ownership
  - Guaranteed funding led to overinvestment
  - Unclear roles led to bad governance
- Post 2008

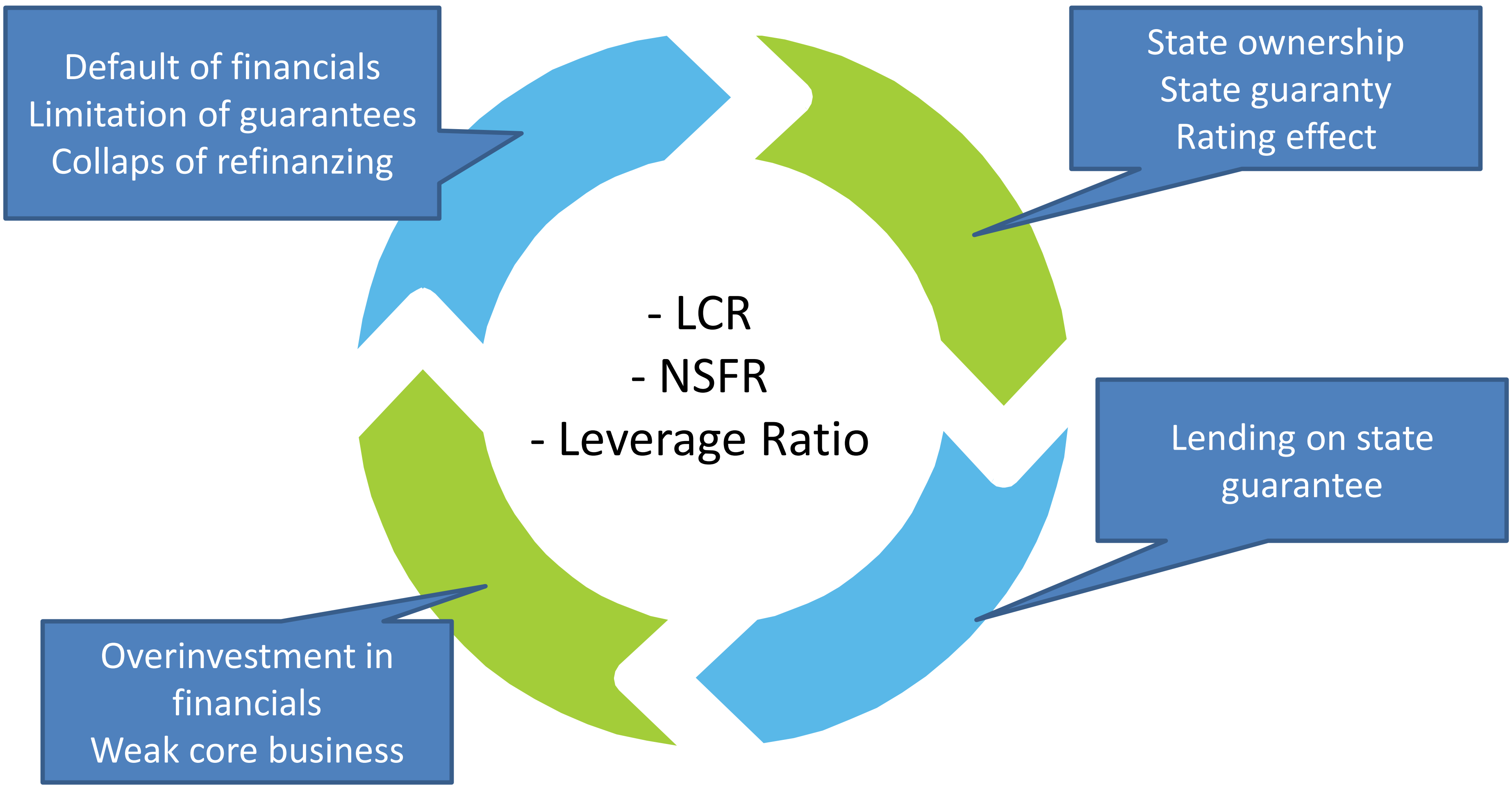
Density – in a global context



Density – Europe vs „World“



State ownership – a vicious circle



“Silver Bullet” needed (European Banking Union)

– Single rulebook for banks
– Single framework for banking supervision
– Single mechanism for resolving banks, funded by levies on the sector itself
– Common backstop in case temporary fiscal support is needed
– Common system for deposit protection

– http://www.ecb.int/press/key/date/2013/html/sp130311.en.html

Sovereign influence

- Public ownership
  - Conflicting interests
  - Guaranteed funding led to overinvestment
  - Unclear roles lead to bad government
- Germany

Date of Issuance	Maturity of Liabilities: Up to July 18, 2005	July 19, 2005 to Dec 31, 2015	After Dec 31, 2015
Up to July 18, 2001	Maintenance & Guarantee Obligation	Guarantee Obligation	Guarantee Obligation
July 19, 2001 to July 18, 2005	Maintenance & Guarantee Obligation	Guarantee Obligation	No Guarantee
After July 18, 2005		No Guarantee	No Guarantee

PATH TO THE EUROPEAN BANKING UNION

Path to the European Banking Union

Break the vicious link between
banks and sovereigns

- Basel III
- Banking Union
– Single Supervisory Mechanism (SSM)
– Single Resolution Mechanism (SRM)
– Common Deposit Guarantee Scheme
- Ban on proprietary trading?

Basel I & II

- Basel I: Minimum Capital Requirement:
- Basel II: Three pillars

– Pillar I : Minimum capital requirements
– Pillar II : Supervisory review

- Market Risk
- Credit Risk: Standardized vs. Internal Ratings

– Pillar III: Market discipline

Basel III Liquidity & Net Stable Funding ratios

• Liquidity requirements:
• Net Stable Funding requirements:
• Required Stable funding is defined based on the liquidity risk of bank's assets

$$\frac{\text{High Liquidity Assets}}{\text{Net cash outflows over the next 30 days}} \geq 100\%$$

$$\frac{\text{Available amount of Stable Funding}}{\text{Required amount of Stable Funding}} \geq 100\%$$

Towards Basel III

- Minimum Capital Requirements

+ Stricter capital definition
+ Countercyclical buffer (up to 2.5% RWA)
+ Capital conservation buffer (up to 2.5% RWA)

- Liquidity Coverage Ratio (LCR)
- Net Stable Funding Ratio (NSFR)
- Leverage Ratio
- Full implementation in 2019

An overview of Basel III—Introduction
Timeline

Annex 2: Phase-in arrangements (shading indicates transition periods)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs, and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

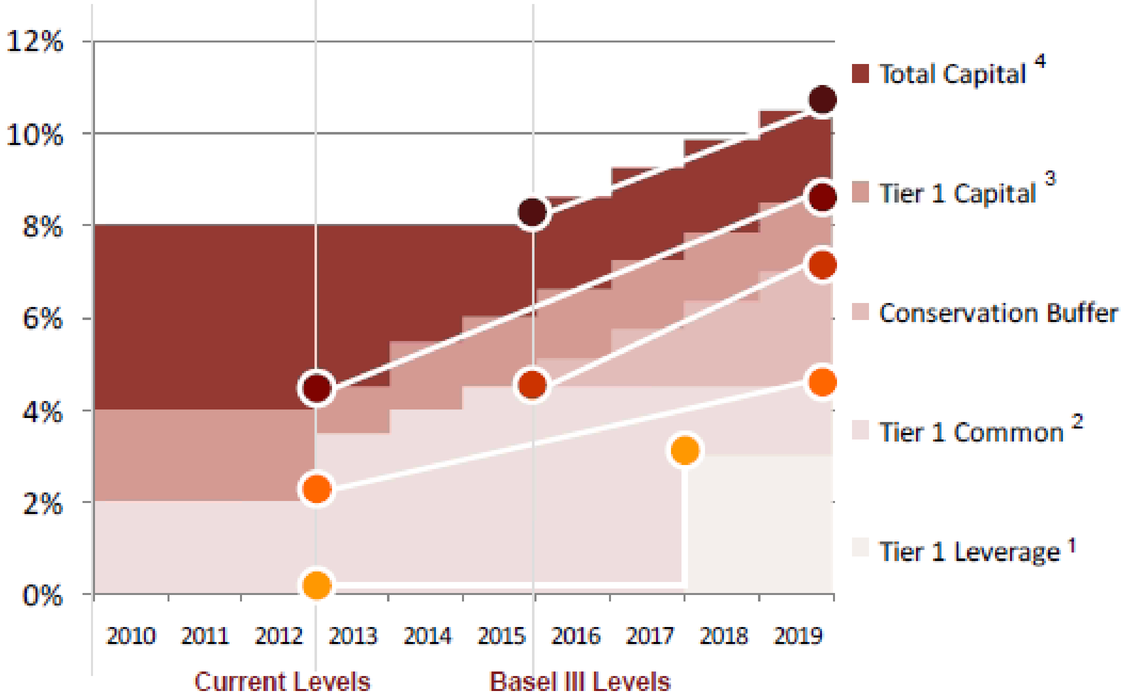
All dates indicate 1 January start

Basel Committee on Banking Supervision
Bank for International Settlements

Path towards Basel III

Main Basel III Components—Capital Ratios and Targets

4 Minimum Capital Standards



Minimum Ratios		Transition Period
Current*	Basel III**	
8%-10%	10.5%	2016-2019
4%-6%	8.5%	2013-2019
NA	2.5%	2016-2019
2%-3%	7%	2013-2019
NA	3%	2013-2018

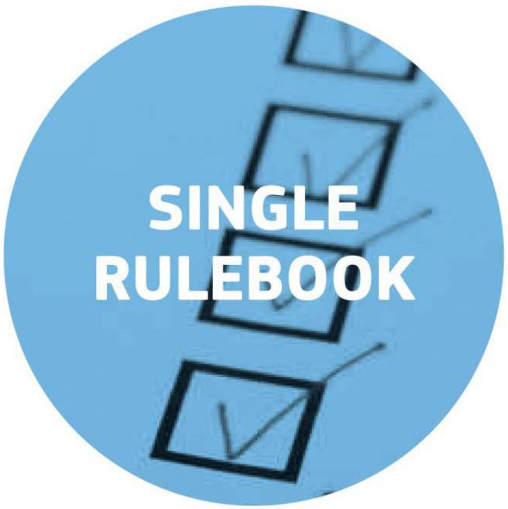
When two numbers displayed, it shows regulatory minimum and well capitalized
Does include conservation buffer, but does not include countercyclical buffer of 0 to 2.5%

1 Tier 1 leverage calculated using the new stricter Basel III definition in relation to the bank's nonweighted assets plus off-balance-sheet exposures. Parallel period starts in 2013 and is implemented as part of Pillar 1 in January 2018.
2 Includes neither conservation buffer nor countercyclical buffers. Current target is equivalent to 1% for an average international bank under the new definition.
3 Includes conservation buffer but does not include countercyclical buffer of 0 to 2.5%. Current target is equivalent to 2% for an average international bank under the new definition.
4 Includes conservation buffer but does not include countercyclical buffer of 0 to 2.5%.

Source: PWC

Banking Union: SSM

- European Central Bank
- Asset Quality Reviews (AQRs)
- Recapitalization Needs

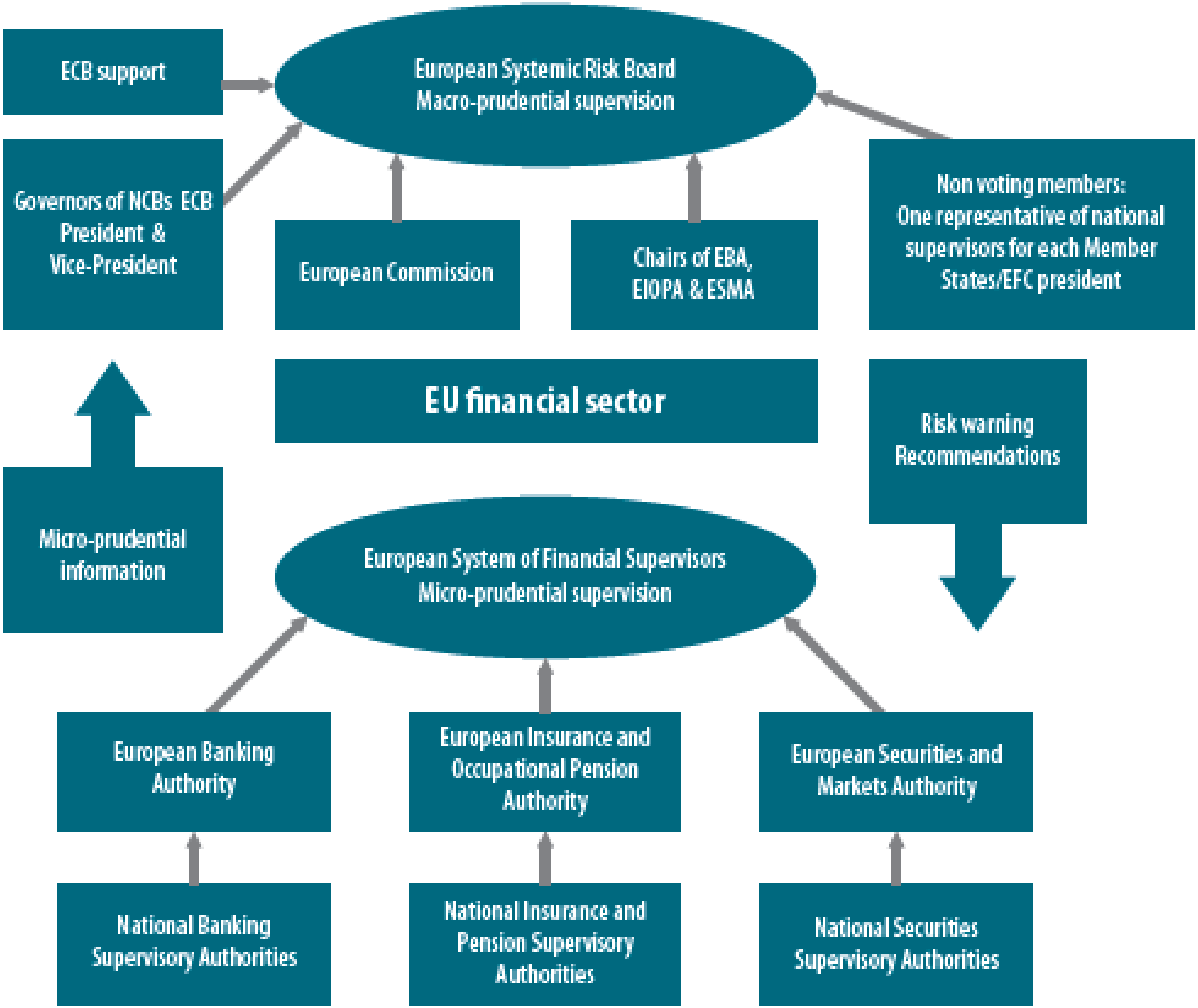


New rules to make banks better capitalised and risks better controlled

ECB directly supervises +/-130 important banks, National supervisors work closely together within an integrated system

If all else fails, as a last resort, the Single Resolution Board can decide to resolve a failing banks, backed by a fund that banks themselves pay in to

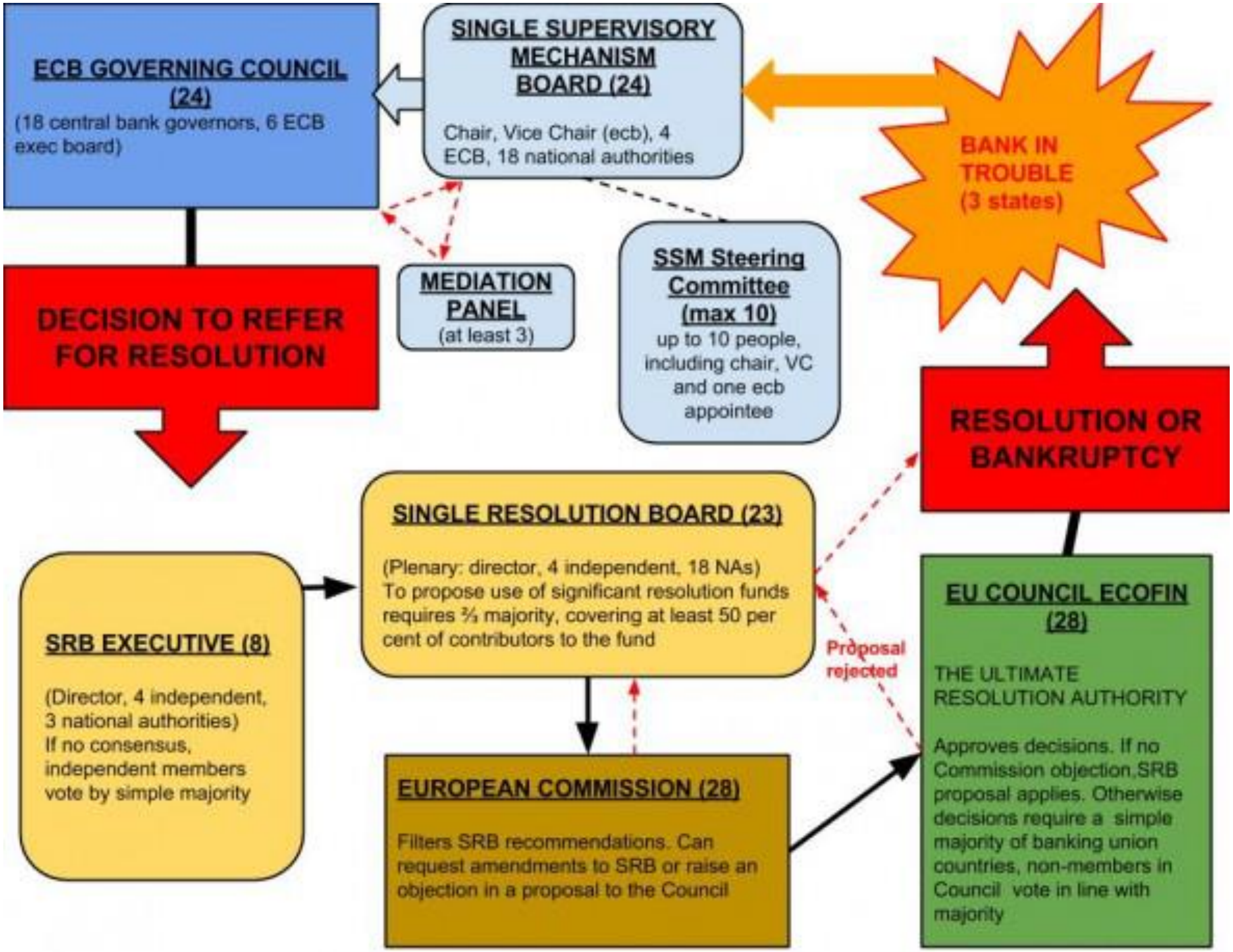
The European supervisory architecture as established in 2011



Source: ECB.

Single Resolution Mechanism (SRM)

- REGULATION (EU) No 806/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 July 2014 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 Resolution Fund and amending Regulation (EU) No 1093/2010


ECB GOVERNING COUNCIL (24)
(18 central bank governors, 6 ECB exec board)
SINGLE SUPERVISORY MECHANISM BOARD (24)
Chair, Vice Chair (ecb), 4 ECB, 18 national authorities
BANK IN TROUBLE (3 states)
DECISION TO REFER FOR RESOLUTION
MEDIATION PANEL
(at least 3)
SSM Steering Committee (max 10)
up to 10 people, including chair, VC and one ecb appointee
RESOLUTION OR BANKRUPTCY
SINGLE RESOLUTION BOARD (23)
(Plenary: director, 4 independent, 18 NAs)
To propose use of significant resolution funds requires ⅔ majority, covering at least 50 per cent of contributors to the fund
SRB EXECUTIVE (8)
(Director, 4 independent, 3 national authorities)
If no consensus, independent members vote by simple majority
Proposal rejected
EU COUNCIL ECOFIN (28)
THE ULTIMATE RESOLUTION AUTHORITY
Approves decisions. If no Commission objection,SRB proposal applies. Otherwise decisions require a simple majority of banking union countries, non-members in Council vote in line with majority
EUROPEAN COMMISSION (28)
Filters SRB recommendations. Can request amendments to SRB or raise an objection in a proposal to the Council

Banks' proprietary trading

• Glass-Steagall (1939): Separation between investment banking & retail banking
• Glass-Steagall repeal (1999)
• US: Volcker rule = Glass-Steagall lite
Underwriting
Market-making
• UK: Vickers report
• EU: Liikanen report

Proprietary trading in Europe

- Separate commercial-retail banks and investment banks within a banking group
- Limited intra-group transactions at market prices (arm's length)
- What about German & French universal banking model (e.g. Deutsche Bank)
- Higher capital for safer assets ?

IMPACT THAT MATTERS – REGULATORY PRESSURE

Impact

- The end of zombie banks (quick look back)
- Finance and service for real economy
- Increased costs due to regulatory issues
- Size matters

The birth of „Zombie- Banks“

- „Zombie- Banks“ are living deads; when you try to terminate them, they come back again
- Zombie Banks are highly subsidized
  - They pay more for deposits
  - They take less for lending
  - …until they collapse again

Bloomberg on Austrian Banks

"Hypo Alpe was nationalized in 2009 after former owners including Bayerische Landesbank walked away and has been supported by Austrian tax money with 1.76 billion euros ($2.3 billion) of capital and with bond guarantees since. It has hired banks to sell its viable parts based in Austria, Italy and the former Yugoslavia.

Hypo Alpe-Adria, based in Klagenfurt, faces potential losses of as much as 6 billion euros should the European Commission force disorderly asset sales, Chief Executive Officer Gottwald Kranebitter said last month. An EU-imposed fire sale would mean that the "Austrian state would face further capital injections," he said. "

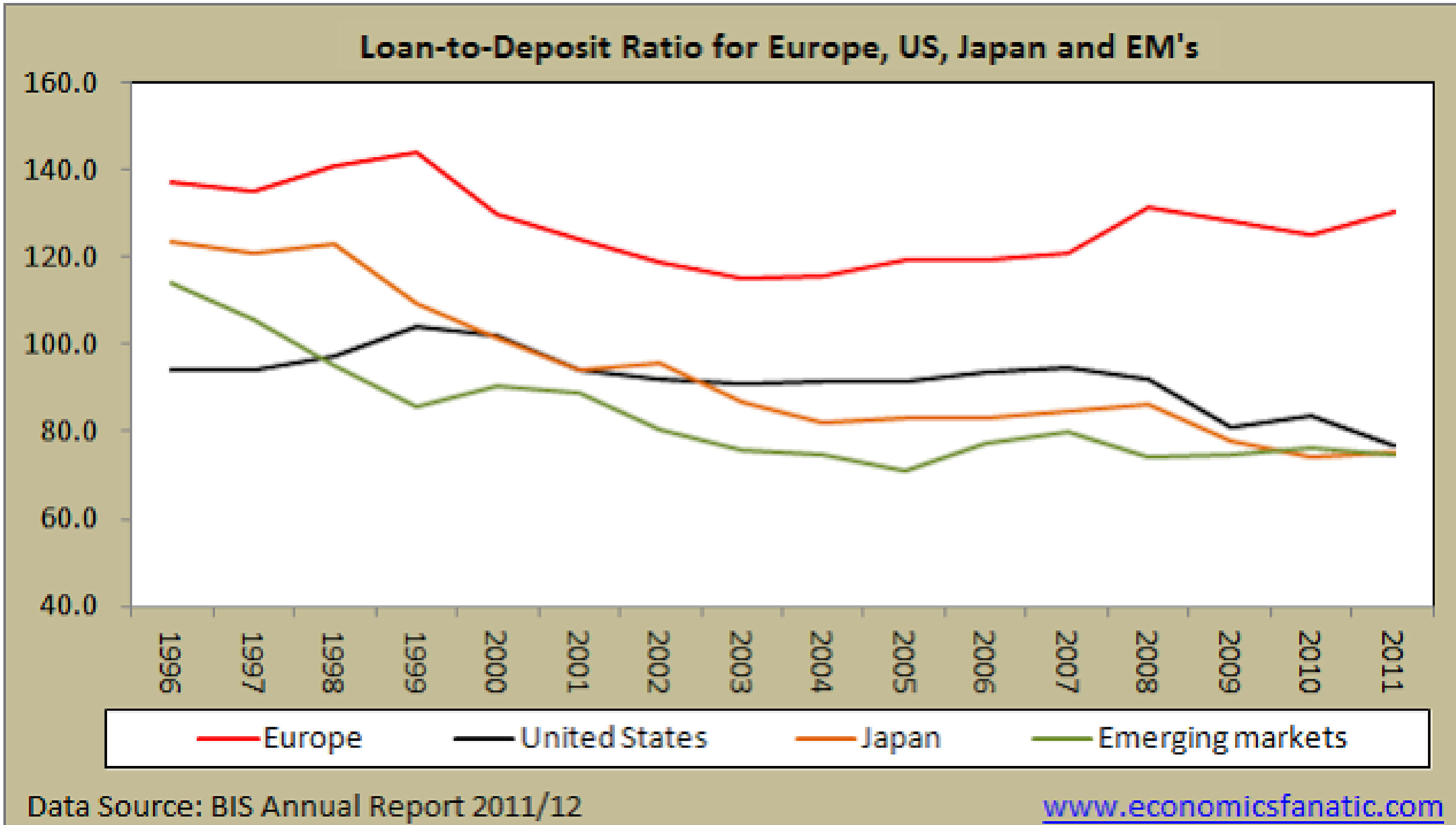
Bloomberg, May 2013 (www.bloomberg.com)

Reuters Headline

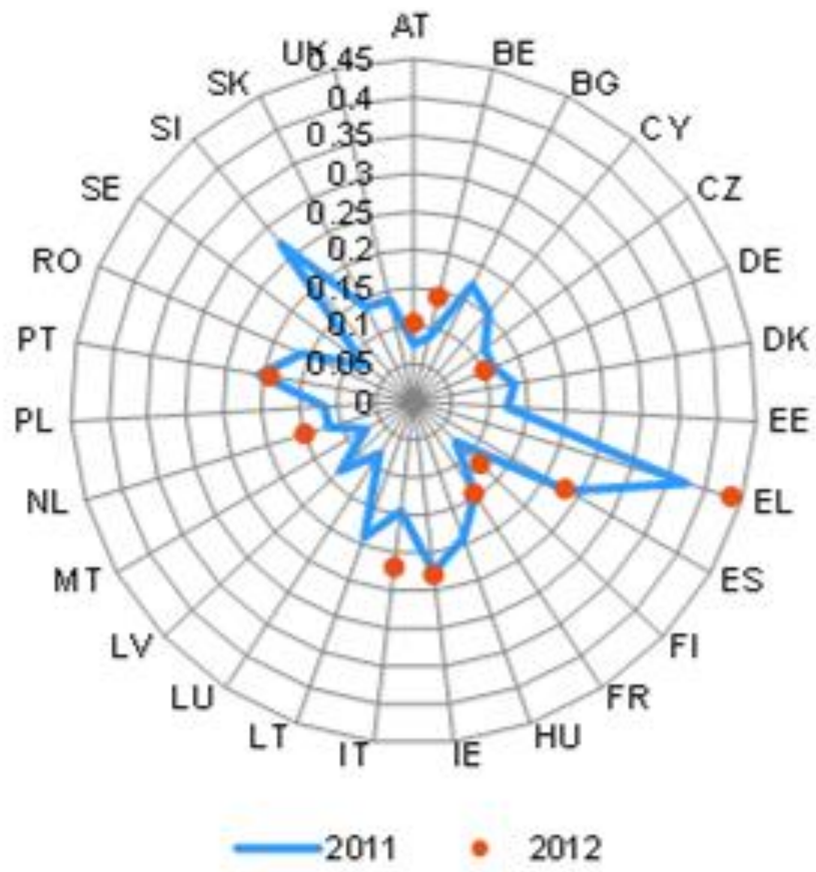
Heta creditors may face haircuts, insolvency - Austria's FMA

VIENNA, March 2 Mon Mar 2, 2015 2:02am EST
(Reuters) - Creditors of Austrian "bad bank" Heta Asset Resolution may face debt haircuts or the prospect of having the wind-down vehicle for defunct lender Hypo Alpe Adria eventually go bankrupt, the co-head of Austria's financial watchdog said.
The Financial Market Authority stepped in on Sunday to take control of Heta and imposed a debt repayment moratorium after the government refused to plug a looming capital hole exposed by an outside audit.
The FMA now needs to work out a plan that treats all creditors equally.

High leverage in Europe

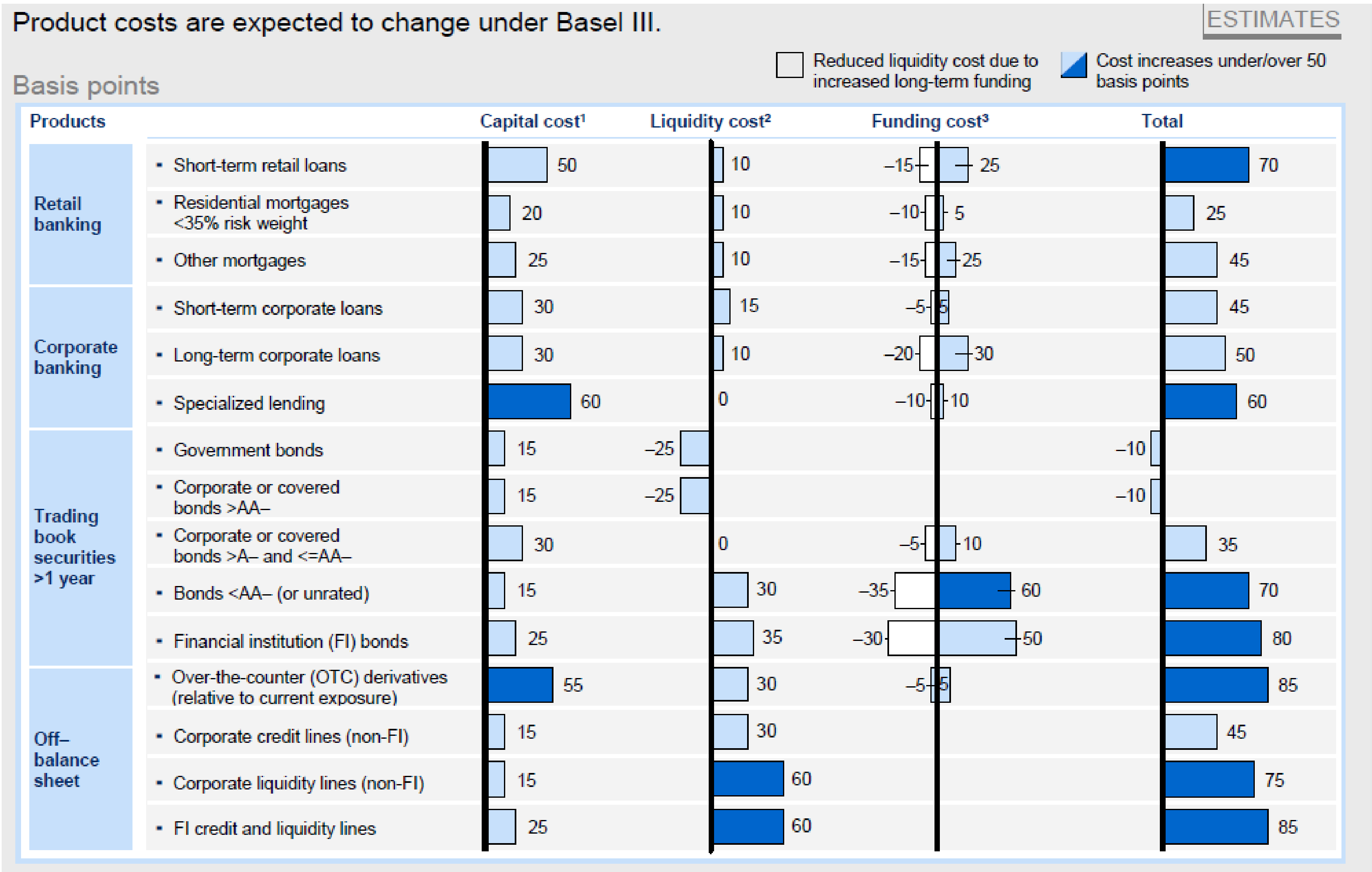


Firms indicating access to finance as the most pressing problem → slow reorientation

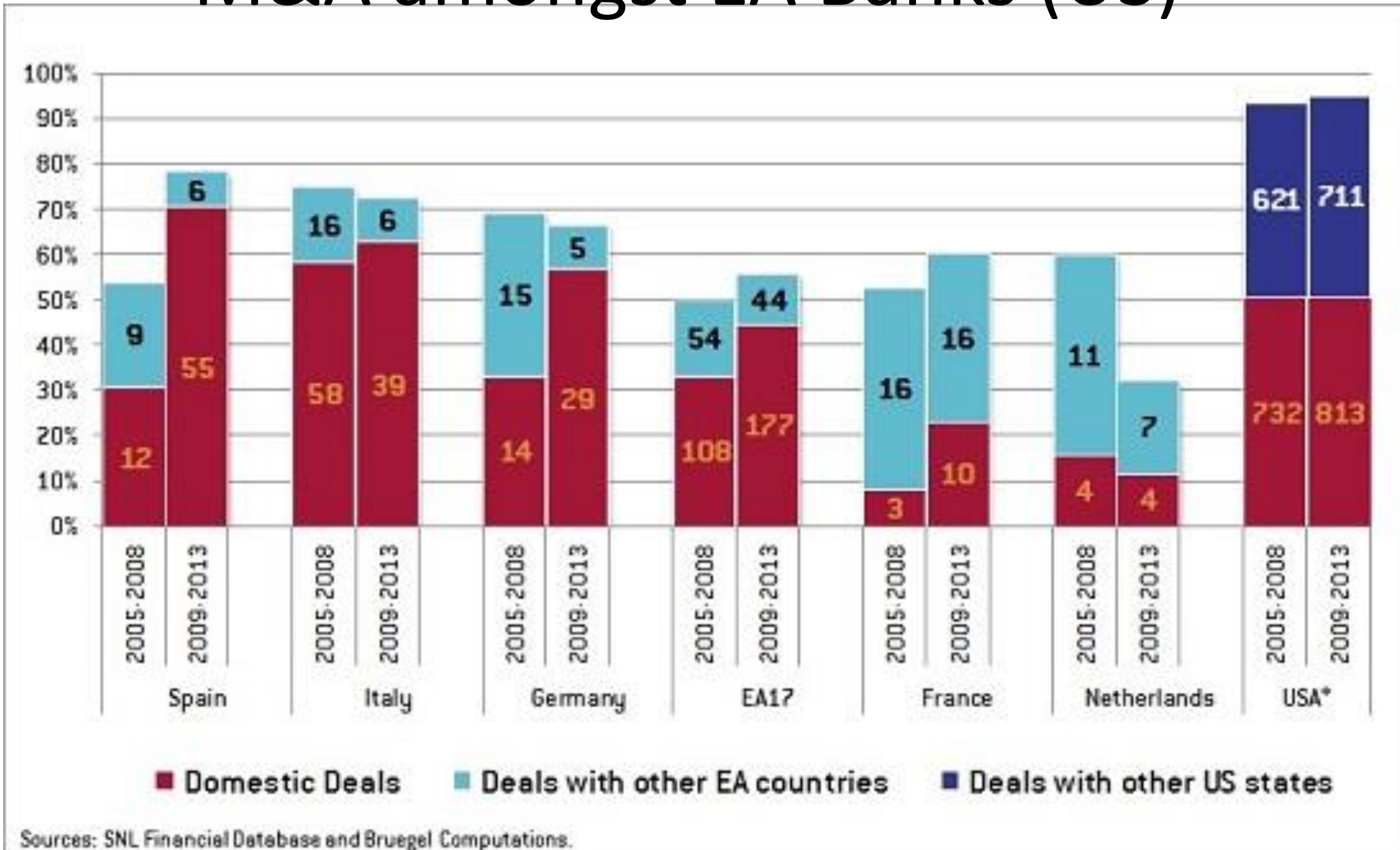


(1) This figure summarises the responses to the question what is the most pressing problem the firm is facing. The indicator takes value 1 if the firm replies "access to finance" and 0 otherwise. Alternative answers are: finding customers; competition; costs of production or labour; availability of skilled staff or experienced managers; regulation; other; don't know.
Source: SAFE survey.

Regulatory Costs



Size Matters
M&A amongst EA Banks (US)



The very important role of IFI´s

- International Financial Instituions
  - EBRD
  - EIB
  - IFC
  - KfW
  - DEG
- Operate through commercial banks and funds
- Foster market development
- Provide know-how, advisory, protection

CONCLUSIONS

Conclusions

- Financial crisis as a main driver towards integration
- Banking Union, securities and markets
  - **ECB, EBA, ESMA**
- State ownership
  - **Short term** – stabilizing institutions
  - **Long term** – destabilizing markets

Conclusions

- New regulatory regime puts pressure on profitability
  - ➢business model and structure impact
- IFI´s
  - ➢Foster market development
  - ➢Provide funding for growth
  - ➢Improve economy

Thank You!

CV Hans Unterdorfer

- Hans Unterdorfer, *1967
- Studies in Politics, law, slavistic
- Master in law, politics and slavistic
- PhD in Public Health – Financing in the Health Sector
- MBA – Imadec
- Assistent professor for slavistics 1990
- Banking industry since 1991
- Project Finance > 1000 beds in health industry
- Retail, Corporate and Project Finance, ALM, Board Member in several banks (Raiffeisen) 2003 - 2010
- CEO Tispa, Member of ERSTE Group, since 2010
- Board Member, Bank Center Invest, Rostov on Don (Rus), since 2013
- Lecturer: Imadec University, Blue Danube Business School, Alpbacher Finanzsymposium

Publications on Law, Banking and Finance

Unterdorfer Hans W. (1990): Der Verfassungsgerichtshof im politischen System Österreichs. Diplomarbeit eingereicht am Institut für Politikwissenschaft der Leopold-Franzens Universität, Innsbruck.

Unterdorfer Hans W. (1995): Die Kapitalbestimmungen des Bankwesengesetzes unter besonderer Berücksichtigung der Genossenschaftsbanken : (Eigenmittel und Solvabilität). Diplomarbeit eingereicht am Institut für Öffentliches Recht und Politikwissenschaft der Leopold-Franzens Universität, Innsbruck.

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