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The Asset Quality Review and Capital Needs: Why re-capitalise banks with public money?

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It is generally assumed that any capital needs discovered by the Asset Quality Review the ECB is scheduled to finish by the end of 2014 should be filled by public funding (= fiscal backstop). This assumption is wrong, however. Banks that do not have enough capital should be asked to obtain it from the market; or be restructured using the procedures and rules recently agreed. The Directorate-General for Competition at the European Commission should be particularly vigilant to ensure that no further state aid flows to an already oversized European banking system.

The case for a public backstop was strong when the entire euro area banking system was under stress, but this is no longer the case. Banks with a viable business model can find capital; those without should be closed because any public-sector re-capitalisation would likely mean throwing good money after bad.

Executive Summary

There are three aggregate numbers that describe the problem the Single Supervisory Mechanism (SSM) is inheriting: the 130 banks under its direct supervision hold assets worth 250% of the euro area's GDP, their capital is equivalent to only 4% of their assets' value and they have made zero profits, in the aggregate, over the last four years.

This is clearly not a 'normal' sector of the economy. Of course, the aggregate numbers hide huge national and sectoral differences, but aggregate numbers do have some immediate implications.

The huge amount of assets implies that any problem with their value could raise massive risk, which could materialise quickly in losses, very large both relative to the bank's capital and relative to GDP. The cases of Spain and Ireland show what can happen if large banking systems make large losses.

Furthermore, given that these banks, which are coming under the Asset Quality Review (AQR), hold already about €1,000 billion in capital, any substantial re-capitalisation of the sector requires funds in the order of hundreds of billions of euro.

But the aim of the AQR is not to change the status quo of a large and thinly capitalised banking system, but only to uncover whether some banks have overvalued assets on their balance sheets.

Any re-capitalisation needs that the AQR uncovers could be covered by the market, which can discriminate better between banks that are viable in the long run and those that are not. Those banks unable to obtain market funding should be restructured gradually under the rules recently agreed.

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The continuing tendency of national authorities to help their banks is evident from the recent decision of the Spanish authorities to allow their banks to recognise 'deferred tax assets' as capital. The revaluation of the share of Italian banks held in the National Central Bank also increases the regulatory capital of some Italian banks (albeit by a rather small amount). In both cases the motives of the national authorities might have been understandable and both measures have been made fully compatible with EU norms. But both episodes show the continuing influence of national authorities on bank capitalisation.

Introduction

When the Heads of State and Government agreed in principle on the creation of a Banking Union in the summer of 2012, the one step that was immediately agreed and quickly implemented was the decision to give the ECB supervisory powers. The main reason for this was that it had become clear during the crisis that national supervisors had become champions of their own banks. National supervisors had not always recognised serious problems at home and had developed a tendency to ring-fence assets of 'their' banks (i.e. banks headquartered or even only with a legal seat in their countries).

The first phenomenon had created the widespread impression that the balance sheets of the major banks which now come under the direct supervision of the ECB might harbour significant amounts of assets that might not be properly valued. It was thus natural to allow the ECB to conduct its own 'Asset Quality Review' (AQR) to make sure that the banks it is now directly supervising are properly capitalised.

It is widely expected that the AQR, which the ECB will be conducting in the course of 2014 will uncover the need to re-capitalise some banks. This had led to much discussion concerning the potential magnitude of the capital shortfall and the sources of funds for the re-capitalisation of those banks in need of additional capital. This contribution will deal only with the latter aspect.

The evaluation of the capital needs of a bank cannot be done only on the basis of a review of the quality of its assets. In the long run, a bank can only survive if it has a viable business model. A forthcoming CEPS publication will go in great detail in the different business models pursued by the many different types of banks that operate in the 28 member countries of the EU. (Every sector and every national supervisor argues naturally that its sector or its banking system is totally safe and that the real problems are elsewhere.) But the broader issues raised by the diversity within the European banking sector cannot be addressed in this short contribution.

1. Asset Quality Review versus business model review

The name 'Asset Quality Review' suggests a simple underlying problem: some assets are overvalued on the balance sheets of the banks. The ECB will organise a proper evaluation of the value of all assets in the banks' balance sheets and if it estimates that the 'true' value of some assets is lower than what provided in the book, the bank in question will be asked to increase its capital in order to cover these accounting losses. That seems to be the end of the story.

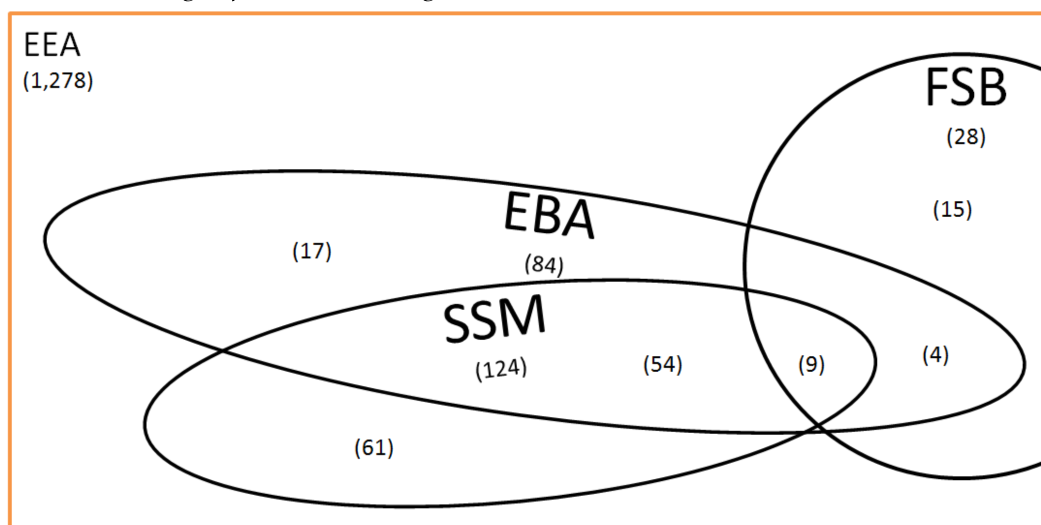
In reality, however, the problem is often much more severe. Indeed, one should also consider that on average the banks under review have not made any profits over the last years. Many banks might not only have overvalued assets on their balance sheets, but they might also lose money on their current operations. If this is the case, the problem can no longer be cured by a once-off injection of capital, but only by a deep restructuring of the bank itself. Moreover, it simply does not make sense to put new capital into banks which for the foreseeable future cannot return (operating) profits.

Gros (2013) has shown that there might be large parts of the euro area's banking system which have a structural profitability problem. The difficulties in southern Europe are well known, although they differ fundamentally from country to country.

Box 1. The overlapping circles of European banking

The group of 130 banks subject to the direct supervision of the ECB (and now under the AQR) should not be seen in isolation, but in the context of a very complex structure with many overlapping circles as shown in Figure 1 given the many levels which concur in banking supervision and regulation in Europe. In ascending order of magnitude there is the euro area, the EU and the EEA. In terms of banks under special scrutiny, there is the group of 130 banks directly under the ECB and now subject to the AQR. Then there is the sample of 84 banks, which the EBA covers more closely. And finally there are, in Europe, 14 banks that are looked over by the Financial Stability Board (FSB) because they are of potential global significance, nine of which will also be under the direct supervision of the ECB.

Figure 1. Banks and banking supervision and regulation



Source: Ayadi & De Groen (2014).

For example, the EBA will launch another of its periodic stress tests next year. Many of the about 90 banks that fall under the stress test of the EBA will also be tested by the ECB at the same time. As the figure shows, there are also over 50 banks coming under the EBA stress tests that do not fall under the AQR. If the EBA stress tests and the AQR (cum stress test) of the ECB are of similar quality, one must presume that there might be an additional need for re-capitalisation coming to light from the EBA stress test at the same time as the AQR.

In Spain banks have over the years issued hundreds of billions of 30-year mortgages whose interest rates are indexed to interbank rates (Euribor), with a small spread (often less than 100 basis points) fixed for the life time of the mortgage. This seemed profitable at a time when Spanish banks were able to refinance themselves at a spread much lower than 100 basis points. But today Spanish banks, especially those most heavily engaged in domestic mortgage lending have to pay much more than 100 basis points spread over inter-bank rates on their own cost of funding. Many local Spanish banks can thus stay afloat only because they refinance a large share of their mortgage book via the ECB. But reliance on cheap central bank (re)financing does not represent a viable business model.

German banks have deposited hundreds of billions of excess liquidity at the ECB. The quality of these assets is 100% (i.e. zero risk), but the return is zero. This does not make a profitable business model since the funding costs of German banks are not zero given the expensive domestic retail network necessary to collect the savings deposits, which form backbone of their financing.

There will of course be wide variations across individual banks and sectors. But it is clear that in an environment of low growth, low interest rates but high risk premia many banks must struggle to survive.

On the one hand, instead of simply reviewing the quality of the assets of the banks under its direct supervision, the ECB should also review their longer terms viability, i.e. their business models. ECB representatives have said that they intend to look at the viability of business models as well. Yet, it remains to be seen whether they will be able to do so since the AQR is undertaken in cooperation with the national supervisors and no national authority is likely to admit that its national 'champion' does not have a viable long term business model.

On the other hand, it should not be the task of a public sector institution to decide which banking business models are viable. This should normally be done by the capital market. But the authorities might have no choice if the bank itself declares that it is not able to raise the capital the supervisors regards as necessary for financial stability.

2. Why use public capital for re-capitalisation?

Most discussions about the AQR assume as given that any re-capitalisation need should be taken up by public funds. In the next section, it is argued that this is not a proper assumption.

2.1 On the 'need' for public sector re-capitalisation

From a theoretical point of view, if the market for bank capital is working normally there should be no need for a *public sector* re-capitalisation.

A properly working market for bank capital does not mean that capital is necessarily cheap (or expensive). On the contrary, given the dearth of profits in the sector, it is quite likely that capital would be very costly; i.e. the present owners might have to issue a lot of new shares to obtain new capital. Deciding about the price of capital for any sector of the economy is exactly what the capital markets are supposed to do – whether or not the present owners of the capital like this verdict or not. The present owner will oppose any re-capitalisation exactly at the time when it is most needed because such need is likely to emerge for banks with problems and hence for which capital will be naturally very expensive (or equivalently where the market value of the bank is very low). Under these circumstances any re-capitalisation via the capital market will dilute the own control rights of the present owners (see also Bini Smaghi, 2013).

The most visible expression of the scepticisms of investors concerning the European banking sector is the fact that (for the banks which are quoted) the market value is usually much lower than the book value. Before the crisis the opposite was true: the market value was higher than the book value as investors then, ex post mistakenly, believe that bank profits would increase forever.

The so called market/book ratio has recently improved considerably, but it remains in the aggregate significantly below one (and it is of course much lower for the problem banks which might be most in need of capital).

The present owners of bank capital have thus a strong incentive to argue that the market for bank capital is not working properly.

Hence the question key question is: What is the evidence that the market for bank capital is closed?

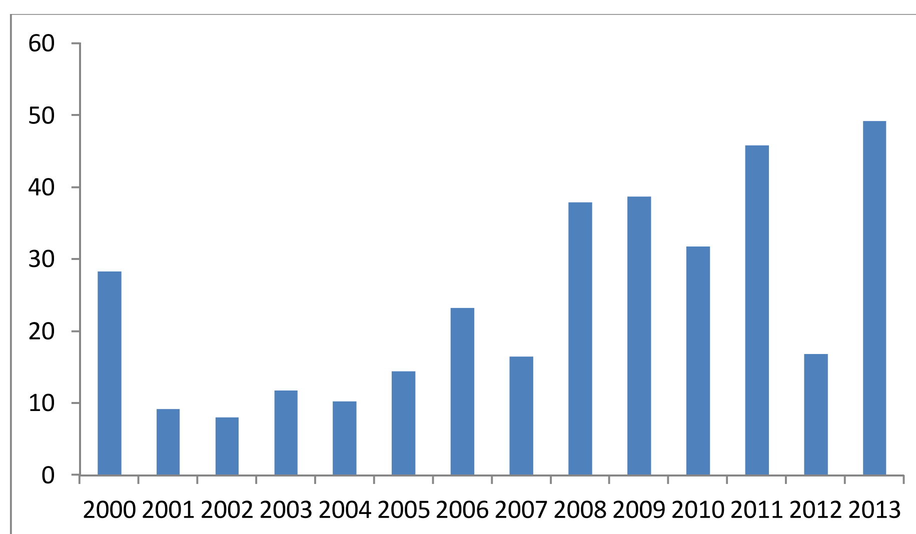
Reliable data on the amounts of capital banks are raising are scarce. Commercial information services provide statements like these:

> "... analysts at information provider SNL Financial estimate that European lenders have raised a total of €415.6 billion of equity since the start of 2009" (as reported in Financial News, 16 October 2013).

If one takes these estimates as correct and spreads the €400 billion over four and a half years (since 2009), about €100 billion per year (including some crisis years) is being raised by banks. This would suggest that it should not be impossible to force banks to raise substantial amounts directly on capital markets to cover any shortfall the AQR might ascertain.

The ECB provides statistical series on quoted shares issued by MFIs. This is a more restrictive definition than overall equity issuance since it includes only quoted share (and many of the SSM banks are not quoted). Under this restrictive definition the numbers are considerably smaller and more variable as Figure 2 below shows. According to the chart, at present, banks are issuing new quoted share at a rate of €40 billion per annum, but this does not seem to be the limit that the market can bear given that issuance was already higher than 60 billion in 2011, when market conditions were much less favourable than today. Given that banks under review will have one year before the AQR delivers its outcome, it could be possible to fill capital holes, in viable banks, with private capital.

Figure 2. Quoted shares issues, other financial institutions, cumulated over 12 months (€ billion)



Source: Own elaboration on ECB data.

All in all it thus appears that the need for public sector funding to backstop any capital needs the AQR might unearth is much exaggerated.

It is often argued that the public sector backstop is crucial for 'confidence'. However, in reality, confidence is in first place based on fundamentals, at least outside panic mood during acute crises. In this same line, the OECD publication on Euro area banks indicates that 'Despite actions to strengthen banks and build a banking union, confidence in the euro area banking system remains week, and is likely to remain so until underlying concerns over low capitalisation of some banks are addressed.'[1]

2.2 The real conundrum: Throw good money after bad?

The concrete issue facing the authorities (not only the ECB, but also the Commission, and the national authorities) is what to do in case of a bank for which the market is really not willing to provide the necessary capital *at any price*. The qualifier at any price is crucial here because as long as there is a price at which investors are willing to put fresh capital into an ailing bank there should be no need for public funding. It is of course possible that market failures occur and that the evaluation by the market of the value of any particular bank is mistaken. It might be too low (or too high), but this does not constitute a reason to help present owners of capital to preserve their control by putting public funding into the bank.

The more fundamental issue is then whether one could leave banks without a clear business

[1] See: OECD (2013).

model (the ones with a clearly viable business model will not have problems to access the market) to the market mechanism.

This should be the case of most sectors of the economy, but for banking. A bank without a viable business model does not shrink gradually and then disappears. Its share price might decline towards zero, but its retail customers will be blissfully unaware of the difficulties, and other creditors will continue to provide financing because they expect that in the end the (national) authorities will intervene before the bank fails by either providing emergency funding or by arranging a merger with another institution.[2] When this expectation is not fulfilled the complacency often turns into panic and very costly bank run ensues. The process leading up to the bankruptcy of Lehman in the fall of 2008 showed this mechanism in action.

This is indeed the rationale behind the asset quality review but also for an assessment of the business model. Depositors would be aware of the real conditions of the bank and creditors' moral hazard would be eliminated.

3. Bank lending in the euro area: A question of quantity or quality?

Keeping a weak banking system afloat has high economic costs. The argument for keeping banks afloat is that a quick restructuring would curtail the availability of credit and be bad for growth. But against these short run considerations one has to keep in mind that banks with too little capital, or those without a viable business model, tend to keep extending credit to their existing customers even if their creditworthiness is low, and to restrict lending to new companies or projects. This misallocation of capital hampers any recovery and reduces longer terms growth prospects. Others have referred to this situation as 'zombie banks'.

The one country where this long run effect can be seen most clearly is Italy (see Gros 2011). Italian banks have over the last decade continued to lend to domestic enterprises, especially SMEs while GDP has not grown. The productivity of investment in Italy has thus been close to zero, even before the crisis. The crisis, with the ensuring fall in GDP has of course exacerbated this trend and has exposed the low returns on investment as many SMEs are failing, creating large losses for the banks. In other words, the real problem might not be too little credit but its allocation: credit flowing to the wrong enterprises and sectors and not flowing where is more productive. Just re-capitalising banks will not change this underlying problem.

Italy represents an extreme case of a low productivity of investment, but it is evident that there were important other cases of mis-allocation of capital in many other countries (e.g. in the housing sector in Spain and Ireland, US subprime securities by German banks). The problem for Europe might thus appear in the short run to keep credit flowing, but the more important problem in the long run is to change the allocation of capital. This will not be achieved if all failing banks are just kept afloat by re-capitalisation.

Conclusion

The raw numbers are stark: The 130 banks under the direct supervision of the ECB and now under review have about €25,000 billion of assets and only about €1,000 billion of capital (about 4% of assets). This is a highly leveraged, and thus potentially unstable, sector. Any losses uncovered by the AQR can at most remedy immediate needs for more capital at some problematic banks, but cannot change the chronic undercapitalisation of the entire sector. Hundreds of billions would be needed to strengthen the entire sector.

Moreover, the set of so-called 'SSM banks' has in the aggregate not made any profit since 2008. This seems to be a sector that has consumed capital for years. This implies that a re-capitalisation per se cannot change the chronic capital shortage of this sector.

This note argues that the market for bank capital is working, and open for banks with a viable business model. Hence, a priori, there is no case

[2] It is now official policy to 'bail in' bank creditors. But the new rules on inflicting losses on creditors of failing banks will enter into force only in 2018.

for a public sector re-capitalisation of weak banks. During a generalised banking crisis, one could argue that markets cannot provide sufficient capital for troubled banks. However, this is no longer the case. Banks that are still found to be insufficiently capitalised after a year-long process during which they had ample opportunity to go to the market should be closed down or taken over.

The present owner will oppose any re-capitalisation exactly when it is most needed because a re-capitalisation need is only likely to emerge for banks with problems, i.e. banks for which capital will be naturally very expensive. But under these circumstances, any re-capitalisation via the capital market will dilute the control rights of the present owners.

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