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Banking Crisis and the Future of Banking

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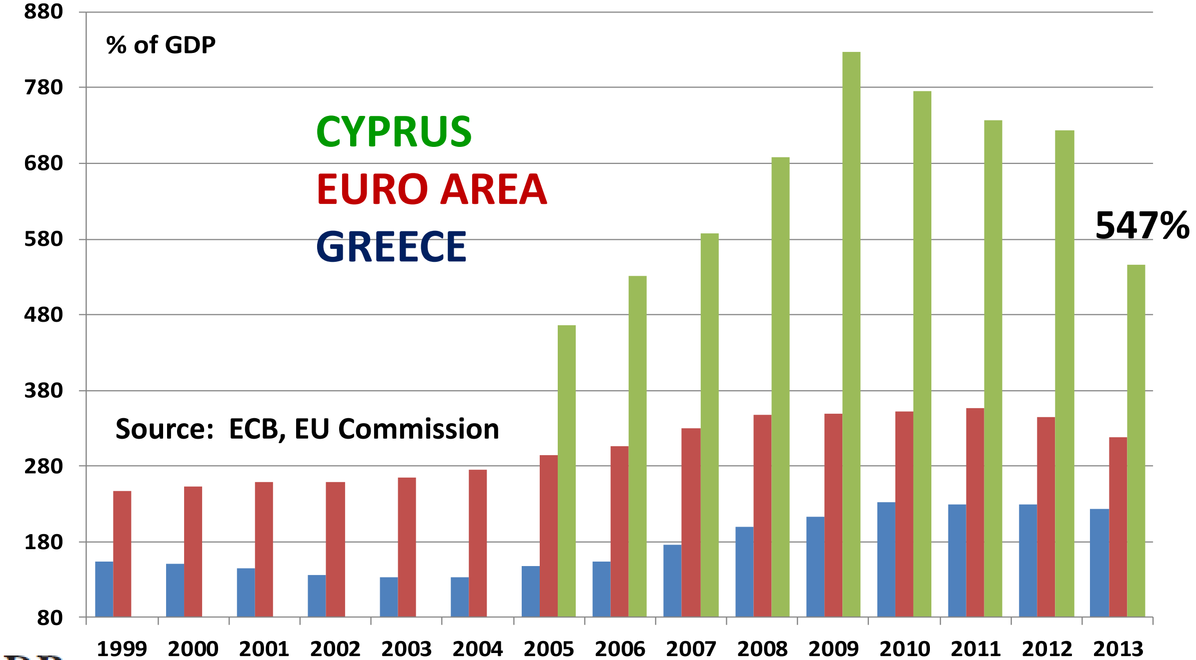
Roundtable discussion on : "The Future of Banking and Cyprus"
Sun Hall Hotel, Larnaca, Cyprus, April 4, 2014, 18:00-19:30

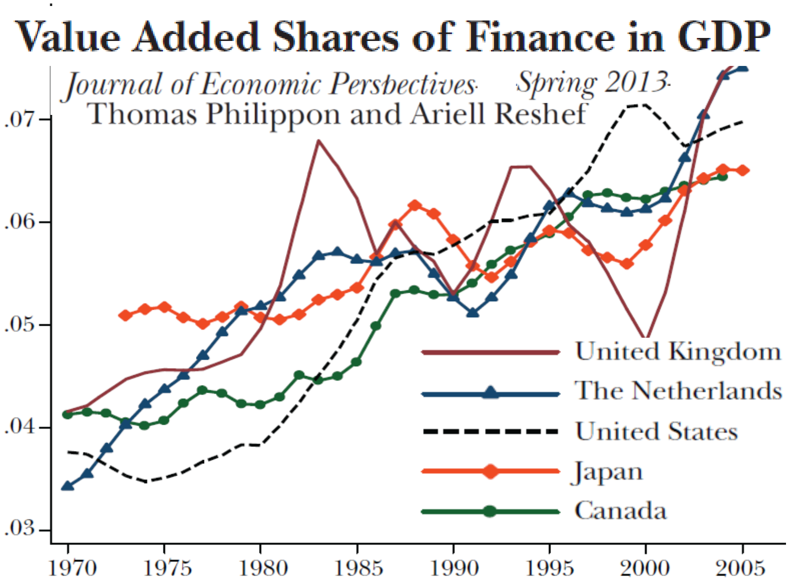
Summary

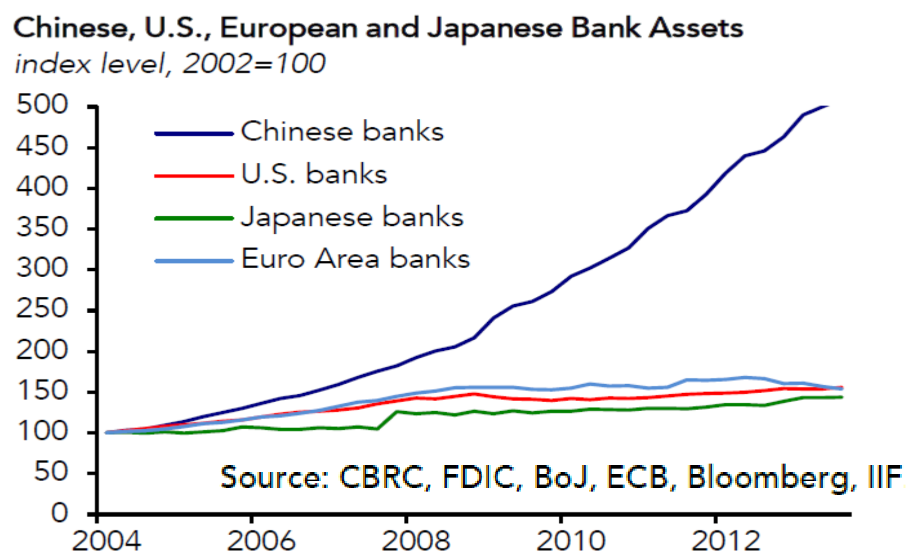
- ✓ Cypriot banking is large relative to other European countries and kept growing until 2009
- ✓ Private debt is also very high in Cyprus, revealing a vulnerable financial sector
- ✓ The international crisis was a financial crisis, hence European financials were hit very hard, with the price of bank credit risk still remaining very high today
- ✓ The EMU crisis was more than a financial crisis, as it was caused by additional imbalances in the fiscal sector and the external sector
- ✓ All three legs of the EMU crisis (Banking, real economy, fiscal) are present in Cyprus
- ✓ Cypriot imbalances in the current account date way back, but the fiscal imbalances started in 2009
- ✓ The bail-in was tried on Cyprus for the first time in March 2013 and caused an immediate crisis
- ✓ A plethora of European policies to resolve the crisis, especially in the financial sector
- ✓ A banking union is slowly forming in EMU
- ✓ Cyprus needs to stabilize its financial system and remove capital controls before it can hope to escape the recession

High growth in banking after 2004, particularly in Cyprus

- ✓ Rising importance of Finance in many countries since 1970
- ✓ Bank assets grew faster than nominal GDP since 2004, particularly in Cyprus & China
- ✓ In 2013, Banking in
  - Cyprus at 547% of GDP
  - Euro Area at 318%
  - Greece at 224%

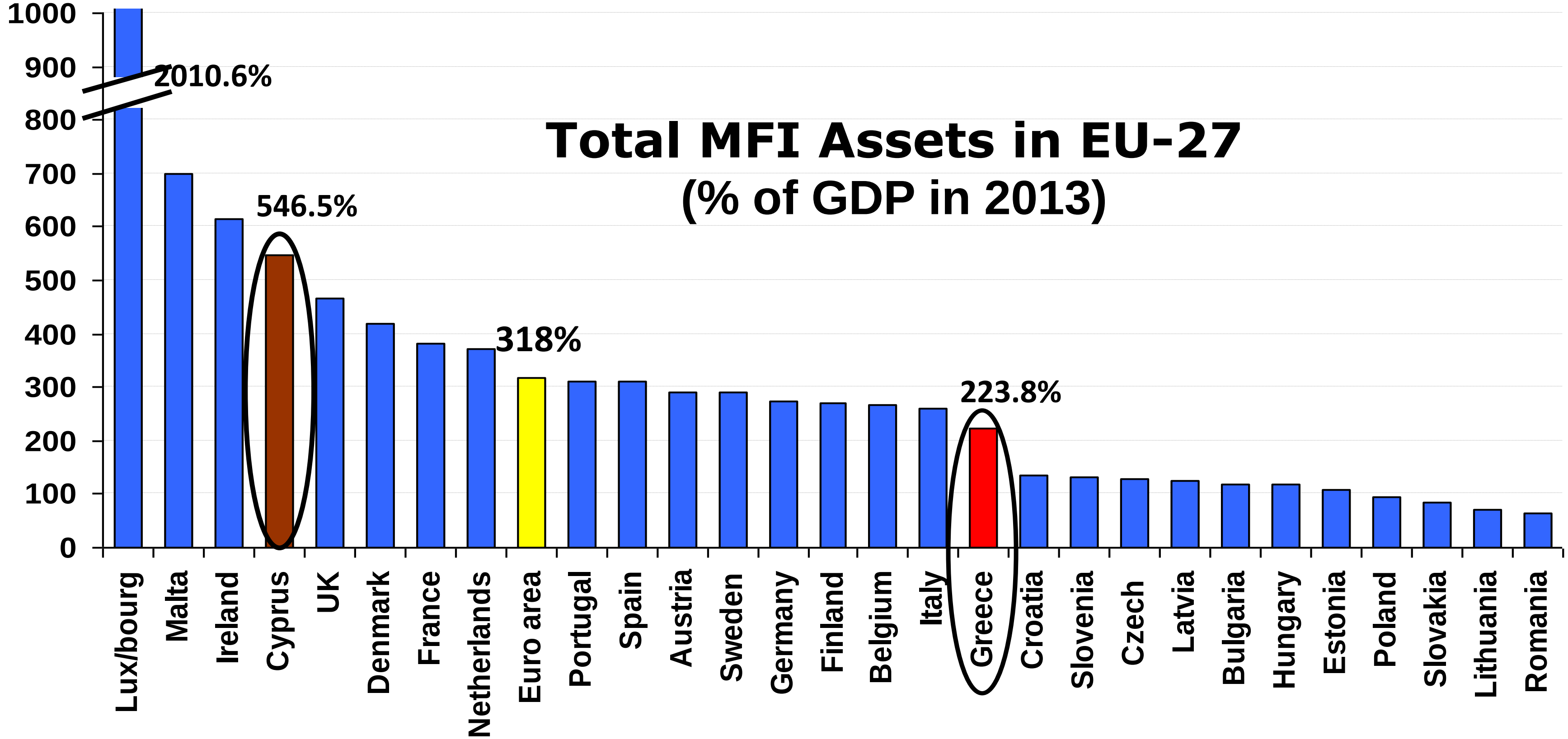






Bank size varies across the Globe & across EU countries

EU, USA & Japan- banking sector (2013)	EU	USA	Japan
Total Assets (€ tr.)	€ 42.5	10.4	7.2
Total Assets (% GDP)	325%	85%	213%



Source: ECB, European Commission

Private debt is high in Europe, particularly in Cyprus

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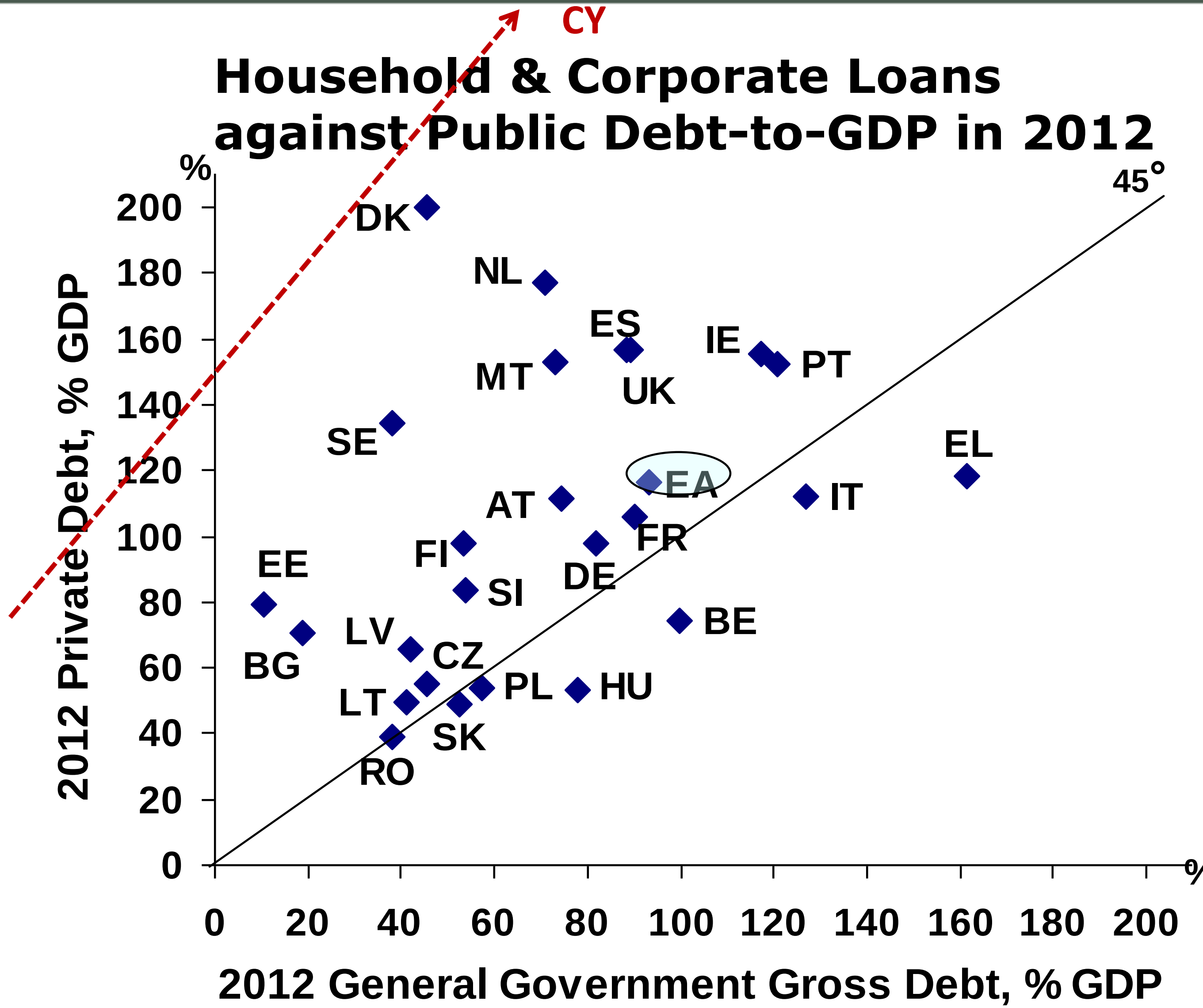
- EA Private debt higher than Public debt in 2012
- Most countries above the 45-degree line: Higher private than public debt
- In Luxembourg, private debt at 292.6% and public at 20.5%
- For Cyprus, private debt at 323.6% and public debt at 86.6%
- Exceptions in the EA are Belgium, Italy & Greece, where Private debt is smaller than Public Debt



Source: EU, ECB

International & Greek crises hit banks hard

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- ✓ European non-financial stocks at 210% their Sept 2004 level
- ✓ European financial stocks only at 80%

Banking risk remains high

- ✓ **Risk has declined after Mario Draghi's proclamation of doing whatever it takes, but is <u>still at a high level</u>**

The unholy trinity: Three legs of the EMU crisis

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Sovereign Debt Crisis

Austerity measures due to sovereign stress weaken economies

Weak growth makes certain indebted sovereigns insolvent

Real Economy Imbalanced & under Stress

Too many bank failures bankrupt sovereigns as they try to support banks

Sovereign defaults bankrupt banks with sizable sovereign debt holdings

Weak banks will slow growth through reduced lending

Weak economy & falling asset prices damage banks' balance sheets

Banking Crisis

❖The <u>**DEEPER PROBLEM**</u>: EMU never adjusted endogenously to an **Optimum Currency Area**, as was hoped in 1990's

Source: BPEA (2012)

Cypriot imbalances less severe than in other Program countries

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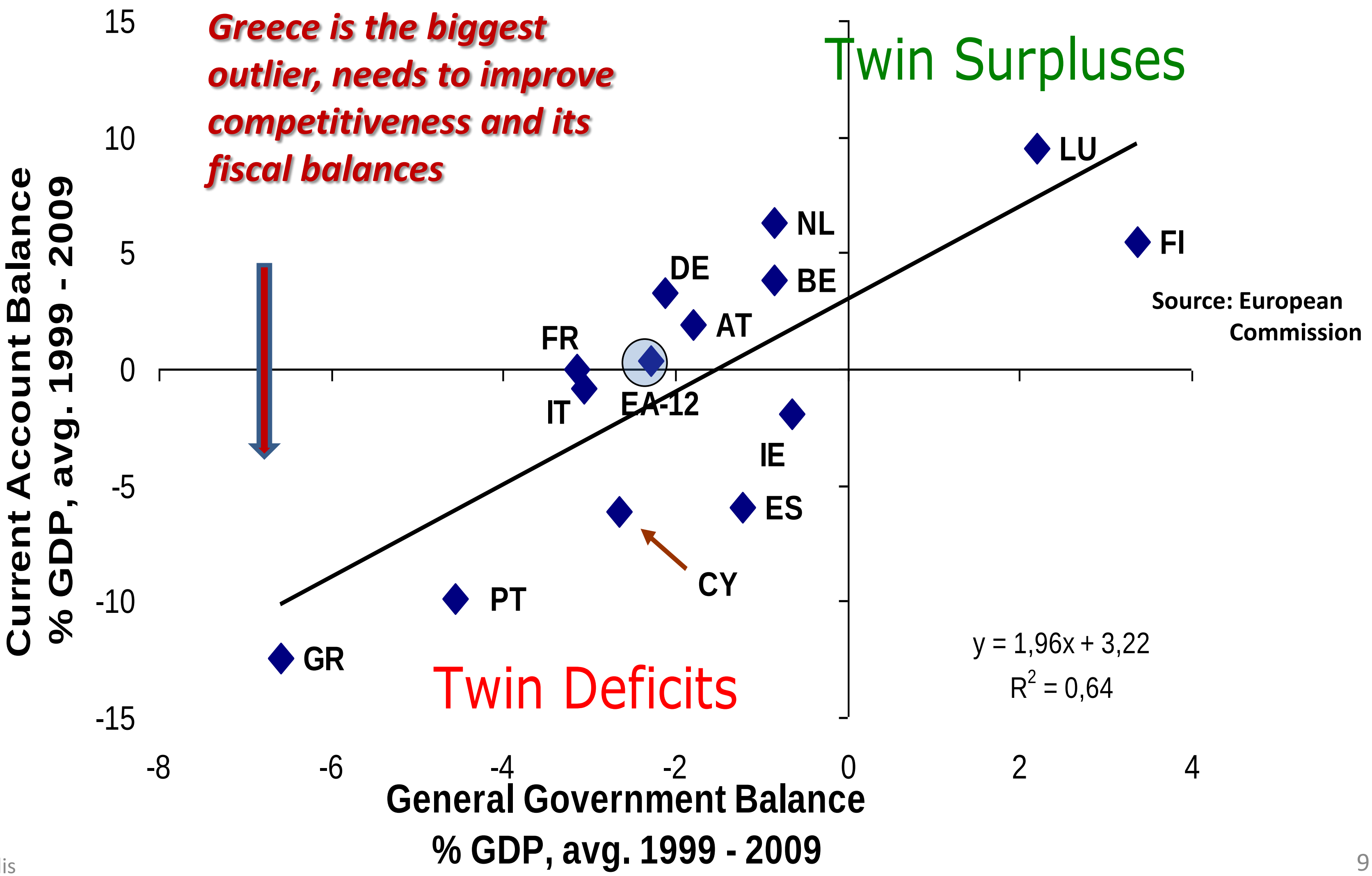
Average annual external and fiscal balance in EA-12 before the Greek/EMU crisis hit in early 2010



Cypriot crisis & sovereign spreads

	Jun-07 (average) Before Int/nal crisis	Aug-08 (average) Before Lehman collapse	Sep-09 (average) Before Greek crisis	Jun-11 (average) Before Cyprus Mari accident	May-12 (average) Before Greek elections	15/3/13 Before 1st Eurogroup Cyprus decision	22/3/13 Before 2nd Eurogroup Cyprus decision	28/3/13 The day after Banking Holiday	31/12/13 End 2013
GR	0.24	0.67	1.30	13.81	25.56	9.36	10.59	11.15	6.49
IT	0.21	0.61	0.83	1.93	4.44	3.14	3.17	3.47	2.20
SP	0.06	0.36	0.55	2.59	4.79	3.46	3.49	3.77	2.22
PT	0.19	0.49	0.68	7.98	10.25	4.50	4.66	5.08	4.20
IE	0.06	0.39	1.65	8.54	5.78	2.54	2.79	2.93	1.58
CY		0.44	0.99	5.77	12.52	7.21	12.00	14.02	6.85

Source: Eurostat, Bloomberg. Monthly averages from Eurostat, unless a date is indicated. Then Bloomberg is used. For Cyprus, individual long term bond is close to 10-yr. For all other countries, benchmark average 10-year bond.

Note: Cypriot spreads started rising steadily 2-3 months before the Mari accident.
Cypriot access to market funding stopped by May 2011

Policies to resolve the European Banking Crisis

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1. **Bank support & bank bailouts,** now **bail-ins**
   a) Support schemes in EU-27 (guarantees, capital injections, etc.) began in late 2008 (€3.5tr or 28%GDP) and by end-2011 were € 4.5tr or 37% GDP. **Total aid used until 2011 was €1.6tr (€1.2 guarantees + €0.32 recap + €0.12 impaired asset relief)**
      - Outliers: **Ireland**, with aid of 224% of 2011 GDP, **Denmark** with 64%

   b) Bailouts transferred the debt to tax-payers and caused sovereign crisis in Ireland
   c) Change of policy with Cyprus Bail-in, has given ammunition to hardliners in Europe
2. **Regulatory response**
   a) Basel III under the G-20 political umbrella, with grandfathering to 2019
   b) Establishment of **European Systemic Risk Board** (ESRB) plus the European System of Financial Supervisors (**ESFS**), composed of :
      i. European Banking Authority (**EBA**),
      ii. European Insurance and Occupational Pensions Authority (**EIOPA**)
      iii. European Securities and Markets Authority (**ESMA**)
3. **Stress tests did not work** (in contrast to US) – summer 2011 – because:
   a) They avoided to include the scenario markets were afraid off: A sovereign default
   b) No central backstop; Needed capital was supposed to be given by the local governments, hence too small for the task in some countries

Policies to resolve the European Banking Crisis

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4. In EMU, liquidity provision by the Eurosystem

a) SMP was too small (€175.7bn as of March 31, 2014) – the “nuclear option”

b) LTROs (€546.3bn as of Mar 31, 2014) only after the Italian crisis in the summer of 2011. Even here ECB merely lends with collateral, it is not taking bad assets out of the system like the FED did in 2007-2009. LTROs can be used to fund the governments and increase the banks’ dependency on the State

c) OMTs with strict conditionality, German Courts sent decision to European courts

5. Preparation for a Banking Union

a) Single Supervisory Mechanism (SSM) – by Nov. 2014, ECB supervises ≈130 banks or 85% of total asset size; UK dos not intend to join

b) Single Rulebook by EBA

c) Single Resolution Mechanism (SRM), Parliament expected to approve it before May elections.

d) Bank Recovery and Resolution Directive with BAIL-IN, effective from January 2016.

e) Harmonized system for deposit guarantees

<u>Liikanen High-Level Expert Group</u>

Proposes <u>separation of trading activities from deposit & retail banking</u>

- For systemic banks (assets for trade > €100bn)
- Banks whose assets for trading & available for sale exceed 15-25% of total assets

Cypriot Banks today

(31.12.2013)

	Group Assets €bn	Group Gross Loans, €bn	Group Deposits €bn	Group Net Loans / Deposits	NPLs / Loans	Cyprus-only Branches
Bank of Cyprus	**30.3**	**26.7**	**15.0**	**145%**	**49%**	**130**
Hellenic Bank	**6.4**	**4.4**	**5.5**	**65%**	**46%**	**64**
Cooperative banks	**15.4**	**12.5**	**13.9**	**90%**	**45%**	**18 entities**
Eurobank Cyprus	**3.0**	**1.1**	**2.5**	**44%**	**9%**	**7**
ALPHA Cyprus	**4.3**	**4.1**	**2.0**	**171%**	**34%**	**33**
Grand TOTAL	**90.2**	**83.7**	**57.7**		***50%**	

Sources: Monetary Survey of Central Bank, Bank announcements in February-March 2014

*** NPLs for domestic banks**

Thank you for your attention

www.eurobank.gr/ research

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