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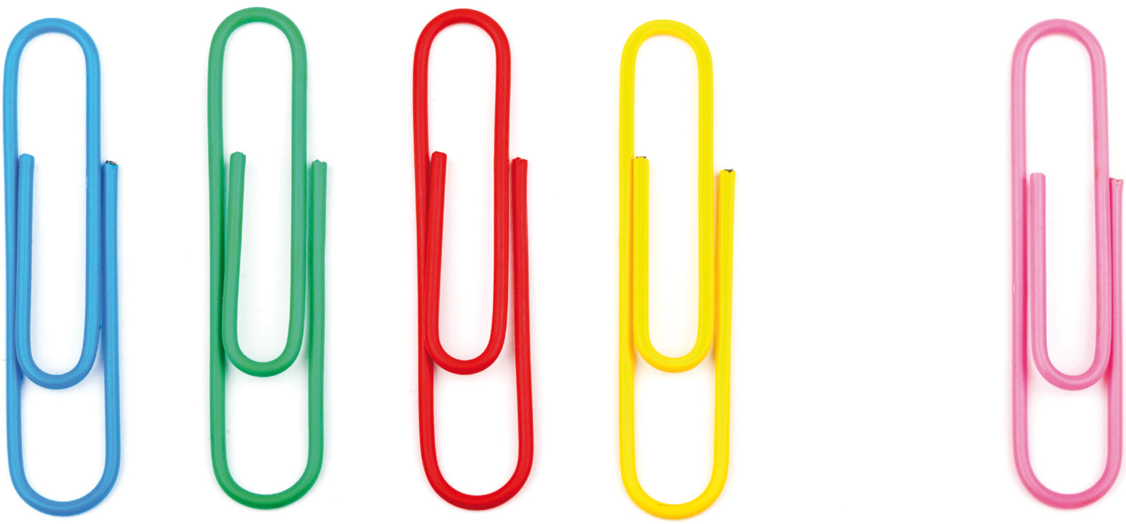
The Single Supervisory Mechanism
Mind the (capital) gap



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Overview

In just under five months the Single Supervisory Mechanism (SSM) will start and the European Central Bank (ECB) will take charge of prudential banking supervision in the Eurozone. The ECB is busy establishing the operational apparatus needed for the new supervisor. Banks designated as 'significant' by the ECB – assessed on the basis of balance sheet size or importance to their domestic banking system or economy – are completing the ECB's comprehensive assessment exercise, designed to test the financial resilience of banks before the ECB takes on responsibility for their supervision.

Through the comprehensive assessment the ECB wants to draw a line under doubts about the quality of assets on all significant banks' balance sheets. At the end of the exercise, the ECB will decide whether any bank needs to improve its capital position.

Estimates of the size of the capital gap vary. It seems likely that some banks will face shortfalls. Mario Draghi, President of the ECB, has spoken about the need for the comprehensive assessment to be credible through being tougher and more conservative in its assumptions than previous European exercises. The Chair of the SSM, Danièle Nouy, has said that it has to be accepted that some banks have no future.[1]

Now is the time to start planning for the results of the exercise, in particular for the possibility that banks have to remedy capital shortfalls. Some banks have already taken action, but others have not. The ECB has indicated that banks will have between six and nine months to address any shortfall after the results are made public in October. For those banks that find themselves with a shortfall, their options will be greater the earlier planning and execution start. Moreover, there is the opportunity to tackle broader, long-standing problems, rather than just apply a quick fix.

In this paper we consider the options available to banks and the practicalities of implementing them in this particular context. None of the options available are simple; all of them may be challenging against the backdrop of a Eurozone-wide exercise, where several banks may be taking similar action and given that by the nature of the exercise, banks will have been found to have material balance sheet weaknesses.

Banks do not only need to anticipate the reaction of the market. Regulators and governments may also stake a claim to influencing the outcome. For example, Mario Draghi has said that "what [the ECB wants] to achieve is a 'good' form of bank deleveraging, where equity is built up, either through retained earnings or through outright issuance, where deposits rise and where balance sheet reduction takes the form of an asset carve-out, rather than of credit attrition."[2]

Just as this is an opportunity for the ECB to start with a clean sheet, so too could it be for banks. The ECB may encourage some well-capitalised banks to make some hard decisions on legacy assets, in the process helping them wipe the slate clean. In some cases this may be received positively by investors.

This is the latest paper in a series on the Banking Union, designed to help banks understand, plan for and manage the challenges it creates. The paper draws together expertise from across Deloitte, gained through our work with clients on the comprehensive assessment exercise, and with banks and public authorities in programme countries[3] during the European financial crisis.

1 Interview of Danièle Nouy with the Financial Times, published on 10 February 2014

2 Speech by Mario Draghi at the presentation ceremony of the Schumpeter Award, Oesterreichische Nationalbank (OeNB) 13 March 2014

3 Programme countries being those that received assistance from the Troika (European Commission, ECB and IMF)

Setting the scene

The comprehensive assessment exercise

The financial and sovereign crises in Europe left many banks' balance sheets stretched, and investors and creditors uncertain about the quality of banks' assets. In June 2012 the European Council proposed the establishment of a Banking Union, to break the link – perceived and actual – between banks and their sovereigns, as part of a longer-term vision for further economic integration in the Eurozone. A key pillar of the Banking Union is the SSM, which will see the ECB assume supervisory responsibility for all Eurozone banks from November 2014.

Prior to this the ECB has been conducting a review of banks' balance sheets, an exercise designed to assess the health of these banks before the ECB assumes supervisory responsibility for them. The exercise has three parts: a supervisory risk assessment, an asset quality review (AQR) and a stress test (Box 1).

Box 1. The comprehensive assessment exercise

In practical terms this takes the form of:

- A supervisory risk assessment, by the ECB in collaboration with national supervisors.
- An AQR, comprising a review of processes, policies and procedures, alongside banking book and (where applicable) trading book exposures. The review is expected to be complete by the end of July.
- A stress testing exercise, under the aegis of the European Banking Authority (EBA), with capital assessed both against a baseline scenario and adverse stress scenario.

The AQR and stress testing exercise are relatively known quantities, having been part of the standard assessment performed in programme countries over the past few years. What is unprecedented is the scale of this particular exercise. Eighteen member states and 124 banking groups are in scope. According to the ECB, The AQR covers €3.72 trillion[4] of risk weighted assets (RWA), representing 58% of the total credit RWA of banks in the exercise.

Following a quality assurance process, the results of the comprehensive assessment exercise will be announced in October.

The timeline below sets out the key milestones over the next year.

Jul-14	Sep-14	Oct-14	Nov-14	Jan-15	Apr-15	Jul-15
Completion of AQR	Finalisation of stress testing	Results of comprehensive assessment	SSM Go-Live	Single Resolution Board takes on first tasks	Deadline for remediating baseline & AQR failure	Deadline for remediating failure of adverse stress test

The ECB will review the results of the exercise in the round in order to come to a view on the adequacy of each bank's capital. Given the nature of the exercise, adjustments to valuations are the most likely source of capital loss. It may be though that supervisors conclude that certain assets are riskier than they were formerly judged to be; that provisions need to be increased; or that additional capital needs to be held against identified weaknesses in management and governance, or systems and controls. In some such cases, ECB supervisors may in effect revisit judgements taken previously by national supervisors.

4 Speech by Danièle Nouy at the OeNB Economics conference, 12 May 2014

How big might the problem be?

It seems likely that some banks will face shortfalls. Mario Draghi, President of the ECB, has spoken about the need for the comprehensive assessment to be credible through being conservative in its assumptions and tougher in its application than previous European exercises. The Chair of the SSM, Danièle Nouy, has said that it has to be accepted that some banks have no future.[5] Some analysts have speculated that the ECB may feel under pressure to fail at least one large bank in order to assert its authority as the new supervisor.

Weaknesses in the European banking sector are a known-unknown. For instance, in Italy non-performing loans (NPLs) rose to €155bn at end-2013 according to the Italian Banking Association.[6] Morgan Stanley analysts estimated that NPLs across the Eurozone would peak at nearly €500bn in 2014.[7] Due to the uncertainty of the exercise, estimates of the shortfall arising from the comprehensive assessment are speculative, and vary between €20bn – €80bn.[8]

The outlook though is not entirely bleak. Compared to the previous exercises, the review will happen against a stable economic backdrop. A conservative approach to asset valuations and stress testing is unlikely to catalyse the negative feedback loop that seemed a possibility last time the EBA stress test exercise was run.

In preparation for higher capital requirements, many banks have been increasing their capital, largely through the accumulation of retained earnings rather than capital raising or a reduction in lending, according to the Bank for International Settlements (BIS).[9] That said, between 2011 and mid-2013, European banks raised less than €75bn of capital compared to almost $200bn by US banks in the same period,[10] which when set in the context of a European banking sector with total assets in excess of those in the US led some to question whether more capital was required.

Since then there has been an uptick in capital issuance, reflecting the recent thawing of capital markets in Europe, with banks looking to raise capital from investors in order to combat any shortfalls they face. Only 12 months ago this option would have been open to far fewer banks.

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5 Interview of Danièle Nouy with the Financial Times, published on 10 February 2014

6 ABI Monthly Outlook, 'Economia e Mercati Finanziari-Creditizi', February 2014

7 Morgan Stanley Research Note by Huw Van Steenis, 'Financials: what I learned at Davos', 27 January, 2014

8 Ibid

9 BIS Quarterly Review note by Benjamin H Cohen, 'How have banks adjusted to higher capital requirements?', September 2013

10 Article in the New York Times by Francesco Giavazzi and Anil K. Kashyap, 'A test Europe's banks musn't fail', 17 February 2014

Tackling a capital shortfall

European banks have implemented write-offs and increased provisions and capital, partly in anticipation of the comprehensive assessment exercise. Estimates based on public information indicate that the SSM banks designated as significant strengthened their balance-sheets by €104 billion between July 2013 and April 2014. According to the ECB, the measures taken included €34 billion raised through issuance of common equity (completed or publicly announced), €15 billion through the issuance of contingent capital hybrid instruments, and €19 billion relating to additional provisioning,[11] with other factors such as retained earnings accounting for the remainder. There has also been a significant increase in portfolio sales of NPLs in certain European markets, with private equity groups amongst the buyers.

These transactions have been prompted in part by banks seeking to get ahead of the curve. In some cases, regulators have also offered encouragement to banks to move early. Many banks though have not started to tackle the potential problems.

Working through possible solutions

If a capital shortfall is identified, the expectation is the bank concerned will rectify it. The ECB has made clear the Banking Union's back-stop capital facilities will be considered only in the last resort.

The cause of the shortfall identified will determine how long a bank has to remedy it. The supervisory risk assessment, AQR and baseline stress test scenario will prompt action within six months; and need to be tackled with Common Equity Tier 1 (CET1) instruments. A shortfall against the adverse stress test scenario will require action within nine months, and could be remedied in other ways, although the ECB will place limits on the amount that can be raised via convertible capital instruments.

The actions that banks take will face scrutiny from investors, customers and clients, and from politicians. The interest of investors will probably be most familiar to banks, while customer and client interest will be heightened if the strategy adopted has implications for their banking relationships. Politicians will be particularly set against reductions in domestic lending. Any remedies need to be managed together with other changes already in train. In deciding a strategy, a bank will need to factor in all of these perspectives.

Banks will also need to have in mind that any shortfall resulting from the comprehensive assessment exercise will be in addition to shortfalls already identified, for example, against end-state CRD IV requirements.

In some cases, banks may be able to remedy a shortfall by withholding distributions, or by reducing net new lending, although the ECB's assessment will take into account any management actions already planned. These options are, however, likely to provide only limited scope to remediate capital shortfalls over the short period of time available to do so. Other options include capital issuance, asset sales/deleveraging, 'de-risking' and capital optimisation, and mergers and acquisitions.

Capital issuance	• ECB statements suggest a strong preference for equity issuance, particularly with regard to a baseline or AQR capital shortfall. The summer is likely to see a number of banks tap investors ahead of the comprehensive assessment results. • Hybrid capital is an alternative option to fill a capital shortfall. Such convertible debt is seen by some as an attractive way to boost Tier 1 capital without diluting existing shareholders, and the tax deductible nature of the interest payments is also very appealing to many banks.
Asset sales	• This is a relatively rapid source of balance sheet reduction and, done appropriately, of capital raising and relief. It should therefore be relatively popular with shareholders, as it shows the bank taking an active approach to cleaning up the balance sheet. The challenge may be that in some jurisdictions the key infrastructure for asset sales is missing and/or there is not yet an established investor base, and the bid-offer spread is too large.
De-risking and capital optimisation	• Banks have been assessing the capital consumption and profitability of the various parts of their business given renewed regulatory focus on capital levels. The challenge may lie in the wind-down of certain businesses, as the nature of some assets will preclude a quick exit. Also, there may not be attractive offers from purchasers if the assets are seen as less desirable.
Mergers and acquisitions	• Members of the ECB have themselves clearly identified scope for consolidation among European banks. However, business combinations take both time and expertise to execute successfully and the Banking Union timetable for remediation is challenging. In addition, at the national level there may be a number of challenges which impede consolidation.

11 Speech by Vítor Constâncio, Vice-President of the ECB, 'Banking Union and European integration', at the OeNB Economics Conference, 12 May 2014

Legal structure will affect the options available to a bank in terms of raising capital. The SSM will supervise both publicly listed and unlisted banks. Some banks have diversified investor bases, whereas others are held principally by a few shareholders. Some have private sector owners, while some are held in the public sector. A number of the significant European banks are mutuals or co-operatives, owned by their members.

The large listed banks have some obvious routes to raise additional capital in the marketplace, but what about a large mutual or state owned bank? Some European countries may lack the requisite legal framework and capital markets that would facilitate such an issue. Mutuals may be further limited by their articles of association or laws in their home country which prohibit various actions. Amending these to facilitate the issuance of capital instruments will take time.

Those banks which have started preparing or have completed the design of Recovery and Resolution Plans (RRP) should be in a stronger position, as they will have already considered how they would raise capital as part of the recovery process.

Box 2. Case Study on deleveraging in Spain

In response to problems in the Spanish banking system, Spain's national asset management agency, SAREB (Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria) was established in August 2012. Approximately €50bn of under-performing loans from five Spanish financial institutions was transferred to SAREB.

Prior to 2013, few loan portfolio transactions had been undertaken in Spain and these were largely retail portfolios due to the lack of commercial servicing platforms. During 2013, the market started to take off: SAREB itself sold €900m of real estate loans; several banks sold portfolios of loans in various asset classes, and others put together successful sales that combined the disposal of servicing platforms with contracts to manage the underlying loans. These sales helped to create the framework needed for a much more active market with leading international players now involved.

With 16 Spanish banks part of the upcoming comprehensive assessment, and under-performing loans in Spain reaching €188bn in November 2013 according to the Bank of Spain, more such sales are likely to take place in the near future.

Considerations for each option

News of a capital shortfall will lead to negative media coverage, but some remedies may be perceived more favourably than others.

Organic capital generation	
What is it?	Increase capital through retained earnings, by reducing costs such as variable remuneration, as well as distributions to shareholders.
Key considerations	Perhaps the most straightforward option conceptually, but could be challenging to execute in practice. Any cost cutting needs to be done with minimal damage to franchise value. Reductions in variable compensation need to be balanced by the need to retain talent. Above all, this takes time to generate capital and there is execution risk, so that regulators may not consider it to be an adequate response.
Stakeholder reaction	Shareholders could react negatively to reduced pay-outs in the near-term, even if in the medium term returns are expected to increase as a result. But given the circumstances they may find it preferable to some of the other options, such as issuing additional equity or M&A on unfavourable terms. Withholding of dividends should not create any domestic political controversy and reduction in variable pay may even generate positive media coverage, unlike other cost cutting measures such as job losses. The impact of this option on customers of the bank should be minimal.
How feasible in practice, in terms of amount and speed?	Only likely to be accepted by regulators if the capital shortfall is relatively small, in particular for shortfalls that need to be remediated quickly. This also relies heavily on the bank's profitability over the six to nine months following the conclusion of the comprehensive assessment exercise; if there are doubts around the bank's future profitability, or whether its plans are achievable, then this option will not be viable.

Capital issuance	
What is it?	Issuance of common equity to meet any capital gap. Such issuance is familiar, with shareholders knowing exactly what to expect in terms of the mechanics of the process. Hybrid instruments such as contingent convertible debt ('CoCos'), designed to absorb losses (for example, by being written-down or converting into equity) when a bank's capital position falls below a specified threshold, could be an alternative, but the instrument would need to qualify for Tier 1 capital to be useful for this purpose. In the current low-yield environment, CoCos have been attractive to certain investors because of the enhanced yield they provide. Additionally, interest payments are typically tax deductible for the issuer, and CoCos do not automatically have a dilutive effect on existing shareholders.
Key considerations	Pricing and timing will be important, both for equity and CoCo issuance. Potential investors may be hesitant if issuance occurs before conclusion of the comprehensive assessment exercise, potentially making it more expensive. Issuance in advance of the results also raises the risk of litigation if the results are subsequently worse than expected. After the results are published, the shortfall will be known with certainty and it will be easier for potential investors to assess the investment opportunity. At that time though, there may be a relatively crowded marketplace, with several banks trying to raise new capital. It may therefore be more difficult for banks to manage the messaging once the results of the comprehensive assessment exercise have been published. In addition, the use of CoCos to meet capital shortfalls is subject to limits, and cannot be used at all to address shortfalls revealed by the AQR or by the baseline scenario. Roughly $70bn of CoCos were issued between June 2009 and 2013 according to the BIS,[12] with the majority being issued by European banks. Some market commentators expect €30-50bn of CoCos to be issued by European banks during 2014, partly in preparation for the comprehensive assessment. According to a sample analysed by the BIS,[13] the bulk of CoCos have been purchased in the first instance by small private banks and retail investors, while institutional investors have largely steered clear. This appears due in part at least to CoCos not meeting the typical investment criteria of institutional investors. To date, CoCos have been issued principally by larger banks, and the investor appetite for CoCos issued by smaller, more regionally focused, banks remains unclear. Bank and supervisor may disagree on how much issuance is required, and some banks will therefore wish to combine their preferred capital issuance with some of the other approaches discussed in this paper.
Stakeholder reaction	Domestic governments are likely to respond favourably to capital issuance, as it should not translate into a reduction in credit provision (although if the government is also an equity holder in the bank, it may hesitate to dilute its stake or in some cases be unable or unwilling to increase its investment.) Well executed capital issuance is likely to be viewed favourably by the supervisor, as this implies a sound business plan and the expectation of a profitable business going forward. However, it is in itself unlikely to be the panacea for all of a bank's challenges. Supervisors will likely look for issuance to occur alongside other actions, such as improving the ongoing operations of the business. Senior bondholders will be relatively happy to see equity or hybrids in the capital structure as they will provide another layer of credit protection. Shareholders may be less enthusiastic, depending on the conversion terms and size of coupon payments. The reaction of rating agencies will be important as any rating changes will affect the bank's cost of funding, which could prevent CoCo issuance. Downgrades may serve to reinforce negative sentiment that already exists around a bank.
How feasible in practice, in terms of amount and speed?	Due to uncertainty around balance sheet quality, some banks may find it difficult to raise equity prior to the announcement of the comprehensive assessment results. Capital issuance is likely to be one of the few options that can be executed quickly enough to respond to failing the baseline scenario (which a bank is required to remedy within six months).

12 Avdjiev et al, BIS Quarterly Review, September 2013

13 Ibid

Asset sales	
What is it?	In certain crisis countries, deleveraging through asset sales has dominated the activities of many banks post crisis. In Ireland, for example, banks that received government support in the early stages of the crisis have been under pressure to redefine their core businesses and clean up their balance sheets. The Irish government established a bad bank, NAMA, to acquire under-performing loans. In addition, major banks initiated deleveraging strategies to reduce their non-core exposures. This has resulted in loan portfolio sales of both domestic and overseas assets covering multiple asset classes. Until recently, continental Europe had not experienced the same levels of activity, due to a combination of later government involvement in the sector, a less aggressive stance on the balance sheet, and jurisdictional issues. The past six to twelve months have seen increased loan sale activity, particularly in Spain, Germany and more recently, Italy.
Key considerations	Banks need high quality and consistent loan data in order to dispose of assets. There have to be creditor-friendly insolvency laws. The market must be large enough to attract big investors over a longer term period. There must be infrastructure in place to service the loans being acquired. Without these in place, investors will shy away from the market and concentrate their firepower in jurisdictions that are more favourable. In some cases the present carrying value of assets is significantly higher than the value which a buyer would be willing to pay. If banks sell below carrying value they will realise a loss. Banks also need to ensure that any transactions do not inadvertently prompt the revaluation of other assets currently held on the balance sheet. Regulators will not want to see firms selling higher quality portfolios while retaining poorly performing portfolios, as this will lead to a deteriorating balance sheet position. We expect to see increasing focus on deleveraging including the establishment of non-core units, potentially more “bad banks”, and more loan portfolio sales. The recent narrowing of bid-ask spreads, possibly reflecting a lowering of target returns by investors, could facilitate the process.
Stakeholder reaction	Deleveraging of the balance sheet in this manner should be broadly welcomed by macro-prudential regulators. However, there may be a concern if foreign/cross-border assets are sold first as this would further link a bank’s health to that of a single national economy. Domestic governments will also welcome the clean-up of banks’ balance sheets but they may hold a differing viewpoint to that of a European regulator. Principally governments will be occupied with rejuvenating their domestic economy, preferring to see their domestic banks selling foreign assets first while refocusing on their home market. The impact on customers is likely to be limited for retail loans, which are typically reasonably well protected. For commercial borrowers the sale could potentially see a more aggressive servicing policy being adopted in order to extract maximum value.
How feasible in practice, in terms of amount and speed?	Depending on the size of the bank’s non-core asset portfolios, a deleveraging plan will typically span two to three years in total and consist of multiple sales of different asset classes. There is a strong buyer community including pan-European and US private equity firms and distressed debt funds who have established European operations to access these assets. Deleveraging will likely not be deemed an acceptable response to failing the baseline scenario (where the capital shortfall needs to be remedied within six months). Should a bank fail the adverse scenario, a deleveraging plan over nine months would then be more likely to be acceptable to regulators and the market, particularly if it is done in conjunction with other solutions for increasing capital, although nine months is still a more compressed time frame than for many previous transactions. While some results can be seen relatively soon, the timeframe to execute the entire plan can be quite lengthy. It is therefore critical to begin preparation ahead of the assessment results and look to see what proportion of the deleveraging can be ‘front-loaded’ so as to achieve the maximum in the nine month window set out by the ECB, bearing in mind that deleveraging will often be part of a longer term strategy by banks to meet regulatory and market pressures.

De-risking, capital optimisation and RWA relief	
What is it?	Capital optimisation involves taking a holistic view of a bank's operations and examining the capital consumption and profitability of the various parts of the business. This requires an analysis of the risk adjusted returns against capital usage, assessed both against the bank's own parameters, and by reference to regulatory risk weights. Through the reduction or even exit of capital intensive businesses, a bank should be able to improve its capital position. Any exit should also include strategic considerations beyond those of profitability, such as the bank's risk appetite, regulatory factors, the needs of its customers, synergies with other businesses, comparative advantage and any other issues deemed key to the bank. In the past few years some banks have stepped up their management of RWAs and embedded parts of this into front line decision making. For other banks though, this remains an afterthought. Even those that do actively manage their RWAs still have legacy assets which were originated before such systems and processes existed. Banks also have the option to deleverage organically, by letting existing books run down while ceasing new origination.
Key considerations	The cost of exit will be key to the market reaction. Withdrawing from low profit businesses to re-focus on more profitable areas could be very positively received by the market. In order to make a meaningful contribution, organic deleveraging will require portfolios with very short weighted average lives, otherwise its impact will be minimal. It is likely that regulators will welcome a withdrawal from capital intensive businesses, if this means a re-focusing on simpler and hopefully safer banking services. What regulators may be concerned about is the migration of certain businesses to non-bank institutions, as they will no longer have the same oversight of these activities. They may also be concerned if optimisation is seen more as an attempt to 'game' the risk weighting than to reduce risk more fundamentally.
Stakeholder reaction	A bank's decision to exit a capital intensive and low margin line of business has the potential to be viewed favourably by shareholders. That said, any significant change in the business should be done as a part of a strategic review of the organisation and not purely as a reaction to failing the comprehensive assessment. This approach to capital optimisation is also likely to be well received by the domestic government as it will potentially signal the bank's withdrawal from riskier areas of business, hopefully reducing the likelihood of future problems. The potential impact on customers is mixed. Some will be affected by a withdrawal of services, and banks may also find it harder to win or retain customers if they are no longer offering certain services. While some banking services are far less profitable than others, many customers expect banks to be able to offer them an 'end to end' service. Organic deleveraging also has the potential to upset both customers and politicians if it results in cutbacks to lending to the 'real economy'. The impact of this should be fully evaluated in any strategic review.
How feasible in practice, in terms of amount and speed?	Capital optimisation is an internal process, with the power to effect change lying principally with management. The necessary strategic review followed by the wind-down plan/exit strategy for the affected businesses will not be fast and will occur over several months or even years, meaning that this will be best suited as a solution to failing the adverse scenario, where there is a longer period for remedial action. Initiating the review prior to the results will put a bank in a position where it can implement the plan shortly after the results announcement. In some cases this shortened timeframe means that such a plan could even become part of a solution for failing the baseline scenario, but in many cases the nature of certain business lines may preclude a quick exit. It is also doubtful that if a bank is faced with a very large capital shortfall this could be solved purely through capital optimisation, with other solutions also required.

M&A within the banking sector	
What is it?	The acquisition of one financial institution by another, or the combination of two or more institutions. Since the financial crisis this has led to the consolidation of a number of smaller players in the sector, such as the Cajas in Spain. In addition, both here and elsewhere, better-capitalised banks have acquired weaker competitors.
Key considerations	Since 2008, vendors of banking assets have principally been motivated to sell in order to shore up regulatory capital ratios or as the result of a political mandate e.g. relating to state aid. Purchasers of assets have taken advantage of discounted prices as a result of the 'fire sale' nature of some transactions. The comprehensive assessment exercise will increase confidence in the quality of assets on bank balance sheets, in some cases forcing banks to recognise losses in the process. This is likely to have the knock-on effect of narrowing the bid-offer spread for banking assets and increasing confidence in valuations, thus making M&A transactions easier to agree. More generally, the consolidation rationale is clear from a business perspective. Europe is frequently described as 'overbanked'. Members of the ECB have identified scope for consolidation among European banks, saying that "On the other hand, the new framework may lead down the road to a period of consolidation in a not much concentrated European banking sector. In fact, there is scope for further consolidation without reinforcing the so-called 'too-big-to-fail' problem and for reaping the benefits of efficiency-driven consolidation. The present weak profitability in the banking sector and the existence of over-capacity in certain areas of the European market suggest that some efficiency gains could be achieved."[14]
Stakeholder reaction	Regulators may welcome M&A in certain cases on stability grounds, but could oppose it if they have concerns about the ability of management to integrate the banks or their competence to run the combined organisations, and will be mindful of creating banks that are 'too big to fail'. Depending on local laws it could also trigger a competition investigation/enquiry which would either slow the process down, or prevent it entirely. Some mergers will be viewed as positive by governments, for example if they increase competition in the domestic banking market. A merger could also be seen as a vote of confidence in the sector. However, if the transaction reduced competition or choice, or led to significant domestic job losses, this would be less well received.
How feasible in practice, in terms of amount and speed?	In Deloitte's experience, the minimum timeframe required to complete a standard transaction process is six weeks. However, this timeframe increases in line with the size and complexity of the underlying assets and is also affected by regulatory requirements. Where transactions can potentially happen faster than this, there may be certain implications on both the consideration achieved and the volume of purchaser protections included in the sale and purchase agreement (SPA). In the case of failing the baseline scenario which requires near term action, a bank may be forced to respond via such a compressed sales process, with the likely implication being the erosion of any remaining shareholder value or the insertion of penal claw back provisions into the SPA. Acquisitions in a short timeframe can raise issues over the quality of due diligence that can be done in such a compressed timeframe. While the comprehensive assessment may give buyers more confidence, it is not the same as M&A due diligence. However, it may help to accelerate the transaction process. Failure of the adverse scenario would likely result in a more traditional sales process for the business or a structured right sizing of the business, given the additional time available. Action over a slightly longer period also opens up the possibility of a merger as opposed to an acquisition, as any merger would likely require a lengthier negotiation process. A further factor to consider is whether domestic legislation in a member state will slow down the acquisition, or if political factors militate against a foreign takeover. It is worth remembering that takeovers have the potential to be influenced by 'politics' more than any of the other solutions we have described.

14 Speech by Vítor Constâncio, Vice-President of the ECB, 'Banking Union and European integration', at the OeNB Economics Conference, 12 May 2014

What should banks do next?

Banks should look to the evidence they have to form a view on the likely outcome of the comprehensive assessment exercise.

Banks should take the opportunity presented by the comprehensive assessment to examine the various parts of their business. If they ultimately decide to re-shape the business, it should not be done purely as a response to the exercise but as part of a longer term strategy which transforms their business model.

One of the important components of the comprehensive assessment is an assessment of policies and processes at the bank. While this provides important context to the data each bank submits to the ECB as part of the AQR and stress test, it may also help to explain how a capital shortfall developed in the first place. For example, a bank may have had lax underwriting processes which allowed poorer quality loans to be originated which subsequently became impaired and eroded the bank's capital. The ECB will be as interested in the process improvements as in the bank remediating its capital shortfall, because otherwise the bank will just burn through the new capital. More generally, banks that show themselves unable to deal effectively with the process and data challenges of the AQR run the risk of making a bad start to their new supervisory relationship.

Banks should look to the evidence they have to form a view on the likely outcome of the comprehensive assessment exercise. Data requests made by the ECB may already have highlighted potential concerns. Throughout the course of the AQR, banks will have become aware of issues being picked up, even if the supervisors have not fed back on them. And since banks are running the stress test exercise themselves, they have full visibility on the outcome. There is clearly a case for addressing shortcomings as they are found, rather than waiting until supervisors raise them.

Points for senior management to consider include:

- **New approach to supervision**: Banks should prepare for rigorous scrutiny of their balance sheets and business models, including risk appetite. The new supervisor is likely to take a conservative position when interpreting the results. The ECB will also be keen to ensure that banks learn lessons flagged in the comprehensive assessment exercise. Banks that fail to action process improvements in areas viewed as weak will not be looked on favourably.

- **New expectations regarding capital planning:** Higher capital standards are a core part of new regulatory requirements. The new supervisor will scrutinise the capital plans of banks in a more quantitative manner than before, with greater focus on the ICAAP and a more consistent approach to capital add-ons across the Eurozone. Banks should ensure they have a capital contingency plan in place, looking at 3 month, 6 month and 1 year scenarios. Balance sheet optimisation will become key. Banks should ensure they effectively and actively manage their RWAs. Stress test governance and process management may well be a target for future supervisory activity, emulating strategies adopted by other supervisors including the US Federal Reserve and the Bank of England.

- **New implications from cross-border competition:** Banks should not expect to be judged solely in relation to their domestic rivals; pan-European peer group analysis will become the norm. A harmonised set of ECB-set standards will evolve. Banks should start to adapt now, for example, with reference to the quality of debtor information; the treatment of problematic borrowers/forbearance; and the wholesale adoption of cash flow based assessment for lending purposes.

- **New expectations regarding data:** Supervisory review and the AQR have exposed material gaps in data coverage, completeness, quality and consistency, requiring banks to enhance this aspect of their operations significantly. Resources need to be devoted to the development of robust and detailed collateral management information systems (MIS) across all asset classes: it is critical to risk and critical to future capital efficiency. The focus on data is not going away. Banks need to ensure data and MIS are given the executive level attention they deserve. The Board should collectively understand where key data come from, any flaws, where differences exist across the group and what the plans are for harmonisation.

Backstop solutions

Although the ECB expects banks to find their own solutions to remediate capital shortfalls, there are mechanisms in place and available to supervisors should a bank fail to find a solution.

The new EU Bank Recovery and Resolution Directive (RRD) will introduce a bail-in tool from January 2016. That is likely to be after supervisors have called time on any banks struggling to remedy problems arising from the comprehensive assessment exercise. In the run up to 2018, the bail-in rules in place will be those stemming from the European Commission's communication on 'State Aid rules to support measures in favour of banks in the context of the financial crisis' of July 2013, which established that any public support to banks considered as State Aid should be preceded by bail-in of bank shares, capital hybrids and subordinated debt. (The text contemplates that exceptions "can be made where implementing such measures would endanger financial stability or lead to disproportionate results").[15] For specific cases at the end of the comprehensive assessment, such principles may be invoked.

One of the pillars of the Banking Union alongside SSM is the Single Resolution Mechanism (SRM). This is a mechanism through which the recovery and resolution of European banks can occur. The SRM goes live on 1 January 2015 and will ultimately have a resolution fund of €55bn which it can deploy to recapitalise banks, but since this will be built up over 8 years, it will not address the immediate problem.

Another potential avenue for government involvement in the banking sector is through the establishment of a bad bank, which will purchase non-performing assets from domestic banks in order to help them clean up their balance sheet. Whatever the merits in theory, there are challenges to doing this, notably the price at which the transfer takes place and the ability of the Member State to finance such asset purchases, particularly given the budgetary constraints many are facing at present. There are also potential State Aid issues to navigate, influenced by the transfer price, which may also influence the wider political reaction.

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14 Speech by Vítor Constâncio, Vice-President of the ECB, 'Banking Union and European integration', at the OeNB Economics Conference, 12 May 2014

Conclusion

The ECB is raising the stakes on the capital planning process.

Banking Union is the biggest institutional change in the Eurozone since the creation of the single currency, with the SSM heralding significant changes in supervision for many banks. The comprehensive assessment exercise provides a first taste of the new regime.

The ECB is raising the stakes on the capital planning process. Meeting the challenge requires banks to address not only any immediate issue, but the underlying governance, policy, data and process issues that may have helped contribute to the problem in the first place. While some will need to focus on the immediate challenge of remedying a capital shortfall, others can take advantage of the exercise and the subsequent capital activity to make longer-term strategic moves.

For a few banks, the comprehensive assessment will be a particularly difficult exercise in which they will be judged to have insufficient capital and forced to take remedial action. This paper has outlined some of the potential options for solving such capital shortfalls. Even for those banks deemed to be well capitalised and requiring no action on the capital front, it is very likely that supervisors will look to see improvements in areas such as process, controls and governance.

In this paper, we have made the case for banks to take early, but considered, action. The time between a bank being informed of the results and a public announcement will be short. It is therefore crucial that banks begin contingency planning ahead of the results so that they are prepared and have given full consideration to the range of scenarios and options, which they can agree with the ECB. That will put them not only in a good position to react, but also to manage communications.

Given that these results will ultimately come from the work done during the comprehensive assessment, this further underlines the importance of getting all the phases of the comprehensive assessment right first time, in order to 'mind the gap' and guard against any mishaps.

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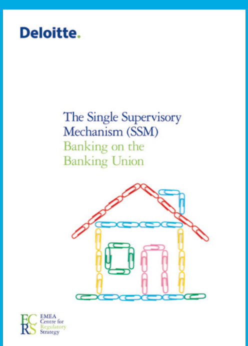

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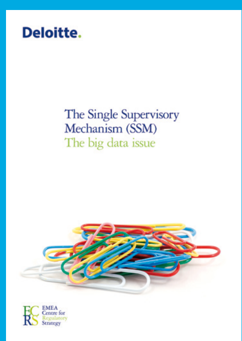

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