CHAPTER 1

Introduction

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This book aims to analyse the potential choice between the raising of capital and the improving of risk management and efficiency in commercial banks in Europe. Given that capital requirement is becoming more and more important for regulatory authorities as a prudential tool and, at the same time, for supervisory authorities as a discretional tool, it is relevant to raise the question of the viability for individual banks and the banking system.

From the theoretical point of view, there is a discrepancy between the prudential view included in the regulatory measures based on Basel agreements and the discretional view included in the supervisory measures based on decisions taken by the supervisory authorities. It is by no means easy to obtain a clear understanding of this twofold approach, which reveals different and dialectically opposing views.

The regulatory and supervisory measures represent a heavy burden for commercial banks in Europe, and the discrepancy has repercussions on choices of individual banks. Is this authoritarian framework justified in the attempt to ensure sound bank management? Finding a reply is not easy. It is worth to point out that application of Basel agreements leads to a rise in costs which needs to be matched by additional revenue in order to maintain the previous economic situation at an individual bank level. At the same time,

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supervision requires system costs arising from the presence of supervisory authorities.

Considering the importance, the spreading effects and the time length of financial crises of recent periods, crisis resolutions involve additional costs for taxpayers in different countries. This is the case both in a bail-in and in a bail-out, as depositors are called upon to contribute in accordance with their deposits and tax position. Will banks survive as fears of systemic risk spreading throughout the system become more pressing? Who correctly estimates the level of systemic risk?

One point is very clear by comparing European banks to American banks: public tools have been called upon to deal with financial and economic crises that have been more serious and more protracted in Europe, whereas considerably shorter periods were involved in the USA. Furthermore, there have been different repercussions on financial and economic systems: American economy did recover in a few years and did continue to grow from solid foundations; European economy did spend a long time before recovering and going through a growing path. It is worth to point out the positive transmission effect from the economy in good shape to the banking system.

In this context, help for recovery from shifts and shocks has been the primary task attributed to public authorities and especially to monetary authorities in order to overcome the critical points in the economic set-up and the bank situation. Establishing strategies for instruments and business areas is of paramount importance on account of the link to cost and revenue and therefore to profit.

Identification, measurement and management of risks associated with financial instruments and business areas constitute the premises for a sound management. This is the strategic issue for banks and financial intermediaries and is the key to positive results and therefore profits or—in contrast—leads to negative results and therefore losses.

This is straightforward for achievement of efficiency in cost, revenue and profit and in scale and scope: it is a complex process which increases the soundness of individual banks by building up a solid system.

Financial crises, which have been particularly severe in Europe over a prolonged period of time starting from 2007, together with related economic crises, have given rise to non-performing loans spreading throughout European banks. This book underlines the need to address and solve the problem in question, which continues to have negative repercussions on the economic growth of the European Union, above all because it has

meant lower loans to the economy and especially to small- and medium-sized enterprises.

In this context, particular attention is devoted to the introduction and spread of the so-called bad bank, which takes the bad assets and, at the same time, leaves the good assets in the previous bank in a sort of "cleaning up" of the asset side of the banks' balance sheets. The cleaning up and the full return to good banks represent the steps towards better conditions for the financing of the economy and economic growth. The greater the rates of return on investments for the good banks in the European Union, the better will be the premises for lending.

Regulation and supervision are typical aspects of the complexity and distinctive features of banks. It is worth pointing out the over implementation of rule constraints on the banking business and especially on capital levels, which are important from the point of view of covering losses but not from the point of view of a rational and sound management of banking risks and business areas. This is the critical point, especially with reference to improving risk management and efficiency. These two aspects are crucial in the development of individual banks and banking systems in different countries in Europe.

In this context, the Single Supervisory Mechanism and the Single Resolution Mechanism, which brought into operation the so-called bail-in from the beginning of 2016, are examined by focusing on weaknesses and critical aspects that involve the evolution of commercial banks and by singling out confidence risks and instability risks. Financial crises have been the cause of many critical points and instability factors as well as the application of the "bail-in" can recreate financial instability. In the past years, states spent a large amount of money for rescue purposes, which has now led to an incorrect use of state aid according to the interpretation given by the European Commission, which considers many cases as state aid when they are not, in fact, genuine state aid. This is misleading as it tends to increase the financial instability risks arising from the application of the bail-in.

This book examines risk management issues in the context of the bank and evolution of the banking business. Attention focuses on non-performing loans and on bad bank as well as the selling of loans to remove obstacles to economic growth on a European scale; at the same time, attention is also paid to rules and single supervision for the removal of excessive restrictions and their inner irrationality on a European scale: thus critical points and weaknesses are identified.

Such circumstances are of considerable importance where bank reinforcement is concerned, as well as banks' capacity to lend credit to the economy. Lending represents the point of return to satisfactory rates of economic growth in the European countries, particularly the weaker ones.

Therefore, this book aims to analyse relationships between risk management, credit risk, banking efficiency, regulatory and supervisory capital constraints, bank regulation and supervision in Europe, monetary policy, supervisory policy and economic growth in Europe, capital raising and bank performance, regulation and supervision in the USA, raising capital or improving risk management and efficiency. The contents focus on a wide range of topics and provide suggestions for the evolution of the European banking system.

This book is subdivided into 11 chapters. Chapter 1, "Introduction", considers a range of topics included in the different chapters and provides a guideline for the topics included.

Chapter 2, "Risk Management and Banking Business in Europe", examines risk management issues in the context of banks and evolution of the banking business, by focusing on identification, measurement and management of all the risks linked with financial instruments and business areas in order to achieve sound management. This is a key issue in devising strategies for banks and financial intermediaries: it can lead to positive results and therefore profits or negative results and therefore losses; in the latter case, the outcome allows identification of critical points and weaknesses.

Chapter 3, "Credit Risk Management and Banking Business in Europe", examines credit risk and credit risk management issues in the context of banks and evolution of the banking business, focusing on non-performing loans. Such topics are of considerable importance where bank reinforcement is concerned and also influences the capacity of banks to lend credit to the economy and especially to small- and medium-sized enterprises. The latter aspect represents the point of return to satisfactory rates of economic growth in the European countries, particularly the weaker ones.

Financial crises, which have been particularly severe in Europe over a prolonged period of time starting in 2007, together with related economic crises, have given rise to non-performing loans that have spread throughout European banks. This chapter underlines the need to deal with and solve the problem in question, which still has negative repercussions on the economic growth of the European Union, above all because it has meant fewer loans to the economy and especially to small- and medium-sized enterprises.

In Chapter 4, "Banking Efficiency in Europe", the efficiency of banks is examined in the framework of production evolution, banking business and business areas, taking into account inputs and outputs and the impact on costs, revenue and profits. Improving banking efficiency constitutes a structural reinforcement in the economic conditions and therefore in the economic account, creating the best premises for bank survival.

Evolving production and business areas and competition between small- and medium-sized banks and great banks, as well as the shocks and shifts induced by financial crises of recent years, tend to improve the strength and solidity of best banks.

Chapter 5, which focuses on "Capital Constraints by Regulation in Europe", considers the evolution of bank capital rules. Capital constraints are important from the point of view of covering losses but not from the point of view of a rational and sound management of banking risks and business areas.

The chapter aims to describe the evolution of the capital adequacy framework for banks, with reference to the international scale: from Basel I to Basel III and the forthcoming Basel IV. As is known, the main reasons for the introduction of Basel III link back to financial crises, overcoming the inability of banks to deal adequately with the consequences. This difficulty was mainly due to operational distortions that have characterised the banking business in the last decades. In particular, in the years preceding the financial crises, banks of many countries had built up excessive on- and off-balance sheet leverage; this was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many institutions were holding insufficient liquidity buffers. The banking system was therefore unable to absorb trading and credit losses. Financial crises were further amplified by a procyclical deleveraging process and by the interconnection of systemic institutions through an array of complex transactions.

In order to respond to financial crises, the current framework focuses on provision of higher quantity and better quality own funds, introduction of countercyclical buffers, the discipline of rules for managing liquidity risk and containment of leverage. However, Basel III provisions have aroused considerable debate. In particular, with regard to capital requirements, questions have been raised as to their real effectiveness in ensuring the soundness of banks. Hence it is important to ascertain the extent to which the increase in capital levels genuinely ensures bank solvency. Such considerations are useful for a critical assessment of Basel III provisions,

especially as far as the latest proposals on the capital adequacy framework are concerned. Accordingly, since the finalisation of Basel III, the Basel Committee has continued to work on various aspects of the detailed capital requirements. These changes (the so-called Basel IV framework in progress) will have a substantial effect on the size of the risk-weighted assets against which capital has to be held and, therefore, the total *quantum* of bank capital. It is worth to point out that capital constraints are imposed following a line of prudential regulation.

Chapter 6, "Capital Constraints by Supervision in Europe", turns to an examination of capital requirements designated by supervisory authorities for individual banks. This chapter aims at providing an overview of additional capital requirements demanded by the Supervision Unit of the European Central Bank in accordance with the appraisal or asset quality review of the economic situation of individual banks. Additional capital requirements can be imposed by an asset quality review or by a stress test indicating bank situations in a crisis or near crisis. This additional constraint considers a number of situations in which the supervisory authorities establish the need for additional capital. It should be underlined that extreme discretion is exercised in relation to decisions concerning additional capital by supervision, which may be required in addition to capital by regulation that is calculated in accordance with Basel III and the forthcoming Basel IV. However, this points to an issue of overlapping rules and uncertainties in the regulatory and supervisory criteria used for calculating and creating the required level of capital for individual banks.

Pursuing additional capital can distract from the real objective, which is the stability of banks throughout Europe: raising capital needs time, and resolution delays underline the worsening of asset and liability values and economic conditions. This in turn leads to increasing levels of capital required in order to restore a bank's situation and enable it to remain on the market.

In Chapter 7, "Banking Regulation and Supervision in Europe", the main focus of attention concerns the evolution of rules applied to European banks as a means of reducing financial instability. Regulation and supervision are typical aspects of the complexity and distinctive features of banks.

Financial crises have been the cause of a considerable number of critical points and financial instability. In the past years, states spent a large amount of money for rescue purposes. Now, according to the European Commission's interpretation, the current situation displays an incorrect use of state aid. However, the Commission's interpretation considers

many cases as state aid when they do not genuinely fall into this category. Thus the Commission's approach is misleading as it tends to increase financial instability.

In contrast, this chapter outlines the best result of a process of restructuring banks in the evolution of production and business areas, taking into account the relevant competition between small- and medium-sized banks and great banks and all adjustments induced by financial crises of recent years.

The Single Supervisory Mechanism, introduced on the basis of the lessons learnt from financial crises, entered into operation in November 2014. Although its statement did not explicitly refer to the banking union or to any other "pillars" of the latter, there was an implicit reference to the fact that supervision was a precondition for bringing other elements of the banking framework up to the European level, notably in the area of crisis resolution.

This chapter underlines that although the framework is comprehensive and well advanced, it remains incomplete, and several challenges still need to be addressed. First, it should be noted that while a single resolution authority, established in 2015, assumed full responsibilities in 2016, a single deposit insurance, despite having been recognised as an integral part of the construction in question, does not exist yet, nor there is an agreed time frame for its implementation. Yet this further step is necessary to complete and harmonise the Single Resolution Mechanism in the euro area.

Furthermore, some issues pertaining to regulatory changes still remain to be addressed by banks and supervisors. The legislative framework, which underpins banking supervision, allows several elements of flexibility, available to supervisors or member states. Moreover, the need of transposition into national legislation opens the door to legislative differences between countries and prevents a truly level playing field within the European banking union.

Finally, this chapter examines critically the relationship between capital rules and other supervisory measures, within a risk-based regulatory framework aiming to ensure the safety and soundness of banks.

In Chapter 8, "Monetary Policy, Banking Supervisory Policy, and Economic Growth in Europe", a description of the definition and trend of monetary policy is given, with a focus on critical issues related to the interaction between monetary and supervisory policy in the euro area in recent years.

Currently, in a context of uncertainty, the monetary policy easing of the ECB may be considered adequate, though opinions differ as to its genuine effectiveness in helping to achieve growth and inflation goals. In the perspective of economic growth, the crucially important point is that the financial system must be able to relay monetary policy impulses efficiently to the economy. In the euro area, the transmission mechanism has been impeded repeatedly in the past, initially by rising risk premia due to doubts concerning the survival of the euro area, and later by widespread bank deleveraging. In this respect it is necessary to discuss and evaluate the consequences of restrictive banking regulation and the supervisory policy with regard to the capital adequacy framework. A supervisory policy should go well beyond the new capital and liquidity regulatory framework, supporting rather than delaying the effectiveness of monetary policy measures.

Chapter 9, "Capital Raising in European Banks", examines the recapitalisation process of the European banking system. Particularly, this chapter seeks to give an overview of recapitalisation operations for a sample of European banks during the years 2012 to 2016. The analysis is designed to assess whether the capital increase genuinely contributed to the soundness of banks or whether a more balanced solution would be to focus jointly on different drivers to achieve this goal, *in primis* the improvement of risk management and efficiency policies.

Chapter 10, "Banking Regulation and Supervision in the USA", considers features of regulation and supervision in the USA. This chapter gives an overview of the financial regulation and supervision applied by US authorities, by pointing out the key features as well the main tools used for examining the safety of banks. In particular, the focus is on CAMELS ratings; the acronym refers to the six components of a bank's condition that are assessed: capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. These supervisory ratings are commonly viewed as summary measures of the private supervisory information gathered by examiners regarding banks' overall financial conditions, although they also reflect available public information.

In the light of banking crises in recent years worldwide, CAMELS can be considered as a useful tool to examine the soundness of banks and help mitigate the potential risks which may lead to bank failures.

Chapter 11, "Raising Capital or Improving Risk Management and Efficiency", takes into consideration the raising of capital from time to time or the improving of risk management and efficiency from one period to another in the context of banks.

The raising of capital is the main tool used by regulation on a prudential application and by supervision on a discretional application in order to maintain the viability of the banking system. Capital requirements are calculated through Basel III and the forthcoming Basel IV; they are also imposed as an additional tool through discretional decisions by supervisory authorities. This can be viewed as a form of "recurrent stressing" to be imposed on banks as a means of pursuing the stability objective. It is important to point out that capital raising is useful only in order to hedge the solvency risk at the specific date examined and only if the solvency risk is correctly estimated at that time.

Looking at only the capital level at a given point of time can be misleading as it cannot create the premises for a sound and stable bank at some future point of time. Improving risk management through the identification, measurement and management of all risks linked to bank instruments and bank business areas is the best strategy in order to achieve structural reinforcement and therefore to assure the soundness of individual banks and the banking system both in the medium and the long term.

This strategy can be carried out by improving efficiency in a wide range of areas, with particular emphasis on the aspects of cost, revenue and profit, in parallel with the structural premises for sound and viable conditions. Taken together, these improvements will lead to better frameworks for the economic account of banks in Europe and in the world from one period of time to another.