Banking Union in Europe – Glass Half Full or Glass Half Empty

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Bank resolution – a critical part of the regulatory reform agenda

- Many regulatory reforms over past five years:
  - Basel 3: capital and liquidity requirements
  - Activity restrictions (Vickers report, Volcker report, Liikanen report)
  - Bonus restrictions
  - Regulation of OTC markets
  - …
- Objective: Make banking safer! Ex-ante prevention strategy
- But: Failure is part of market process
- Objective not to prevent failure at any price, but minimize external costs of bank failure. Ex-post resolution strategy
- Dynamic feature: today's behavior by authorities will influence tomorrow's behavior by banks
  - Expectations are important
- 2008 crisis has been addressed with ad-hoc and transitional arrangements; need for longer-term resolution framework
- Much progress has been made on national and supranational level

The externalities of bank failure

- Network problem
- Hostage problem
  - Depositors panic
  - Contagion through payment system
- Fridge problem
  - Destruction of lending relationship, soft information

→ Try to resolve swiftly

- Financial safety net
  - Supervision
  - Lender of last resort
  - Deposit insurance
  - Bank resolution
- Opposing objectives
  - Minimize risk of contagion and protect small depositors, maintain financial service provision
  - Reduce moral hazard risk, bail-in, living will etc.

From national to cross-border banking

- Failure of cross-border bank imposes costs on foreign stakeholders that are not taken into account by home country supervisor
- Contagion effects through common asset exposures, fire sale externalities, informational contagion, interbank exposures etc.
  - Does not depend on direct cross-border engagements by banks and – on bank-level – not even on direct exposures to international markets
  - More prominently as banks move towards market finance

Financial safety net in a currency union

National supervisors "biased" vis-à-vis national stability interest and national champions?

- Germany, Spain, Portugal, Italy turning a blind eye towards weak banks
- Regulatory ringfencing undermines Single Banking Market
- Need for supranational supervisor

A deposit insurance scheme is only as good as the sovereign backing it

- Deposit insurance is for idiosyncratic bank failures
- In case of systemic bank crisis: needs public back-stop funding
- What if fiscal situation does not allow it?
- Need for Eurozone-wide deposit insurance, with back-stop funding by ESM

The Eurozone crisis – a tragedy of commons

Compare Nevada with Ireland

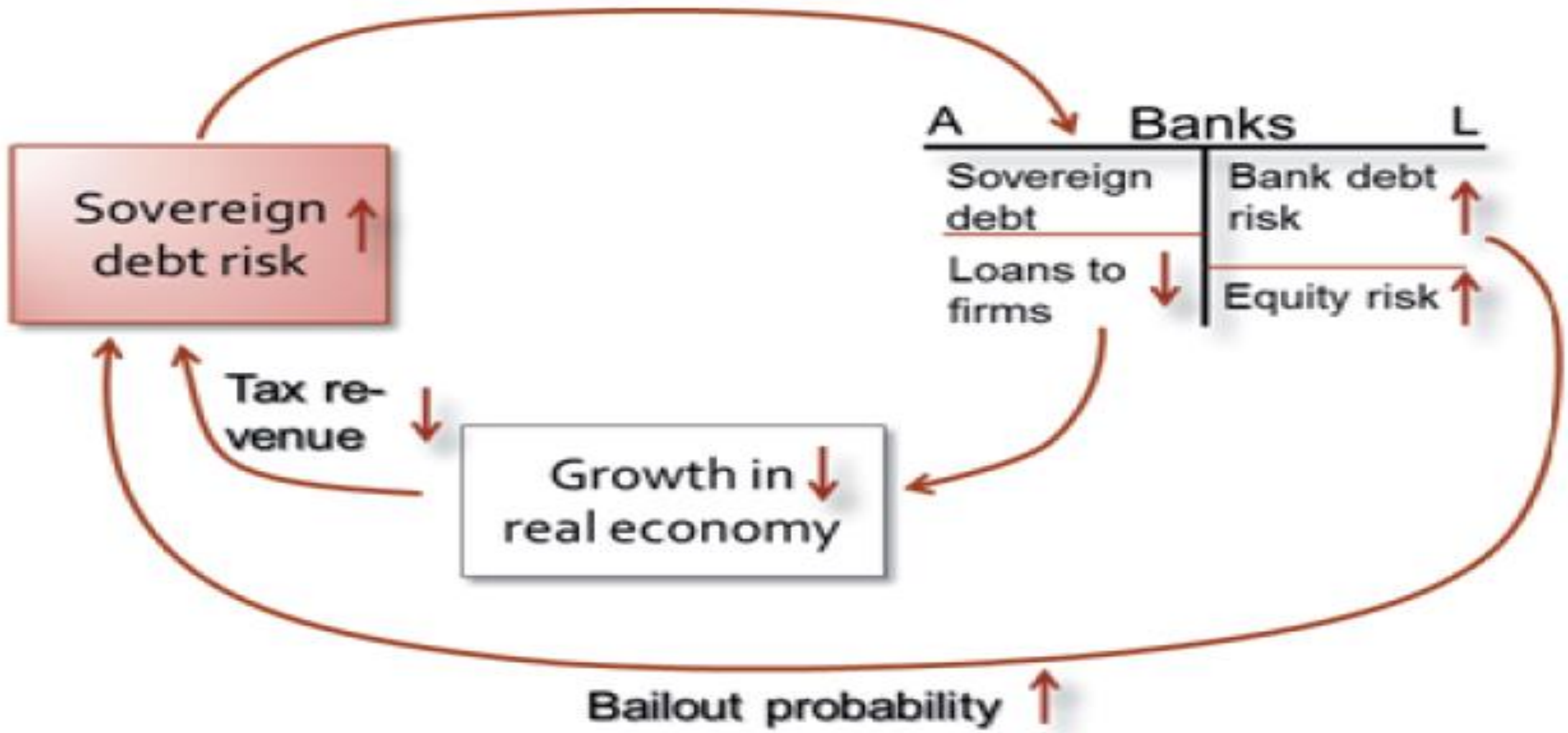
- The ECB and the Eurosystem are being used to apply short-term palliatives that deepen distributional problems and make the crisis resolution ultimately more difficult
- Interest of every member government with fragile banks to "share the burden" with the other members, be it through the ECB's liquidity support or the TARGET2 system
- Nobody internalizes externalities
- No Eurozone authority

If you kick the can down the road, you will run out of road eventually

- Low capital buffers going into the crisis and no significant strengthening since
- Strong reliance on ECB funding
- What if interest rates go up? More skeletons?

Plus ça change, plus c'est la même chose

- Many special cases!
- One common thread: close ties between government and banks



How can a banking union help?

- Increase distance between supervisor and supervised, internalize cross-border costs of bank failure through SSM
  - Overcome regulatory and political capture
  - Will ECB be really a more stringent supervisor?
- Help address Eurozone's Tragedy of Commons problem
  - Allows intervention into failing banks, with sufficient tools and funding options
  - Reduces incentives to kick the can down the road
- Re-establish Single Banking Market
  - Restoring bank soundness and thus bank lending is a critical part of the "growth compact"
  - Re-establish bank lending transmission channel of monetary policy

Banking union – three pillars

- Single Supervisory Mechanism
- Single resolution mechanism
- Single funding mechanism

Partial solution does not help

- Centralizing supervision alone, while leaving bank resolution and recapitalization at the national level, is not only unhelpful but might make things worse
  - Supervision without consequences
  - Walking zombies that cannot be resolved
  - Cannot solve vicious cycle between bank and sovereign fragility
- Banking union for all financial institutions, not just large institutions
  - Monetary and financial stability linked through systemic channels, not just large institutions

Banking union – can it stand on 1.5 legs?

- Single Supervisory Mechanism
  - But: still different legal/regulatory frameworks
- Resolution directive
  - Bail-in
  - But: committee decision slows things down
  - But: still resolution and first level of funding on national level
- No funding mechanism
  - Envisioned resolution fund too small
  - No public back-stop

What can BES Portugal tell us about the "new reality"

- National supervisor missing long-standing deterioration
- Bail-in as envisioned
- But: needed to rely on external funding (IMF) for resolution

Part of larger reform effort

- Need to address sovereign fragility as well
  - European Redemption Pact
  - Need to cut link between bank and sovereign fragility that has caused downward economic spiral in several periphery countries
- Adjustments in regulatory framework for sovereign debt holdings
  - Adjust capital charges and liquidity requirements
  - Concentration limits
  - Sovereign insolvency regime
- Fiscal union?
- Political union?

A banking union is needed for the Eurozone, but won't help for the current crisis!

- Status quo: short-term fixes with enormous pressure and burden on ECB and piece-meal approach to long-term reform
- BUT: Urgent need to address banking and sovereign fragility – transitional solutions
  - Suggestion: **European Recapitalization Agency**
  - Banking union takes longer time to build necessary institutional framework
- Don't mix crisis resolution with long-term reforms
  - Introducing insurance after the accident
  - Distributional fights
  - Political sensitivity

European recapitalization agency

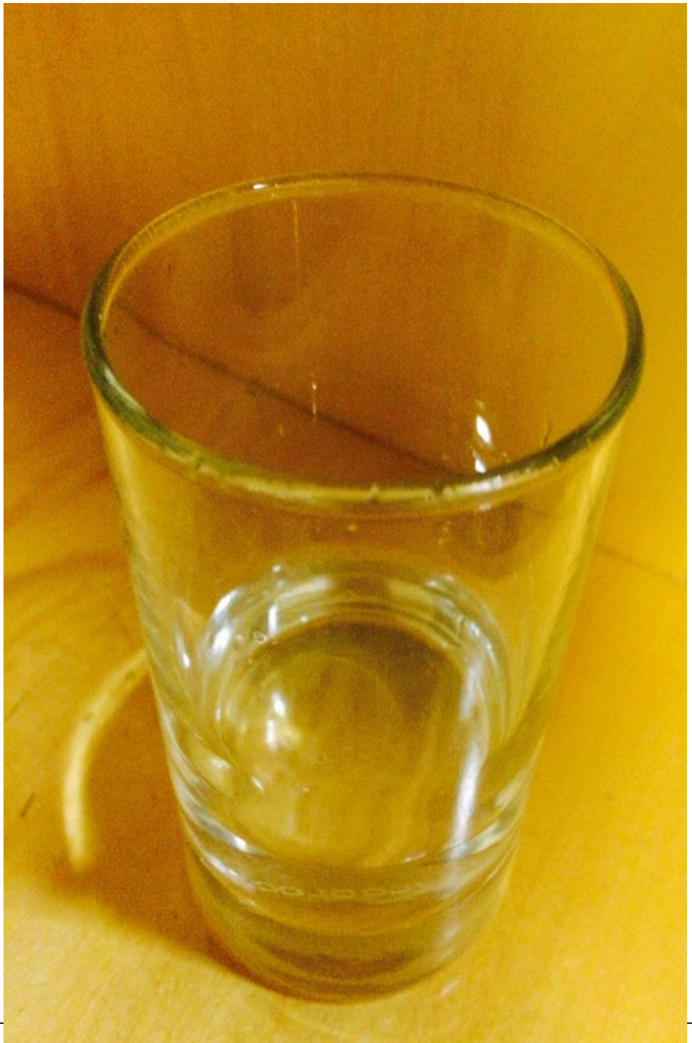
- Temporary asset management company to restructure and resolve weak banks across the Eurozone
- Could be housed at ESM
- Where possible, banks should be recapitalized through the market
- If not feasible, recapitalize by taking an equity stake
  - Receive upside as well!
  - Bail-in of junior and possibly some senior debt holders
- Need for fiscal backstop from ESM

Conclusions

- Glass half full, but can turn easily half empty in a crisis
- Good start, but more to be done

October 2014: moment of truth?

- Asset quality review and stress tests
  - Serious? Banks' funding efforts seem to indicate that yes
  - What if….
  - Back to square one if not enough funding on national level



Thank you

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