The Role of the Banking and Capital Markets Union for Euro Area Stability

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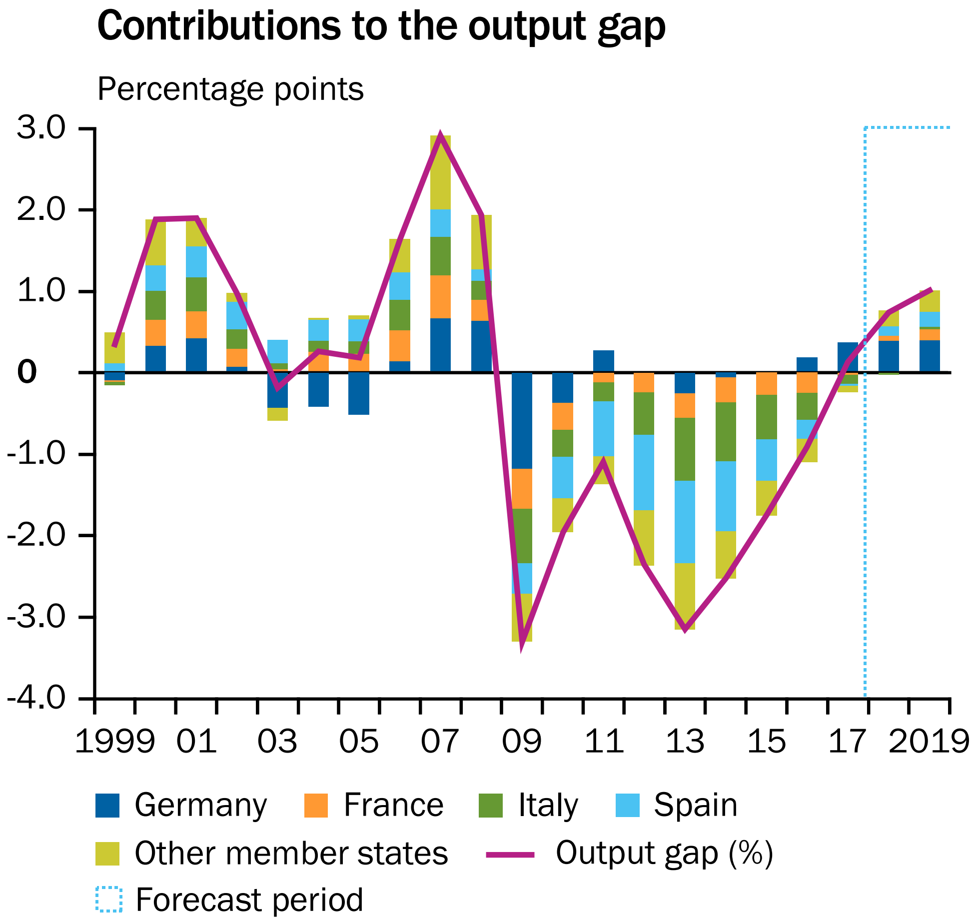
How to finance cohesion in Europe?

Vienna, 26 November 2018

I. Diagnosis: Fragility of the euro area

Troubles ahead in Europe

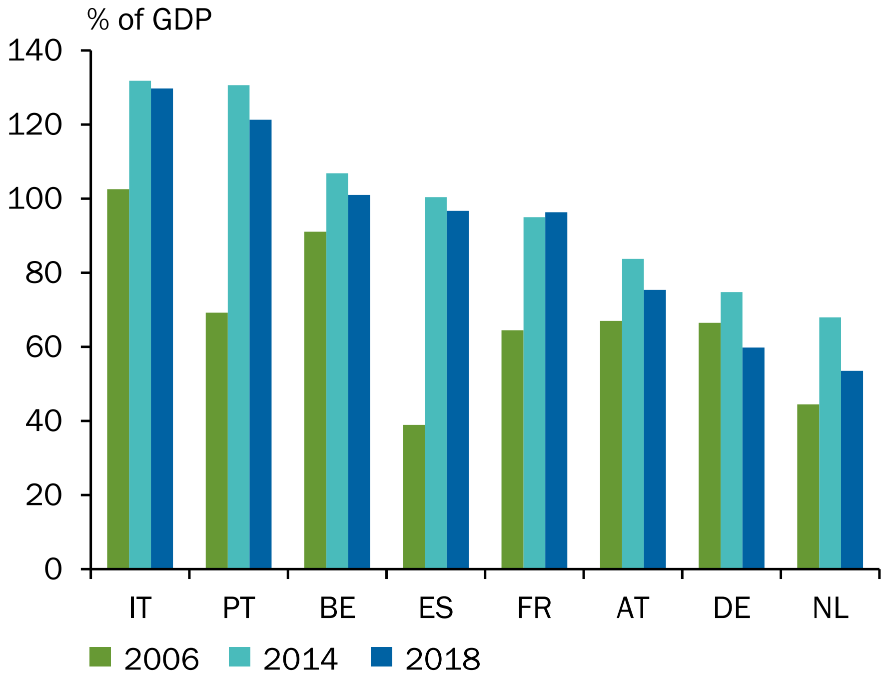


Sources: European Commission, own calculations

- Growth remains strong but heterogeneity and high uncertainty
- Brexit: No decision on exit agreement
- Italy: Difficult budget negotiations with European Commission

High public debt levels in many member states

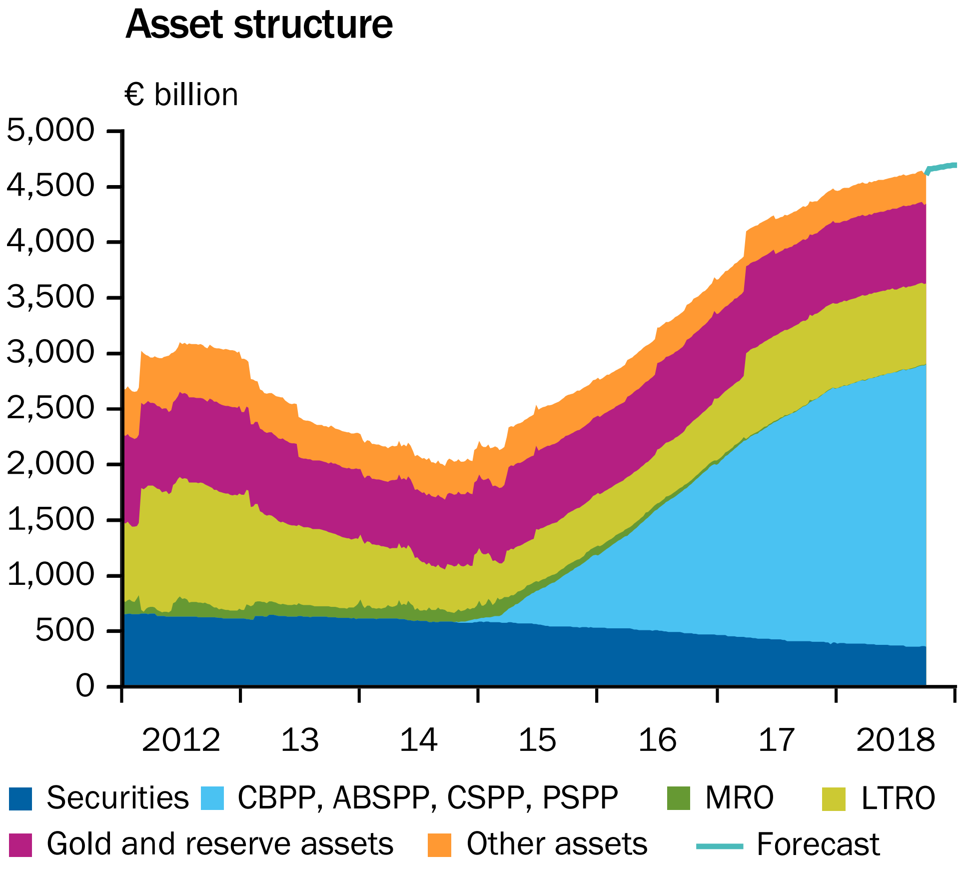
Gross government debt



Sources: IMF, own calculations

- Sharp increase of public debt during the global financial crisis
- Good times have not been sufficiently used for consolidation
- Little fiscal space for a next crisis or recession

Time for exit in monetary policy



Sources: ECB, own calculations

- Macroeconomic situation suggests a normalization of monetary policy
- Normalization should go along with a reduction of bond portfolio
- Little monetary space for another crisis or recession
- But exit is also risky

Significant progress since the euro area crisis…

- New / improved institutions:
  - European Banking Union (Single Supervisory Mechanism SSM, Single Resolution Mechanism SRM)
  - European Stability Mechanism (ESM) for crisis management
  - Reformed Stability and Growth Pact
  - …

- New regulation:
  - Basel III
  - Macroprudential regulation
  - …

… but European banking sector remains weak

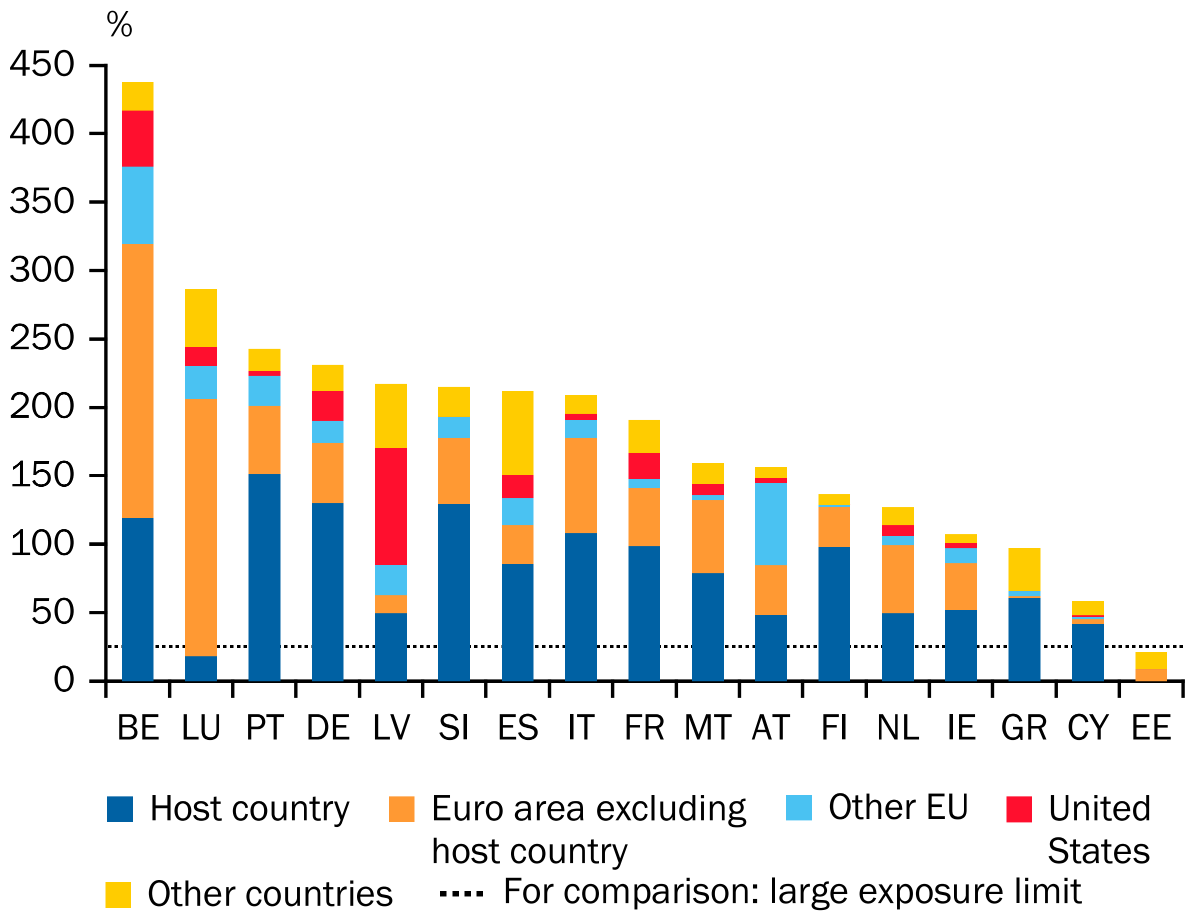
Bank share prices and price-to-book ratios

Sources: EBA, ECB, Thomson Reuters

- Capital ratios higher but not high enough
- NPLs lower but not low enough
- Rising interest rate risk
- Structurally low profitability

Exposures to domestic sovereigns remain (too) high

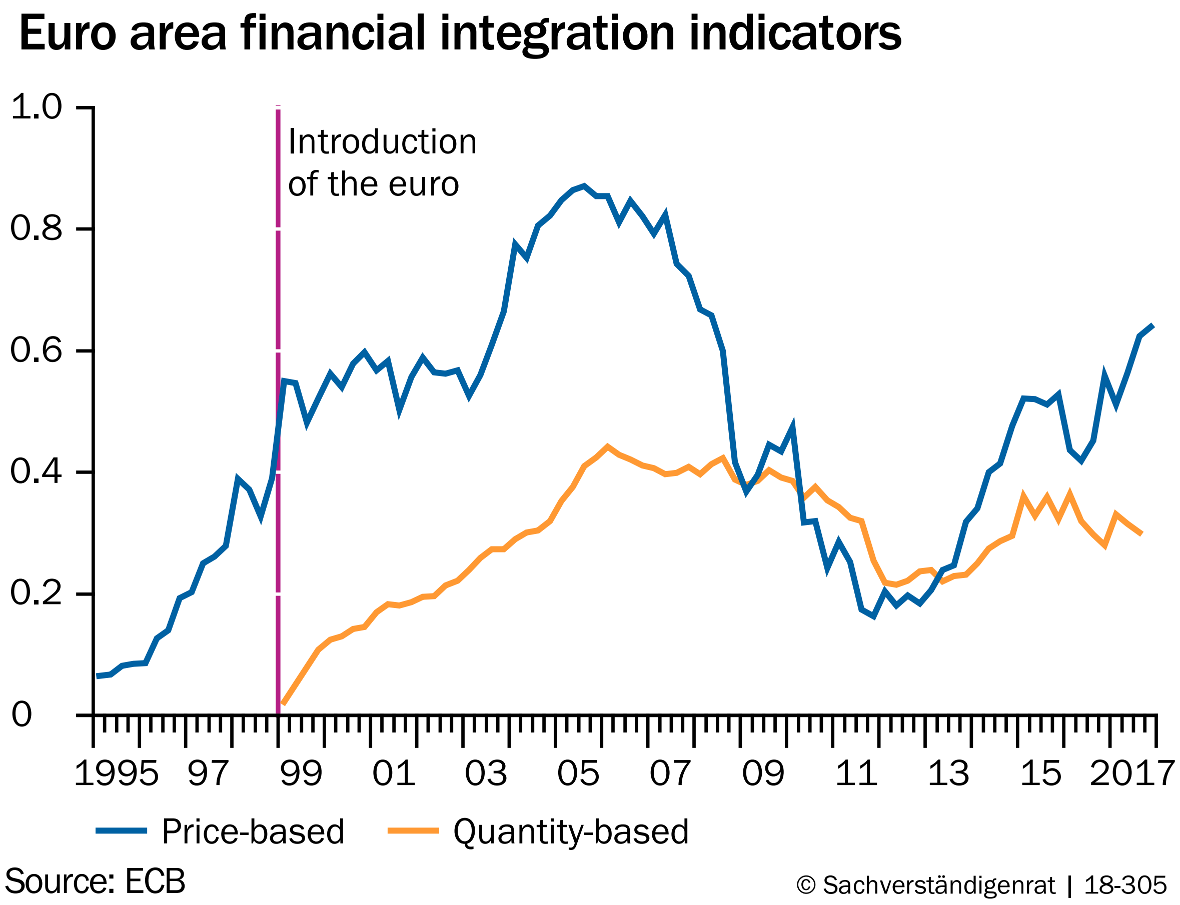
Ratio of banks' sovereign exposures to own funds by country and country groups



Sources: EBA, own calculations

- Still high concentration of banks' sovereign exposures in claims to domestic government ("home bias")
- Direct contagion channel from sovereigns to banks

Financial integration in the euro area below pre-crisis level

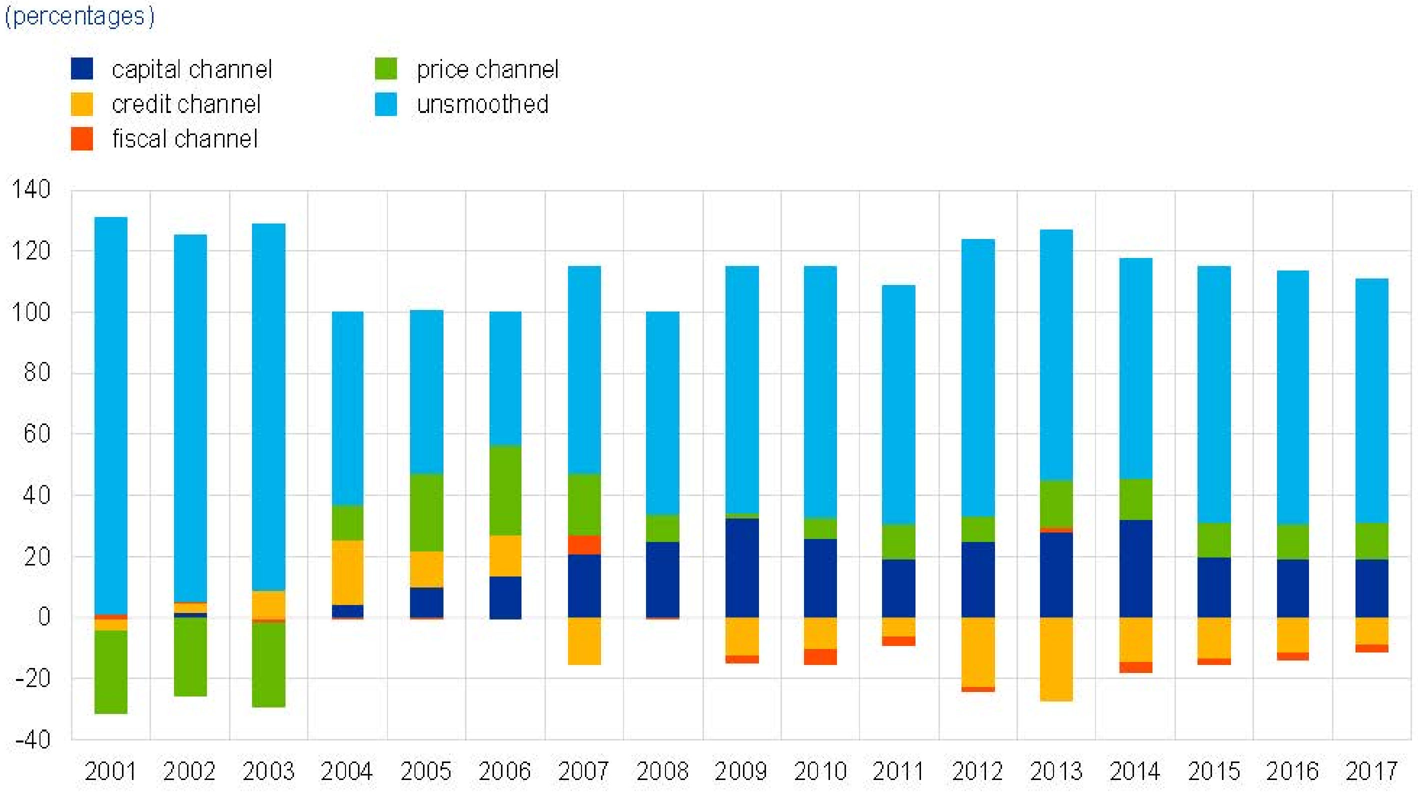


- Sharp drop in financial integration after the financial crisis
- Increase since 2012 (OMT, decision on Banking Union)

(Too) little risk sharing in the euro area (ECB, 2018)

Chart 2

Consumption risk sharing in the euro area and its channels



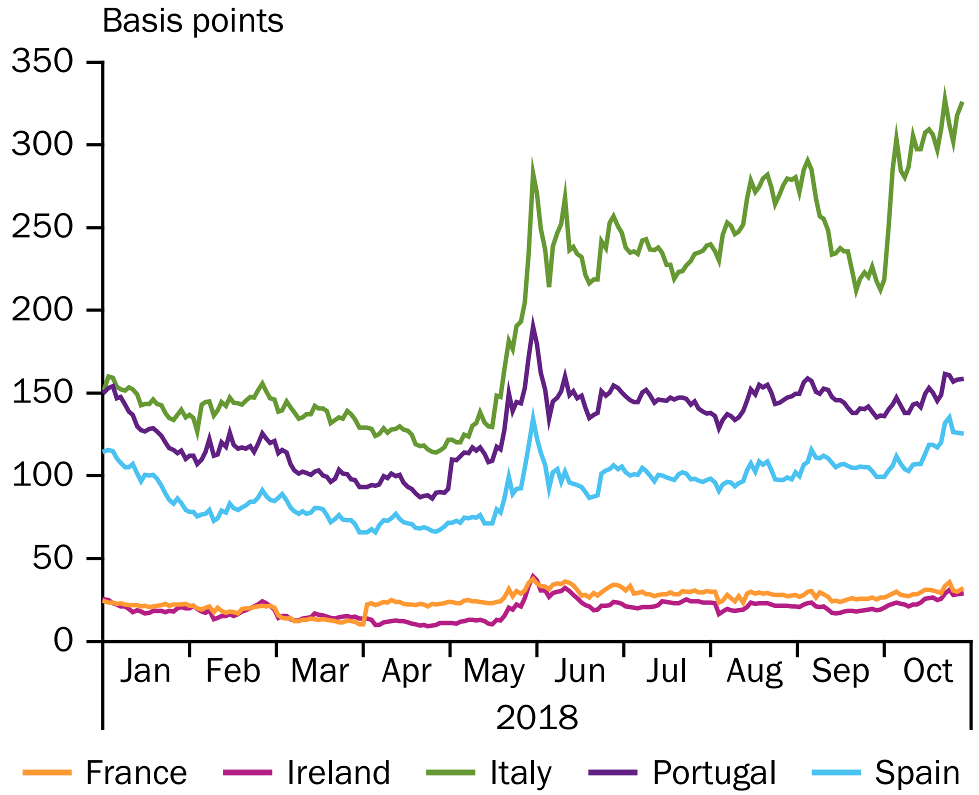
Source: ECB calculations.

- Three fourths of shocks are not smoothed at all
- Smoothing through the credit channel (largely interbank loans) collapsed after the crisis

II. Wake-up call from Italy

Turbulences in capital markets in response to government formation and budget negotiations in Italy

10-year government bond spreads

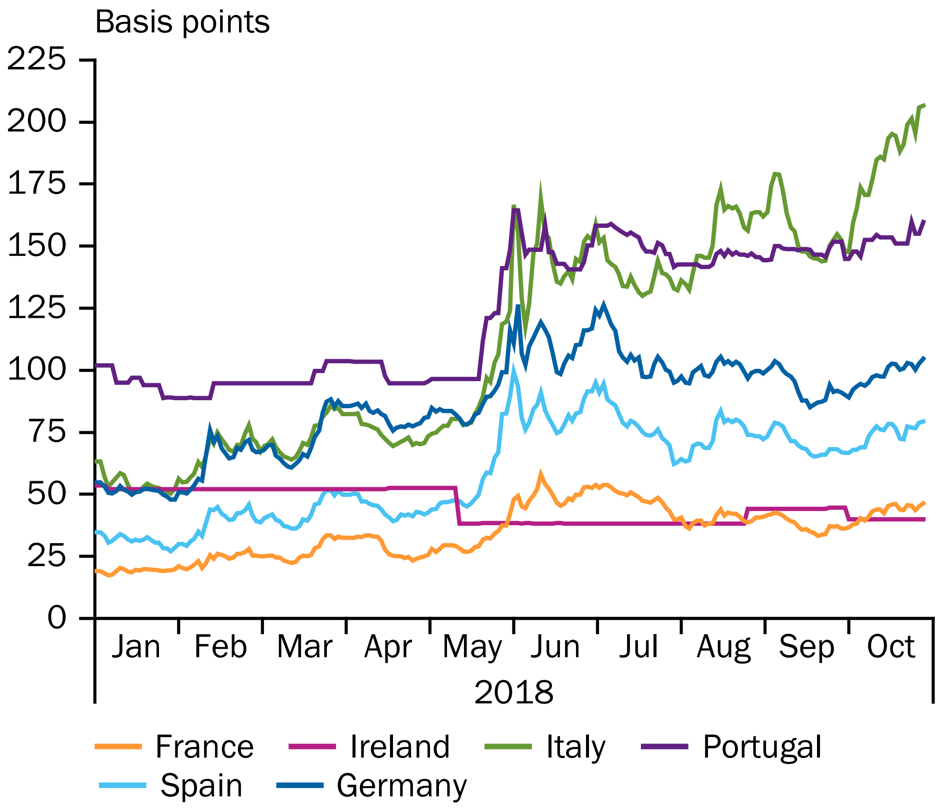


Sources: Thomson Reuters, own calculations

- Sharp rise in Italian government bond spreads
  - Evidence of market discipline
  - But also redenomination risk
- Transmission to other countries
- Fear of a new euro area crisis

Transmission to banks

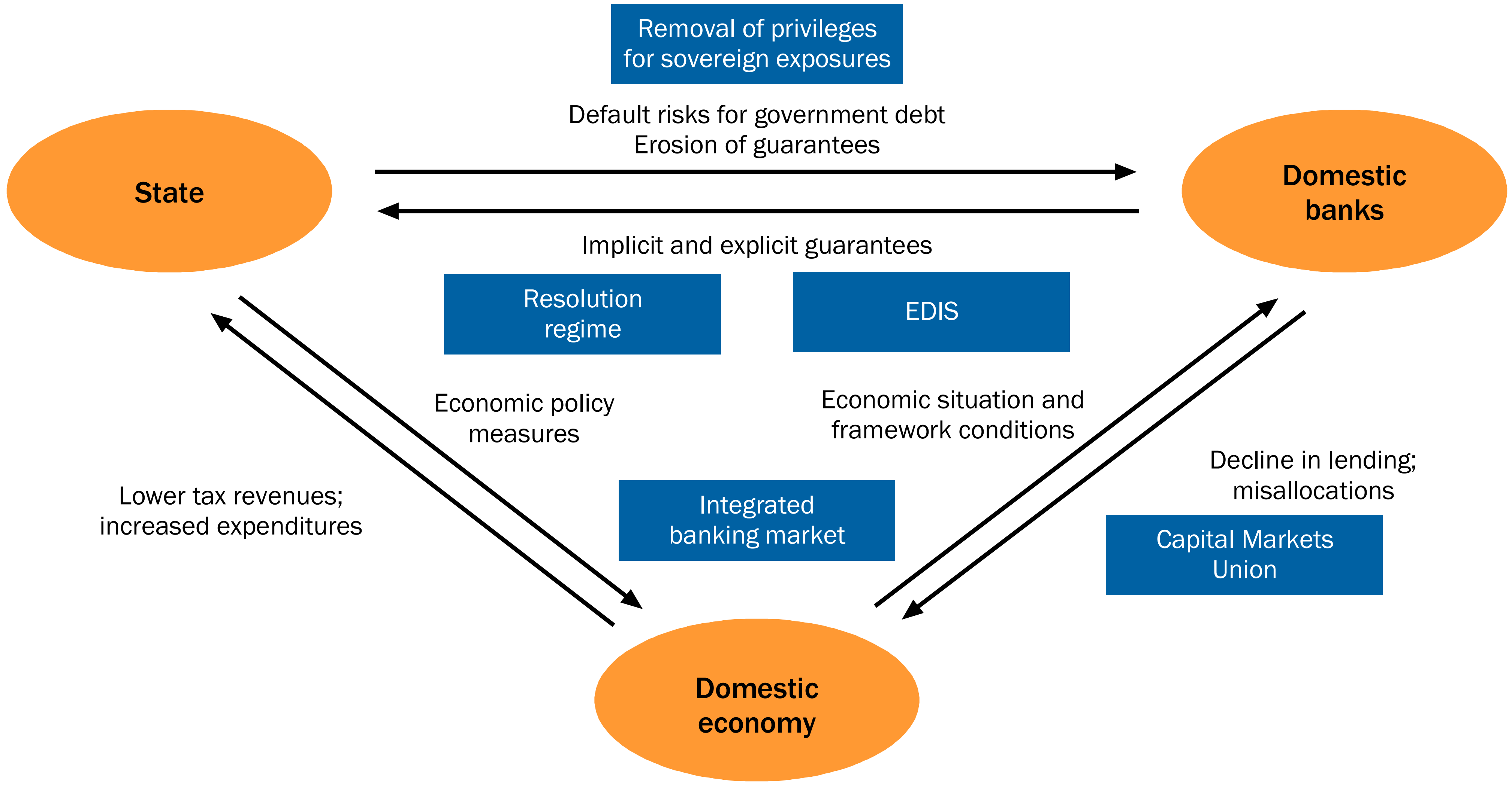
Senior CDS spreads of banks



Sources: BankFocus, Thomson Reuters, own calculations

- Sharp increase in senior CDS spreads of Italian and non-Italian banks
- Transmission to banks makes the situation much more harmful

Sovereign-bank nexus as a root cause



Source: own illustration based on Shambaugh (2012) and Schnabel and Véron (2018)

III. How to break the sovereign-bank nexus

How to break the sovereign-bank nexus

1. Credible resolution regime

2. Well-designed European Deposit Insurance Scheme (EDIS)

3. Ending regulatory privileges for sovereign exposures

4. Integrated European banking market

5. Well-developed European capital market

(1) Credible resolution regime

- Idea: Costs from bank failures should be borne by shareholders and creditors, not the taxpayer
- Single Resolution Mechanism (SRM) as an important achievement

- Further action needed:
  1. Common fiscal backstop to the Single Resolution Fund (SRF) as a permanent credit line by the ESM
  2. Special liquidity facility for banks in resolution („Eurosystem Resolution Liquidity“)
  3. Strengthen the role of the SRB
  4. Tighten conditions for state aid and precautionary recapitalization
  5. Harmonize national bank insolvency laws

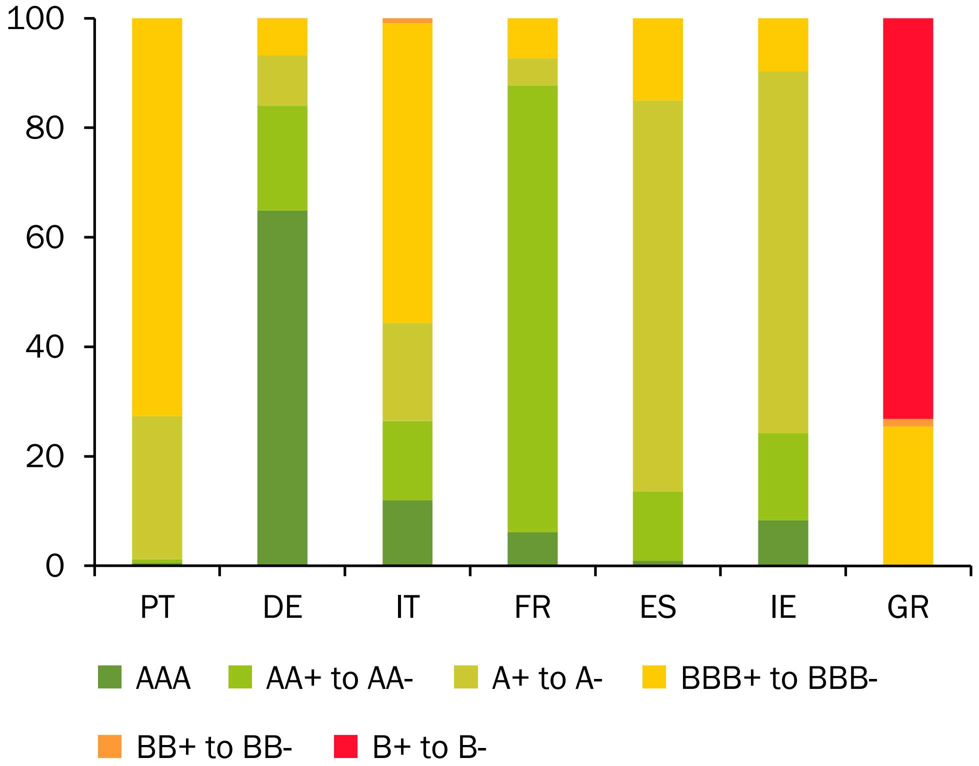
(2) European Deposit Insurance Scheme (EDIS)

- European deposit insurance would …
  - … exploit the benefits from diversification
  - … mitigate the sovereign-bank nexus
  - … contribute to the unity of liability and control
  - … reduce the need for ring-fencing
- EDIS has to be designed in an incentive-compatible way (Bénassy-Quéré et al., 2018; Schnabel and Véron, 2018)
  - Reinsurance-type system
- Prerequisites:

1. Regulation of sovereign exposures
2. Further risk reduction: Reduction/provisioning of NPLs, build-up of bail-inable liabilities (MREL, TLAC)

(3) Ending regulatory privileges for sovereign exposures

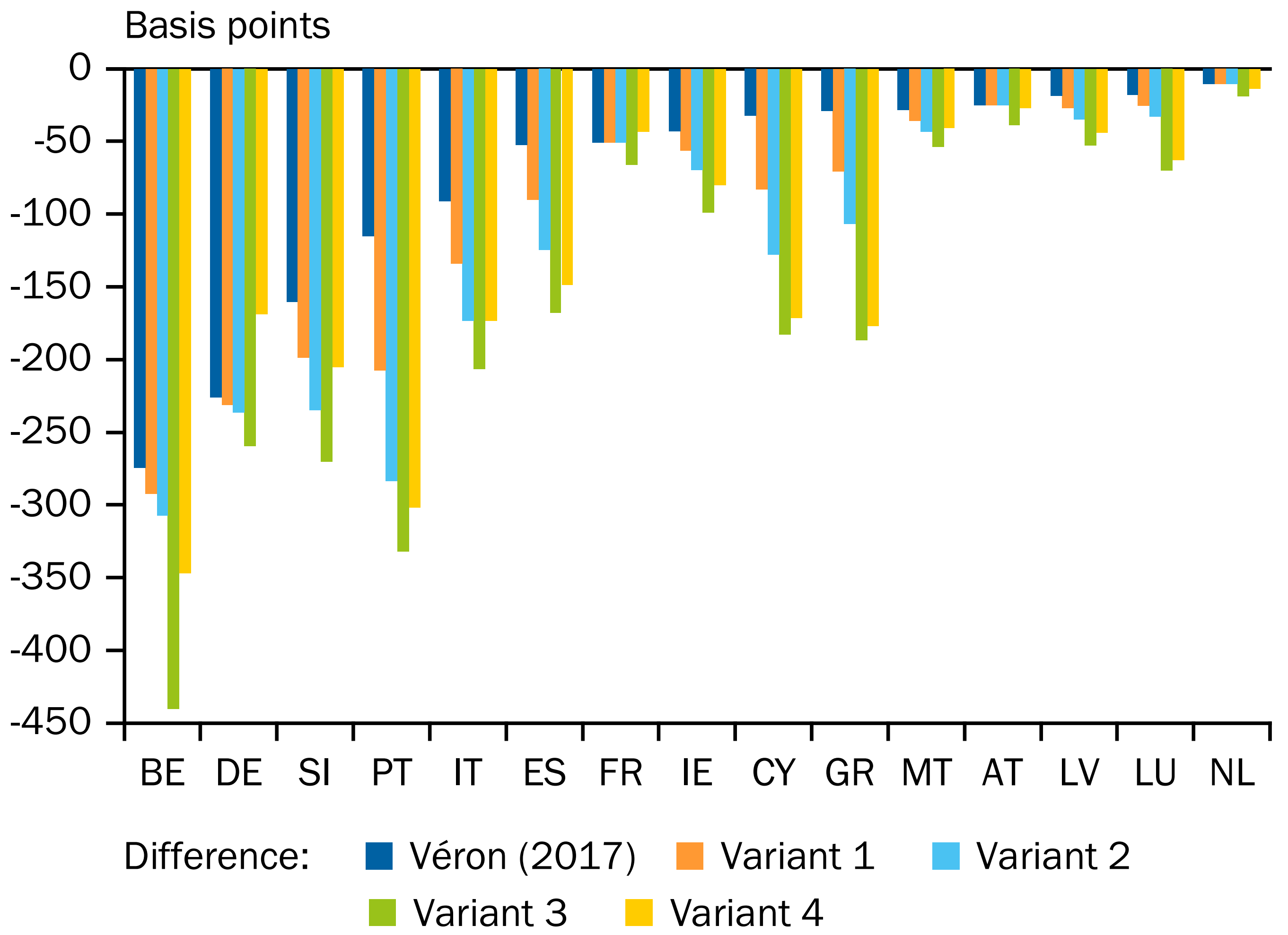
Distribution of exposures to EU member states by rating category



Sources: EBA, Standard & Poor's, own calculations

- Strong home bias in many countries, but risks vary across countries
- Problem is more pertinent in a currency union
- But: Removing the privileges may destabilize public debt markets and create a competitive disadvantage for euro-area banks

Effect of concentration charges on tier 1 capital



Sources: EBA, own calculations

- Non-risked-based concentration charges (Véron, 2017) would mostly affect banks in Belgium and Germany
- Concentration charges should take the credit risk of sovereign debtors into account
- But: Diversified portfolios could be exempted, long transitions needed

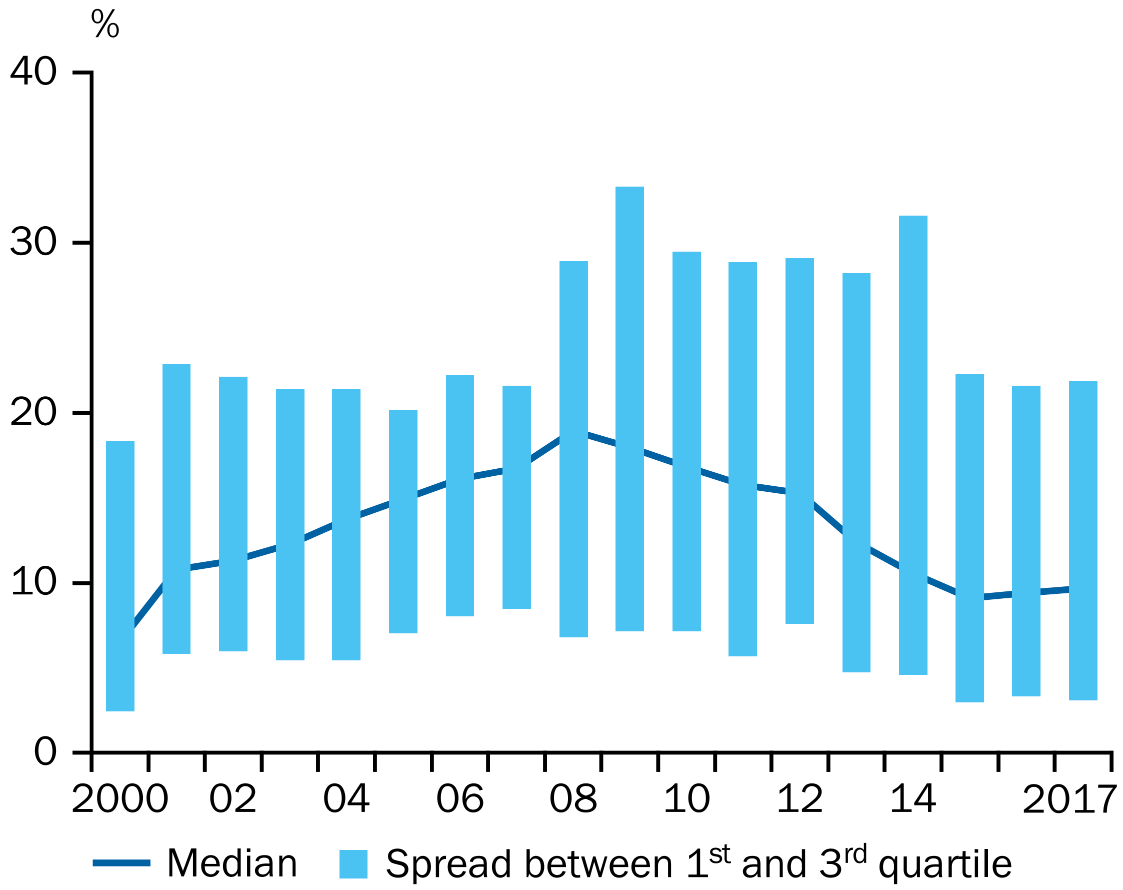
Is there a need for a safe asset?

- Requirement for larger diversification would push some banks into riskier securities, which may make these banks less safe

- Risks could be reduced by creating a "safe asset"
  - For example, ESBies: Additional layer of protection through tranching

(4) Integrated European banking market

Share of foreign bank assets in the euro area



Sources: ECB, own calculations

- European financial system remains strongly bank-based and segmented
- Interbank lending decreased sharply after the crisis and has not recovered since
- Reduction in the share of foreign bank assets

How to foster banking sector integration

- Important role of Banking Union
- Further harmonization of banking regulation and supervision (phasing out options & national discretion, Single Rulebook)
- Remove obstacles to pan-European mergers
  - More flexible system for sharing liquidity and capital within banking groups (including MREL and TLAC)
  - No promotion of “national champions”
- Broader legal harmonization, e.g. in insolvency law, consumer protection

(5) Well-developed European capital market

- Goals:
  - Better access of firms to capital market financing, especially for high-risk firms
  - Greater diversification of funding sources
- Resilience of capital flows matters greatly

- How to foster capital market integration:
  - Important role of Capital Markets Union
  - Remove debt bias
  - Expand the competences of the European Securities and Markets Authority (ESMA) to ensure more consistent implementation of regulation and to avoid regulatory arbitrage

IV. Conclusion

How to proceed?

- Financial issues are key to stabilize the euro area
- High urgency to break the sovereign-bank nexus by completing the Banking Union
- Strengthening resilient financial integration through Banking and Capital Markets Union is important to enhance private risk sharing

- Political constellation has become very difficult in Europe
  - Very little appetite for additional risk sharing in some countries, or more market discipline in others
- But reform is more urgent than ever

Thank you very much for your attention!

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