

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

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2014 – a year of progress

- European Union agrees on SRM
- Comprehensive Assessment by ECB/EBA
- Start of SSM on 4 November

Substantial progress over past five years!

BUT:

- Half-baked SRM (e.g. limited funding)
- Third pillar of banking union (deposit insurance) dropped
- Still questions on solvency of Europe's banking system
- What is the future role of banks in Europe?

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Questions I will be asking...

- Where does Europe stand in terms of regulatory integration?
- Will the recent achievements help us overcome the crisis?
- Will it help us get back to a Single European Banking Market?
- And what else is there to do?

..and some tentative answers

- Where does Europe stand in terms of regulatory integration?

AT THE VERY BEGINNING

- Will the recent achievements help us overcome the crisis?

NO

- Will it help us get back to a Single European Banking Market? **IT MIGHT EVENTUALLY**

- And what else is there to do? **A LOT**

Why do we need a banking union?

Why do we need a financial safety net?

- Network problem
- Hostage problem
 - Depositors panic
 - Contagion through payment system
- Fridge problem
 - Destruction of lending relationship, soft information
- ➔ Try to resolve a bank swiftly to minimize effect on rest of financial system and real economy
- Financial safety net
 - Supervision
 - Lender of last resort
 - Deposit insurance
 - Bank resolution
- Lots of progress post-crisis across Europe on national level

From national to cross-border banking

Moving from national to supra-national level

- 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
- Broaden resolution possibilities within a supra-national financial safety net

Financial safety net in a currency union

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

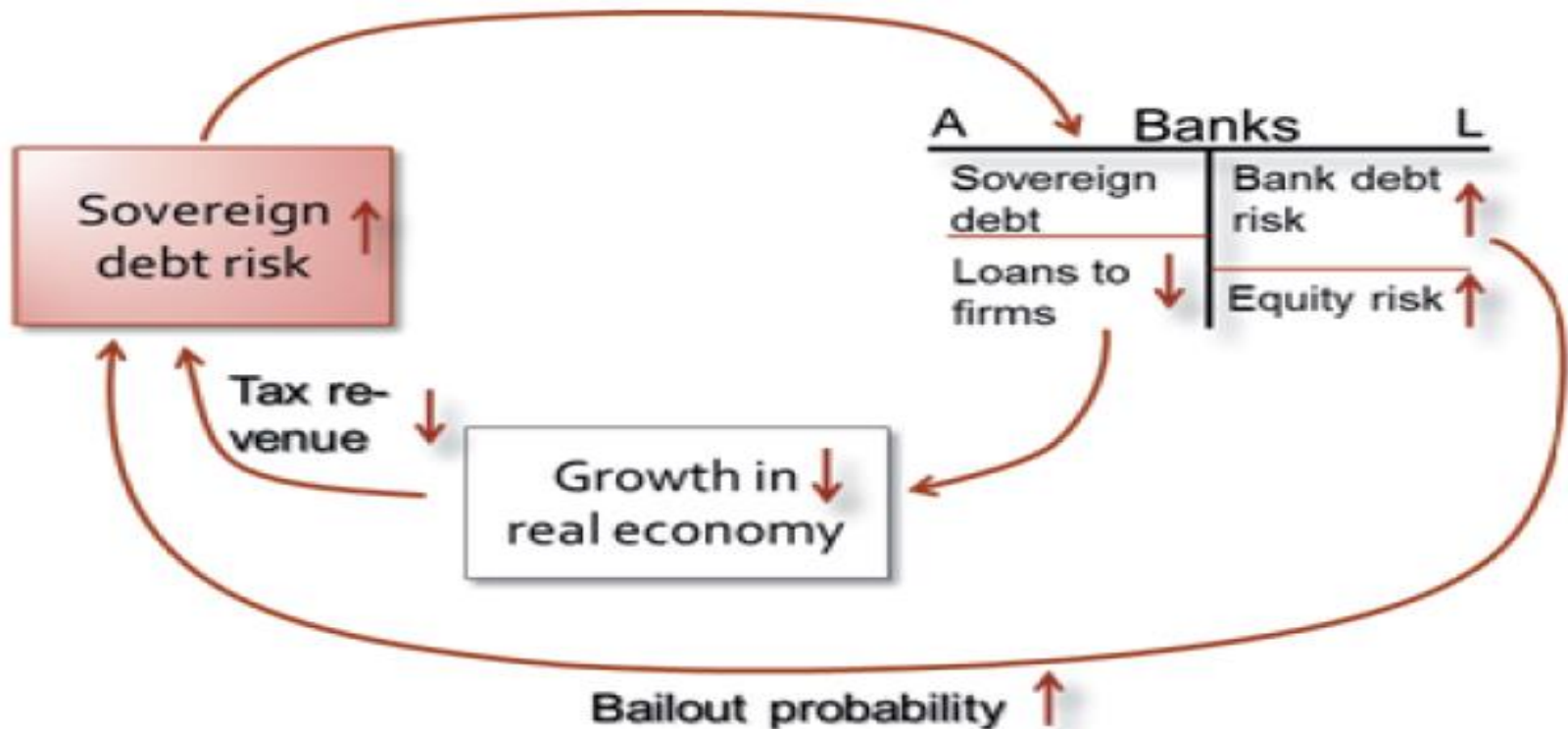
- Germany, Spain, Portugal, Italy turning a blind eye towards weak banks
- Regulatory ring-fencing undermines Single Banking Market
- Need for supranational supervisor

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? Example: Cyprus
- Need for Eurozone-wide deposit insurance, with back-stop funding by ESM

Plus ça change, plus c'est la même chose

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



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, e.g. through the ECB’s liquidity support
- 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
- Resistance to act decisively, compromise solutions on European level rather than taking crisis heads-on

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
 - More stringent and consistent 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

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Banking union – can it stand on 1.5 legs?

- Single Supervisory Mechanism
 - But: still different legal/regulatory frameworks
 - Relative roles of EBA and ECB?
 - Level playing field between directly and indirectly supervised institutions
- Resolution directive and Single Resolution Mechanism
 - Bail-in important new tool
 - But: committee decision slows things down
 - But: still resolution and first level of funding on national level
 - UK not part of resolution mechanism
- 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

Comprehensive assessment – a STEP in the right direction

- Top-down rather than bottom up
- Asset quality review cum stress tests
- Several banks searched market funding pre-emptively during 2014
- The “right” outcome: not too many, not too few banks with net capital shortfall
- Ultimate verdict still outstanding

Concerns:

- No sovereign debt default or deflation in stress scenarios
- Only applied RWA-capital ratio, not leverage ratio
- ...
- First step in a long process

Part of larger reform effort

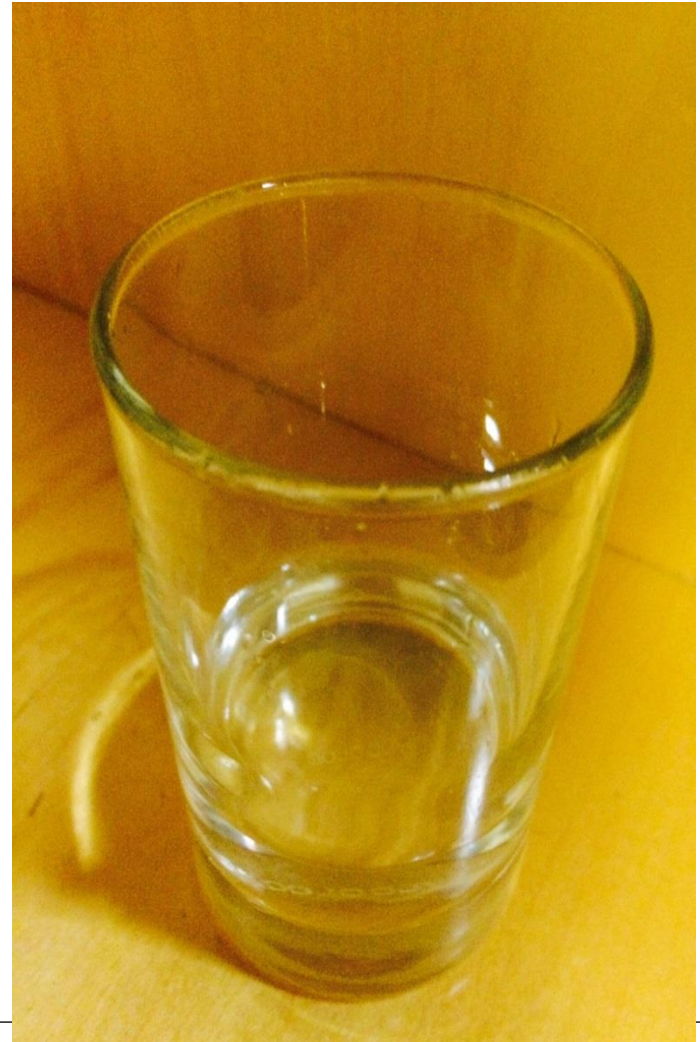
- Need to address sovereign fragility as well
 - European Redemption Pact
 - Need to cut link between bank and sovereign fragility that has caused downward economic spiral in several periphery countries
- Adjustments in regulatory framework for sovereign debt holdings
 - Adjust capital charges and liquidity requirements
 - Concentration limits
 - Sovereign insolvency regime
 - Increase incentives for private sector (including SME) lending
- 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
 - European Recapitalization Agency
 - European Redemption Pact
- Will the recent achievements help overcome the crisis?
 - Lack of demand and threat of deflation
 - On-going political coordination failure
 - High political risks
- Well-capitalized banking system necessary but not sufficient for crisis resolution

Conclusions

- Looking backward: Glass half full
- Looking forward: Glass half empty
- Good start, but more to be done
- Risk: complacency!



Thank you

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