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Revolution or Evolution

The Structural Effects of Banking Union on National Economic Policy Making

Banking union will change the structure and functioning of financial markets in Europe. And it will change economic policy making in ways not yet fully discussed. In order to capture a number of possible effects, I will start by describing some aspects of policies under the present regime, and then try to draw out some of the changes from 2015 onwards. Some of these changes are more certain to materialise than others. It is the latter that may matter more.

1 Where Did Banking Union Come from?

Financial integration and regulatory practices have developed in cycles for more than a century with changing degrees of restrictive regulation and supervision. The choice between market efficiency on the one hand and tighter regulation in order to avoid boom-bust episodes on the other is seldom free of self-interest. Liberalisation of capital movements and the conduct of monetary policy have followed similar cycles, and are closely related to the issues of financial regulation and supervision. In their design, beliefs often play a larger role than knowledge.

Within the European Union the Internal Market brought about a significant degree of financial liberalisation and market integration from the early 1990s onwards. However, even with the advent of Economic and Monetary Union (EMU) it did not become "One Money, One Market" as the title of a then Commission publication suggested. This is not surprising considering the problems of (lack of) rules on burden sharing and supervisory cooperation in a large and integrated financial Internal Market. Attempts by the European Commission to elaborate and codify such rules were met with very effective resistance. An agreement on supervisory cooperation in crisis situations, signed in 2008, had more than 100 signatories. It was never put into practice even at the height of the crisis. The legal framework was mostly created by way of Directives (i.e. not fully harmonised Regulations); cross border banking by way of branches remained the exception, not the rule.

The Maastricht Treaty already contained a provision that allowed for banking supervision tasks being established in the context of the ECB. This was the last remnant of earlier drafts of

the Maastricht Treaty that had recognised that a Monetary Union needed to be complemented by – inter alia – a common banking supervisor in order to avoid supervisory arbitrage or competition. For 20 years these provisions remained unused, and indeed it seemed nearly unthinkable that they ever would be used. Supervision remained firmly anchored at the national level, which has had at least two consequences of interest in the present context: In the case of cross-border banks the divide between host country and home country supervisors has intensified over 20 years with both sides mistrusting each other. The even more significant result has been an industrial policy type approach to financial supervision that has contributed strongly to the current financial sector problems.

The economic risks of supervisory nationalism were partially understood by the main actors, and the political obstacles to tackling them were considered unsurmountable. Discussions between Ministers of Finance of macroprudential risks remained few and far between in the Eurogroup. The degree of contingent liabilities that had accumulated in balance sheets was little understood, and the international interlinkages underestimated. There were only very few examples of risk mitigation even at the national level, such as in Spain. But with the global economic and financial crisis playing out in Europe the consequences became quite obvious.

This became very clearly visible from 2008 onwards as the EU tried to coordinate its approach to banking rescue and restructuring. Close relations of politics, supervisors and banks have been a defining feature of economic policies in many countries. In most of the EU Member States with macroeconomic adjustment programmes – and also others – such "special relationships" led to bank activities that were considered to be in the interest of certain groups or regions. Ultimately they usually were to the detriment of the financial health of the bank and of the tax payers as asset/GDP ratios reached multiples of GDP. In Cyprus for example that ratio reached around 800% of GDP.

A related issue is that bank balance sheets have historically been heavily biased towards government bonds of the home country. In times of a sovereign debt crisis this accelerated the deterioration of the balance sheet of the banks holding government bonds of vulnerable countries, as we have witnessed over the past few years.

The tension between financial stability concerns on the one hand and the avoidance of moral hazard on the other usually only emerges at times of acute crisis. Priorising one over the other is in practice a difficult choice as second and third round effects are especially hard to foresee, and even more difficult to reverse. The choice in Europe and Japan has historically been to try to avoid contagion and ensure systemic stability at nearly all costs. The U.S.A., and to a certain extent the Nordic countries have had a higher emphasis on holding market participants accountable for their actions. A corollary to bail-out being the rule was that decisions on resolution of banks that were failing, or in danger of failing, were taken far too late, thus aggravating the problems and costs of failure or resolution for tax payers.

Instead of rapidly cleaning up banks' balance sheets which would eventually have led to shutting down some of the troubled banks, governments in Europe have usually intervened with capital injections, loans and guarantees. Since such support qualified as state aid it had to be approved at the EU level. During the crisis state aid was allowed to be disbursed rapidly, before the final approval of the restructuring plans and time tables had been given by the European Commission. This led to significant delays in restructuring plans and decisions by national authorities, in a few instances dragging on for years. Bailing-out the banks with tax payers' money continued to be the norm. The overall costs of bank bail-outs in the EU in the recent crisis period is estimated at EUR 413 billion (equity only), added to which 179 billion in impaired asset measures, EUR 258 billion for liability measures other than guarantees (i.e. loans and direct liquidity), and guarantees that reached a peak in 2009 at EUR 836 billion.

The stress tests of the banking (and insurance) industry in 2010 and 2011 coordinated by the European Banking Authority (EBA) were conducted and influenced by national authorities with some top-down coordination and plausibility checks. As it turned out they were too mild to trigger sufficient restructuring. Even certain banks that were later resolved under euro area financial assistance programmes passed the test.

As the financial crisis in Europe reached new dimensions in 2012 the negative linkages between banks' and sovereigns' balance sheets influenced the financial stability of the euro area as a whole. In May of that year it was considered that one of the means for breaking this feedback loop, and thus for stabilising sovereign debt markets, was to directly capitalise banks in need through the European Stability Mechanism (ESM). In these cases programme lending to the sovereigns concerned would have been superfluous. Macroeconomic stigma effects would have been avoided.

As these discussions progressed it became evident that this would be conceivable only if the banks concerned were supervised by a common (and thus impartial) supervisor. At the European Council meeting on 29 June 2012 it was thus concluded that such a supervisor should be set up. Two years on it is all set to start operating. It has long ago left the reasoning of merely underpinning direct recapitalisation far behind and became a part of something larger, the banking union.

2 A Changed Environment for Policy Makers

Following the crisis a new and more robust regulatory framework has been set up for the EU as a whole. Banking union as per 2014 is made up of different complementary components. The *Single Supervisory Mechanism (SSM)* in Frankfurt will directly supervise the major banks within the banking union, and indirectly the minor ones. New rules on the *recovery and resolution* of banks will ensure that tax payers no longer bear the financial burden of bank bail-outs, but that owners and investors of banks will contribute to these costs by bailing-in their assets. A *Single Resolution Mechanism (SRM)* for the banking union will trigger the resolution of failing banks and will adopt resolution plans for these institutions. After a mandatory bail-in of shareholders and investors, remaining costs of resolution will be born by the *Single Resolution Fund (SRF)* which will be financed by industry contributions. This Fund will be progressively mutualised from 2016 onwards. This means that the costs of bank resolution will partially be born by levies of banks throughout the banking union, and not just by those located in the country concerned, as is the case for countries outside banking union. A single *Deposit*

Guarantee Scheme is not foreseen for the nearer future as this is regarded as a step too far in the direction of Fiscal Union.

A Gradual Disappearance of "National" Banking Systems?

With a Single Supervisor strategic industrial policy approaches to banking will largely cease to function. Supervisory practice will become more of a level playing field with the issuance of a single rulebook as the SSM supervisory manual. Discretionary actions will no longer be "granted" by national policy makers. This also changes the political economy of relationships between banking and politics at the national level – also for the only indirectly supervised "smaller" banks.

Ring-fencing of liquidity within bank groups will no longer be possible – national regulators will not be able to limit transfer of assets from banks on their national territory to subsidiaries or to the parent located elsewhere. This should facilitate the functioning of the monetary transmission mechanism, which has over the past years been severely hampered. Supervisors with a national microstability mandate have - individually acting rationally – often acted against the macrostability interest of the euro area as a whole.

The more independent, transparent and objective the single supervisor, the less possible it will be for national authorities to refuse to acknowledge identified risks to viability of individual banks. This will result in quicker triggering of the resolution process. When the Single Resolution Mechanism is operational (in 2016), an independent Single Resolution Board will make it more difficult to justify financial stability concerns in order to be allowed the use of public money to rescue failing banks.

Over time, as conditions of competition become more and more aligned across banking union differences in cost structures will play an ever increasing role in the competitive position of banks. This will influence the strategies of banks in gaining market shares even more so than today. It may also lead to a different type of industrial policies as tax regimes will have a very direct effect on competitive positions, and ultimately on the location of headquarters.

Does Bail-in Change the Macropicture?

With the updated state aid rules as of summer 2013 bailing-out banks as in the recent crisis is no longer possible, and the applicable rules for bail-in will get more stringent over the coming years. Therefore, the traditional reliance on bailing-out banks in trouble will no longer occur as it did in the past. This shifts the costs of bank resolution which is budget positive for the sovereigns. In a truly integrated financial market the effects of the new rules also should be beneficial for the economy across the whole banking union. What is not a priori clear is whether the new rules:

- change the overall costs of bank resolution,
- or merely change the incidence.

On the issue of overall costs the experience of recent years suggests that costs of resolution have been larger than necessary for a number of reasons: national authorities have certified banks as "sound" where an independent authority would not have done so; resolution decisions and plans have thus been taken much too late, usually thereby increasing the costs. And in the case of cross-border resolution coordination failures between supervisors have led to higher costs, and sometimes an asymmetric attribution of costs to the national authorities concerned.

The question of incidence is less straight forward. In the case of bail-out the costs are born by future tax payers, whereas in the case of bail-in the costs are born immediately by investors and possibly unsecured depositors. To what extent the wealth effect of the costs of resolution have significant domestic macroeffects depends not only on the size of the problem or the magnitude of resolution costs, but on the distribution of ownership between different classes of investors. Only in certain cases, such as with a large non-domestic investor base can one unequivocally say that the sign of the macroeconomic effects of bail-in will be clearly different than in the case of bail-out. Obviously, the inter-temporal distribution effects will be very different from each other, but the impact on banks, business and households will be more direct than has been the case so far.

When the Single Resolution Fund (SRF) contributes towards the costs of resolution this will have a noticeable burden sharing effect across banking union as of 2018, when significant parts of the SRF will have been mutualised. This implies that the costs of resolution covered by the SRF will be born by bank levies across banking union as a whole, and no longer by national banking systems. This should have macroeconomic stabilising effects compared to the status quo, especially for small countries with large banking systems.

The main dynamic economic effects of bail-in can obviously not be quantified as they relate to the positive incentive effects of bail-in and thus to risk management within banks. They should dampen the cyclicality of banking crisis as they lead to lower risk. On the other hand they should contribute to slightly higher cost of capital.

Risk and Pricing

Given the new rules on resolution attitudes towards risk will change. Bank finance will be considered relatively riskier, thus the cost of funding will go up and the structure of financing bank balance sheets will become more conservative. Interestingly, banks' risk managers will do well to not only focus

on risks in their own balance sheets. Given the fact that bank levies of all banks in the banking union will contribute to the financing of resolution costs there will be an inherent interest in the de-risking of competitors' balance sheets. First signs of this awareness come as some central banks start hiring supervisors in order to start analysing banks abroad.

Consequently, banks will have to re-evaluate their lending policies. As the loan to deposit ratio comes down, the costs of financing the economy will be pushed upwards, with slightly mitigating effects from positive selection bias for less risky projects and loans. The corporate sector may thus be encouraged to diversify its funding strategy and look for other sources of funding.

For large corporates this is, even in Europe, not a new situation as they routinely finance themselves via capital markets. For midcaps and especially SMEs the situation may change more perceptibly. Given the lower degree of capital market development in large parts of Europe this will pose challenges. Leading (larger) SMEs towards capital markets will also require a new kind of investment banks with a different cost and fee structure. Initiatives to develop markets, e.g. through securitisation are underway, but will take a long time to have a significant impact.

3 And Effects on Policy Makers?

As these changes work through our economies the role of economic policy makers will shift. The present crisis has already shifted requirements significantly. Gone are the days when Finance

Ministers and officials could focus largely on spending and taxation as the main drivers of growth and stability. Gone are the days when banking supervision was a mainly domestic occupation.

With an independent banking sector, integrated across the EU, national policy makers will have to better understand the implications of its functioning on their respective economies.

The role of banking and finance in Europe is changing. The contribution of finance to GDP, i.e. the value added of the sector to the national economy will not be as much of a growth driver as it has been in the more recent past. Financing of investment will face different challenges. As deleveraging of the sector (and other sectors of the economy) continue there will be additional transition issues. Policies will need to address these challenges preemptively. A non-exhaustive list of issues includes the following:

- Developing the necessary framework conditions for the development of capital markets and for SME financing;
- Influences on savings and investment decisions will undergo changes as costs and risks of instruments change; especially on the saving side this needs to be handled with care;
- As sources of growth shift, a better understanding of what is hampering and what is driving growth needs to evolve at the national and the European level. The interaction between public spending, taxation and financing decisions on growth and employment needs to be understood precisely.

Economic Policy is "Risk" Management

Policy makers, among others, tend to ignore the difference between risk and uncertainty, and treat everything as a risk. This may actually at times increase risk. Such an approach may lead, for example, to ever more detailed regulation of activities in the attempt to address known risks, but does not take into account that uncertainty is the problem.

Sources of instability will not go away in the banking union, but dealing with them will require careful analysis at the national level and subsequent policy action at the national level, or the banking union level – sometimes joint. We will therefore need to develop (or improve) our analytical apparatus for detecting emerging imbalances, and stand ready to take action. Instability may come from the real sectors of the economy, such as housing and real estate. Or it could emerge from different parts of the financial system. As intermediation chains get longer the role of shadow banking gets more important. At the same time the use of collateral does not reduce risk, but shifts it around in the financial system. While understanding banks and their balance sheets is important, understanding the other parts of the financial system is more complex, but at least just as important. Only then can one design policies that mitigate risk and decrease uncertainty. This need not be only at the global or EU level, but also national risk management will play a decisive role.

The role of publicly owned financial institutions will face new challenges as risky behaviour with the backing of implicit, and sometimes explicit state guarantees may lead to the resolution of such institutions, instead of bail-outs. Thus, owners of such institutions will need to exercise a different quality of control than sometimes seen in the past. This also implies that "public interest" mandates may have to be rethought and reformulated as a consequence.

A last remark on some debt management issues: The risks associated with banks loading up their balance sheets with government bonds of "their" sovereign has at times exacerbated the financial crisis. This may bring about changes to the risk weighting of such instruments in the future. Direct supervision by an impartial SSM may possibly contribute to judging this "privileged access" as risky. National funding strategies for (potentially) vulnerable Member States may need to change. This also puts further pressure on lowering government debt levels as exposure to market risk gets greater when the bond-absorption capacity of the domestic banking system shrinks. Understanding market reactions and funding strategies becomes part of the tool kit of policy makers not yet exposed to international market pressures due to "captured" domestic markets.

Cooperation and Coordination Ever More Important

The design and implementation of policies that have a direct and indirect impact on banks balance sheets and profit and loss will to a large extent be decided at the EU level, whereas the implementation will remain in the hands of national institutions. They should therefore play an active role already in the EU decision-making process in order to understand the implications of the proposed EU-wide legislation to be able to shape it to the benefit of the national banking sector and economy.

National authorities will have to consider how to best adapt to the new environment – not only regarding their structure, but also the ways in which they interact with each other. A separation of the function of banking supervision from central banks at the national level may be desirable to match the EU structure, where the SSM is independent from the ECB.

National authorities will have to cooperate closely with the SSM and SRM and with relevant national authorities in other banking union member states. This will especially be important when dealing with groups directly supervised by the SSM, where national authorities will remain involved for subsidiaries located on their respective territories. Supervision of smaller banks will still remain in the hands of national institutions, but always in cooperation with the SSM. If such a bank is resolved, the SRM will take over from the national resolution authority if the funds from the Single Resolution Fund are used in the process.

With an increasing impact of policy decisions and events taking place beyond their borders on macrofinancial stability in individual countries, the question of how to organise the flow of information and discussions between the relevant institutions (ministry of finance, central bank, supervisor, resolution authority) will gain importance.

Their interaction at the national level will be complex enough, but at the EU level we will be facing several dimensions: monetary union for the euro area (currently 18 Member States), banking union for the "euro area plus", and the single market for the EU as a whole (all 28 Member States). A reduction of this complexity is desirable, but difficult to bring about.

4 Concluding Remarks

Banking union is going to change the structure and organisation of banking and financial markets in Europe. It will also bring about noticeable changes in the interaction of these sectors with other parts of our economies, and thus their functioning. This will also require a different approach to national economic policies, and a more holistic understanding of how the different parts of the puzzle that our economies are fit together.