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

Isabel Schnabel
University of Bonn & German Council of Economic Experts

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How to finance cohesion in Europe?
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I. Diagnosis: Fragility of the euro area
Troubles ahead in Europe

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

Contributions to the output gap

Sources: European Commission, own calculations

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High public debt levels in many member states

- 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
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

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

Bank share prices and price-to-book ratios

1 January 2004 = 100

Stock price indices:
- Euro area
- United States

Price-to-book ratio (right-hand scale):
- DE,FR,IT,ES
- United States

Sources: EBA, ECB, Thomson Reuters
Exposures to domestic sovereigns remain (too) high

Still high concentration of banks’ sovereign exposures in claims to domestic government ("home bias")

Direct contagion channel from sovereigns to banks

Sources: EBA, own calculations
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)

Euro area financial integration indicators

- Price-based
- Quantity-based

Source: ECB

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

Chart 2
Consumption risk sharing in the euro area and its channels

- Three fourths of shocks are **not smoothed** at all

- Smoothing through the credit channel (largely interbank loans) collapsed after the crisis

Source: ECB calculations
II. Wake-up call from Italy
Turbulences in capital markets in response to government formation and budget negotiations in Italy

- 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

Sources: Thomson Reuters, own calculations

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Transmission to banks

- 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

State

Default risks for government debt
Erosion of guarantees

Implicit and explicit guarantees

Resolution regime
EDIS
Integrated banking market

Lower tax revenues; increased expenditures

Decline in lending; misallocations

Domestic banks

Domestic economy

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
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)
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.

Sources: EBA, Standard & Poor's, own calculations
Effect of concentration charges on tier 1 capital

- 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

Sources: EBA, own calculations
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

- 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

**Share of foreign bank assets in the euro area**

- Median
- Spread between 1st and 3rd quartile

Sources: ECB, own calculations

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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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