Strengthening Banking Union

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Mandate

- European Council, 18 December 2015

Further to the Five Presidents' report on completing the Economic and Monetary Union requested by the December 2014 European Council, the European Council confirms its commitment to work towards completing the Economic and Monetary Union, in full respect of the internal market and in an open and transparent manner. It asks the Council to swiftly examine the proposals put forward by the Commission as a follow-up to the report. In particular, work should rapidly advance as regards:

a) more effective economic and fiscal governance, to boost competitiveness, convergence and sustainability;

b) the euro area's external representation, to better reflect its weight in the world economy;

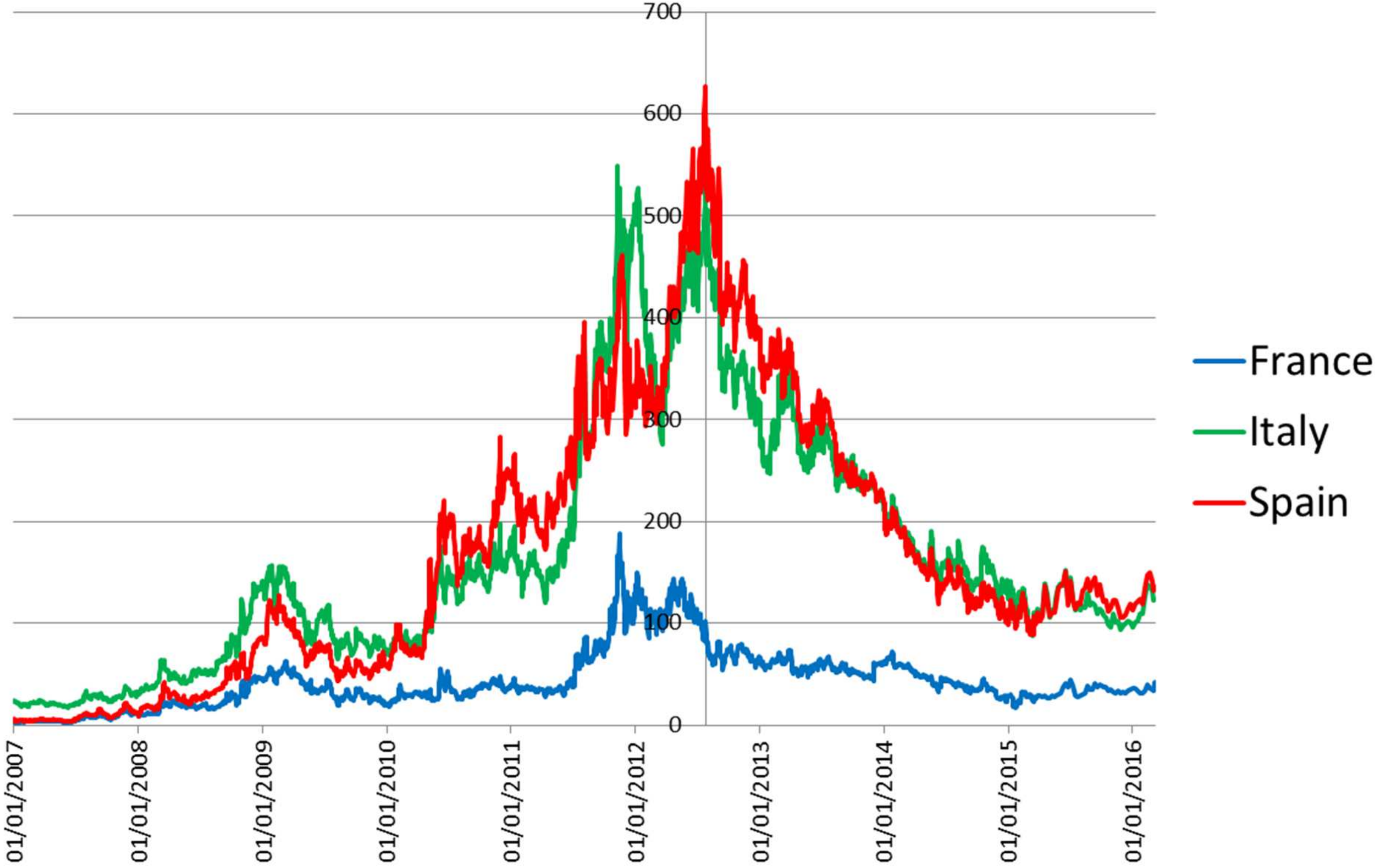
c) the Banking Union, to enhance financial stability in the euro area.

The Council will report on the progress achieved by June 2016.

Context

- Banking Union has been a regime change
  – Massive contribution to euro area stabilization
- But the bank-sovereign nexus remains
  – National deposit insurance
  – Long transition to mutualized SRF, bridge financing
  – Implicit guarantees (incl. institutional protection schemes)
  – Home bias in banks' sovereign exposures
  – Bank governance & ownership, barriers to entry
  – ELA, issuance of own-use GGBBs
  – Banking policy distortions: bank insolvency, accounting, auditing, consumer protection, bank taxation…
  – Policy beyond banking: corporate insolvency, housing…

The Banking Union Promise



10-year sovereign bond spread over Germany. Source: Bloomberg

Link Banking Union / OMT

‘‘The June 2012 summit was perhaps the most important European Council of my five years in office. (…) I will never forget, a couple of hours later on that Friday, Mario Draghi walking into my office, right before the start of the summit’s last working session. A man under huge pressure, for the first time in the eight months during which I’d seen him at work, he now looked relieved. *“Herman,”* he said, *“Do you realise what you all did last night? This is the game-changer we need.”* The commitment of political leaders to European banking supervision created the opening he needed for his own institution to step up its role in the crisis – with words, now famous words, and with action, the OMT, which both came that summer. It was a turning point.’’

Herman Van Rompuy, Speech at the occasion of the Inauguration of the SSM, Frankfurt, 20 November 2014

High-Level Objective

- Not “risk sharing” or “risk reduction” per se…
- … rather “decouple banking sector risks from [national] public sector risks”
  - As evidenced e.g. by sovereign-linked limits in ratings
- i.e. disarm national financial repression
  - Politically directed lending to specific sectors / borrowers
  - Forced lending to sovereigns (a.k.a. “moral suasion”)
- Local macro linkages will always persist
  - But the bank credit channel of private-sector risk-sharing can powerfully erode them (as in the US)
  - This in turn will be positive for fiscal discipline

Macroeconomic Impact

‘‘Financial cycles are more divergent and have caused greater risks at the eurozone level. Knowing this, we need to ask ourselves: what is the best way forward to strengthen our risk-absorbing capacity and assure built-in stabilisation tools? I see two ways. We need to complete our Banking Union and we need to establish a real Capital Markets Union. There is a clear trade-off between a banking union and a capital markets union on the one hand and the need for a fiscal capacity on the other. I strongly believe shock absorption through a strong and well-functioning Banking Union and a Capital Markets Union is preferred over additional budgetary means. I believe strongly in private risk buffering over public risk buffering.’’

Jeroen Dijsselbloom, speech at Tatra Summit, 4 November 2015

Taking Stock: SSM

- Strong, credible start
  - Significant banks (SIs) quickly adopted new regime
  - “tough and fair”, very centralized, strong culture
  - Tests passed: compr. assessment, Greece, SREP2
  - Relations with NCAs: rocky start, stabilizing gradually
- Challenges
  - Complete initial balance sheet scrubbing
  - Bank governance issues will take (much) longer
  - Seamless career paths SSM/NCAs
  - Supervisory transparency
  - SSM governance

SSM Governance

- Imperfect but workable
- Embeddedness in ECB is theoretical not actual problem
  - Delegation to Supervisory Board (with link through VP)
  - System worked in Greece
  - Being in ECB protects SSM independence
- Scope for incremental changes
  - Supervisory Board overload
  - Full-time ECB appointees
- Close cooperations?

Taking Stock: System Repair

- SIs cleanup likely complete by 2017
  - Considerable progress in past two years
  - Most SIs now well-capitalized
  - Tightening of regulatory capital definitions
- LSIs: mostly about Italy in the short term
  - More decisiveness needed from Italian authorities
    - Politically difficult, but financially manageable
  - Austria, Germany: Institutional Protection Schemes
    - Medium-term challenge (recent ECB consultation)
  - Others: few small banks (<25% of total)
- EDIS presupposes LSIs soundness

Taking Stock: Moral Hazard

- Still lots of uncertainty
  – Ratings: uplift reduced, but sovereign links maintained
- Recent wake-up calls useful
  – HETA, Novo Banco, Deutsche CoCos
- "Private-sector bailouts" big unknown
  – e.g. Germany (Düsseldorfer Hypothekenbank), Italy
- Single Resolution Board
  – Younger, smaller, less strong basis than SSM
  – Constrained decision-making
  – Ultimately will be tested in crisis
- BRRD discovery process / case law

Current Policy Agenda

- Deposit insurance
- Banks' sovereign exposures
- Banking law harmonization

Deposit Insurance

- Major (if hidden) driver of system stability
  - Especially after experience of Cyprus 16/03/2013
  - Self-fulfilling equilibrium: credible DIS reduces risk by making all deposits safer
  - Bank runs infrequent, but mother of all systemic risks
- EDIS proposal (Eur. Commission 11/2015) technically sound basis for discussion
  - Sequence re-insurance / co-insurance / Eur. Insurance
  - Same legal issues as SRM
  - Same backstop challenge as SRF (change ESM treaty)
- Exemptions for Inst. Protection Schemes?

Banks' Sovereign Exposures

- Specific euro area issue of vicious circle
  - Separate from Basel-level discussion (& non-euro EU)
- Aim should be diversification
  - Deter "Sarko trade" ("each state can turn to its banks")
    - Precedent: Greece 2015
  - Incentivize rebalancing of banks' portfolios
- Simplicity / neutrality is key
  - Current stance doesn't recognize sovereign credit risk
  - Risk measures inherently problematic (& pro-cyclical)
  - Case for progressive, uniform risk-concentration charge
  - Still, inherently experimental: keep flexibility to adjust

Harmonization Agenda

- “We do not have a single rulebook yet”
  - ECB’s Options & National Discretions
  - Nat.+EU law change “not just desirable but necessary”
- Existing (largely Basel-driven) agenda
  - Better Basel III compliance
  - Implementation of TLAC, leverage, NFSR, floors
  - Tightening of EU capital definition e.g. DTAs
- Harmonization of bank liabilities ranking
  - Separate from corporate insolvency / CMU discussion
  - Further steps towards single bank insolvency regime?

Overall Balance

- SSM now has a proven track record
  - "Legacy" from pre-SSM supervision eliminated by end of decade if not before
- Decisive decoupling of banking-sector risks from national policy
  - Subsidiarity & proportionality point against status quo
  - Even though old habits will die hard
- Case for Banking Union package
  - EDIS + sov. exposures diversification + harmonization
- Fiscal framework a separate issue

Items Left Behind

- Strengthening of SRB
- Phasing out of geographical ring-fencing
- ESM direct recapitalization (now that SSM “established’’)
- Accounting & auditing harmonization
- Consumer protection, data security, bank taxation
- Corporate/personal insolvency frmaework, housing finance
- Macro-prudential policy coordination
- ELA / own-use GGBBs / lender-of-last-resort reform
- Financial repression beyond banks
- Eurobonds
- Sovereign debt restructuring regime
- Demerging SSM/ECB

Summary

- Banking union already a game-changer
- Bank-sovereign vicious circle still extant
  - Massively destabilizing in crisis. Remember 2011-12
  - Has (rightly) become standard narrative of euro crisis
- No perfect construct without fiscal union
  - Current: Monetary Union + “half Banking Union”
  - MU + ½BU much more stable than MU alone
  - MU + ¾BU much more stable than MU + ½BU
- No time for complacency
  - Recent market volatility was timely reminder
  - More tests likely ahead

Thank You For Your Attention

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ANNEX: ITEMS LEFT BEHIND

Strengthening of SRB

- Streamline decision-making
  - More autonomy for SRB
  - Less scope for political intervention
  - May not require treaty change under “New Meroni”
- Increase control over implementation
  - SRB should control execution of resolution schemes, not just their design
  - Removes legal uncertainty
  - May not result in more EU-level litigation (SRB will be sued anyway)

Geographical Ring-Fencing

- Ring-fencing by SSM
  - e.g. entity-specific liquidity requirements
- Ring-fencing by national authorities
  - Under national resolution or deposit insurance mandate
- Should be phased out
- But at least partly conditional on SRM strengthening and EDIS implementation

ESM Direct Recapitalization

- Seen (rightly) as backtracking on initial Council decision of 29 June 2012
  - SSM now "established"
  - But current conditions are extremely restrictive
- No need for adding ex ante conditions to BRRD bail-in
- Specifically, reference to prior national recapitalization entrenches bank-sovereign linkage and should be removed
- No need for change to ESM treaty

Accounting & Auditing

- Make IFRS mandatory for all banks
  - At the consolidated level
  - Several SIs and many LSIs don't use IFRS
  - Conforms to international practice
- Integrate the EU auditing market
  - i.e. single Auditing regulation with no loopholes, and EU agency to supervise auditors (may be ESMA)
  - More difficult, as this cannot be limited to banks
  - But long overdue
  - Fits well in Capital Markets Union agenda
  - At a minimum, external audit for all banks (incl. ISPs)

Other Bank Regulations

- Consumer protection, AML/CFT
  - Link with fit-and-proper test
  - Broader overlap with prudential concerns
    - e.g. Italian banks' sales of own debt as savings product
- Data security
  - Part of prudential framework (SSM 2016)
  - Broader overlap with Digital Single Market
- Bank taxation
  - Sector-specific taxation jars with single market
  - Possibly enhanced cooperation

Other Non-Bank Regulations

- Corporate insolvency
- Personal insolvency
- Housing finance / foreclosure law

- May be partly covered by CMU agenda
- Rationale for reform/harmonization cannot be Banking Union alone

Macro-Prudential Framework

- Current division of authority
  - National central banks
  - ECB
  - ESRB
- National-level activism reduces space for SSM supervisory discretion
- Extent of challenge still debatable
  - as is macro-prudential policy more generally
- May require unanimity (Art. 127(6)) or treaty change

Liquidity & own-use GGBBs

- ECB has no lender-of-last-resort (LOLR) mandate
  - LOLR is national Emergency Liquidity Assistance (ELA)
  - Even though ECB also provides liquidity to banks under its monetary policy mandate
- Own-used GGBBs: Greece 2010, others
- Prospects for reform
  - In principle, completion of banking union also implies decoupling central bank liquidity from national level
  - But many other issues to be addressed prior to this
- May require treaty change

Fin. Repression: Non-Banks

- Banks are no longer captive buyers of home-country sovereign debt
- Sovereign issuers may look for other sources of captive demand
  - e.g. insurers, pension funds
- Different set of risks from banks
- European supervision would better align incentives with interests of customers (policyholders, pensioners)
- May require treaty change

Fiscal Union

- Backstop to SRM (and EDIS) will remain ambiguous as long as European-level financial capacity is limited
- Only a form of fiscal union can fully resolve this challenge
  - Possibly based on contingent rather than actual revenue-raising capacity
  - But needs to be credible
- No short-term prospects for this
- Would require treaty change

Sovereign Debt Restructuring

- Current stance is that European sovereigns represent no credit risk
  – Greece was a unique case, not a template
- "Safe assets" play important role in developed financial systems
- Euro-area SDRM appealing for fiscal discipline, but likely to be highly destabilizing in the absence of fiscal union
- Would require treaty change

ECB / SSM Demerger

- In theory, possible misalignment of incentives monetary policy vs supervision
  - Even though many non-euro-area jurisdictions have at least part of the supervisory authority located in the central bank: e.g. BR, HK, IN, JP, MX, SG, UK, US
  - Not AU, CA, CH, CN (but current debate), KR, SE
- In practice, early experience suggests ECB/SSM separation works well
  - see previous slide on SSM Governance
- Would require treaty change