The European Debt Crisis and the Banking Union Proposal

Claudia M. Buch (IWH Halle & University Magdeburg)

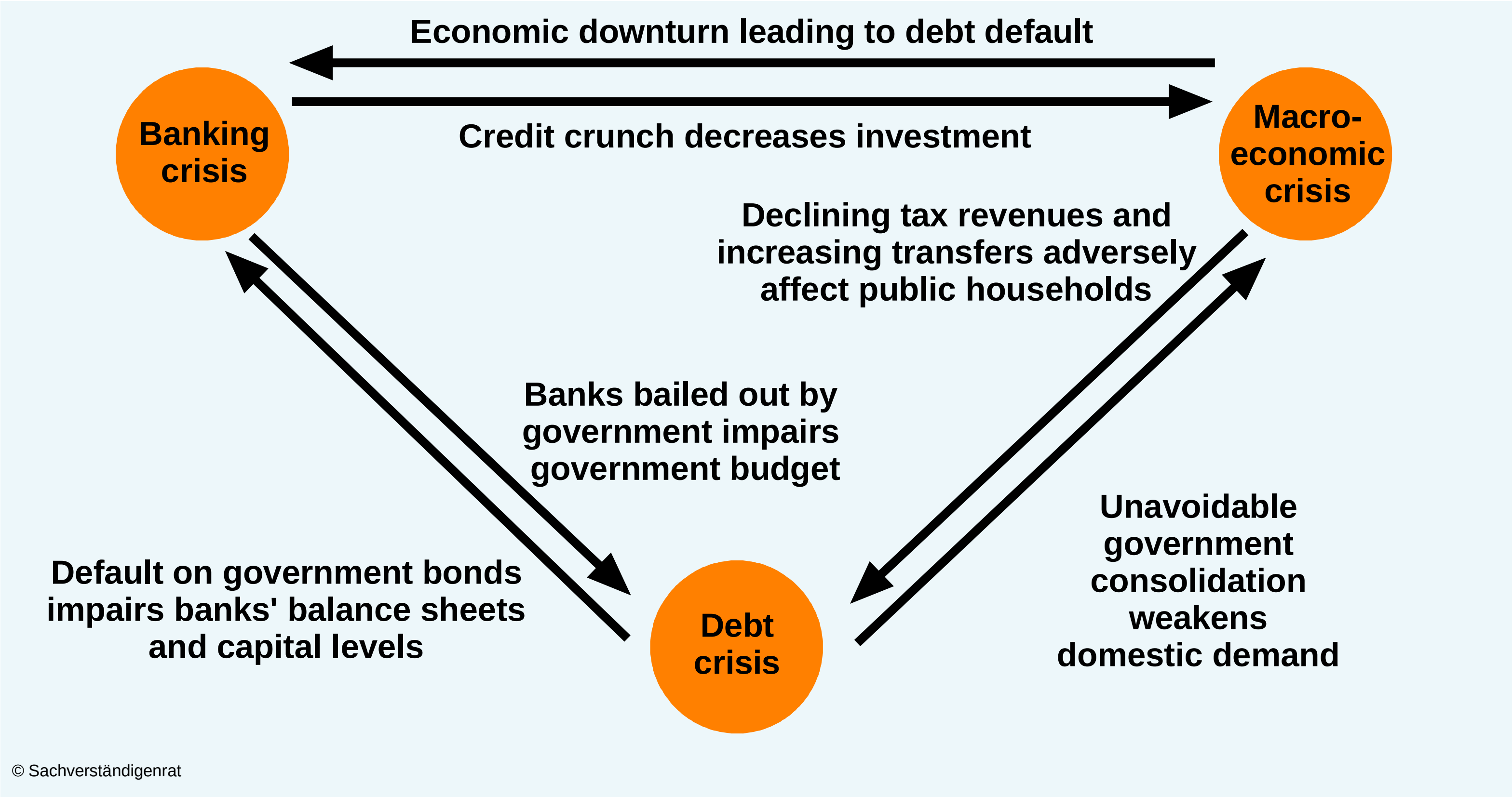
Tobias Körner (German Council of Economic Experts)

Benjamin Weigert (German Council of Economic Experts)

Boston College/DIW Summer School

June 11, 2013

A vicious circle of bank distress, sovereign risk, and macroeconomic crisis



The EU’s Banking Union Proposal

- **June 2012 summit: Policy measures that aim at breaking the “vicious circle between banks and sovereigns”.**
  - Establishment of a Single Supervisory Mechanism involving the ECB by January 1, 2013.
  - Afterwards, the ESM shall be allowed to recapitalize banks directly.
- **Establishment of a Single Supervisory Mechanism would be an important step towards a Banking Union consisting of pan-European supervision, restructuring and resolution, and deposit insurance.**
  - Internal Market rests on the principles of home country control, mutual recognition, and minimum harmonization.
- **So far, only the Single Supervisory Mechanism has been decided upon (March 2013).**

Why the Banking Union is Necessary

Institut für Wirtschaftsforschung Halle

- Weak supervision and weaknesses in the real economy have created a debt overhang.
- Bank risks do not stop at national borders.
- Formal risk-sharing mechanisms have been absent prior to the crisis.

- Risks have been shifted to the European level through common monetary policy – without corresponding control rights at the European level.
- The goal should be to align liability and control – without mutualizing legacy assets.

Designing the Banking Union

	Supervision	Restructuring	Financing
European level	European supervisory authority • Microprudential supervision – Issuance of banking licences – Ongoing supervision – Early intervention • Macroprudential supervision – Identification of systemic risks – Specification of additional capital buffers	European restructuring authority • Restructuring and resolution if the stability of the European financial system is at risk	European restructuring fund • Financing of bank restructuring and resolution measures • Funded by European bank levy • Fiscal backstop, for example through the ESM
National level	National supervisory authorities • Ongoing microprudential supervision at the request of the European supervisory authority • Early intervention in coordination with the European supervisory authority	National restructuring authorities • Restructuring and resolution at the request of the European restructuring authority • Restructuring and resolution if the stability of the national financial system is at risk; in coordination with the European restructuring authority	National deposit guarantee schemes • Compensation of depositors in the context of – Resolution by European and/or national restructuring authorities – Insolvency proceedings • Funded by harmonized, risk-based insurance premiums

How can risk-sharing mechanisms be improved?

- **Contingent claims allow for ex ante risk sharing:**
  - ➢ Cross-border equity ownership improves risk-sharing.
- **Bank assets and liabilities are non-contingent claims and allow for ex post risk-sharing only:**
  - Deposit insurance provides risk-sharing – but it requires risk-adjusted premia and effective supervision to prevent moral hazard.
  - Bail in of creditors as a risk-sharing device
- **The type of shocks matters:**
  - Bank-specific or regional shocks can be insured at the national level.
  - ➢ Risks of banks and sovereigns need to be disentangled.

Structure of the Talk

1. **The present:**

   How are risks allocated in Europe's banking markets?

2. **The long-run:**

   How can the Banking Union contribute to improved risk-sharing?

3. **The transition:**

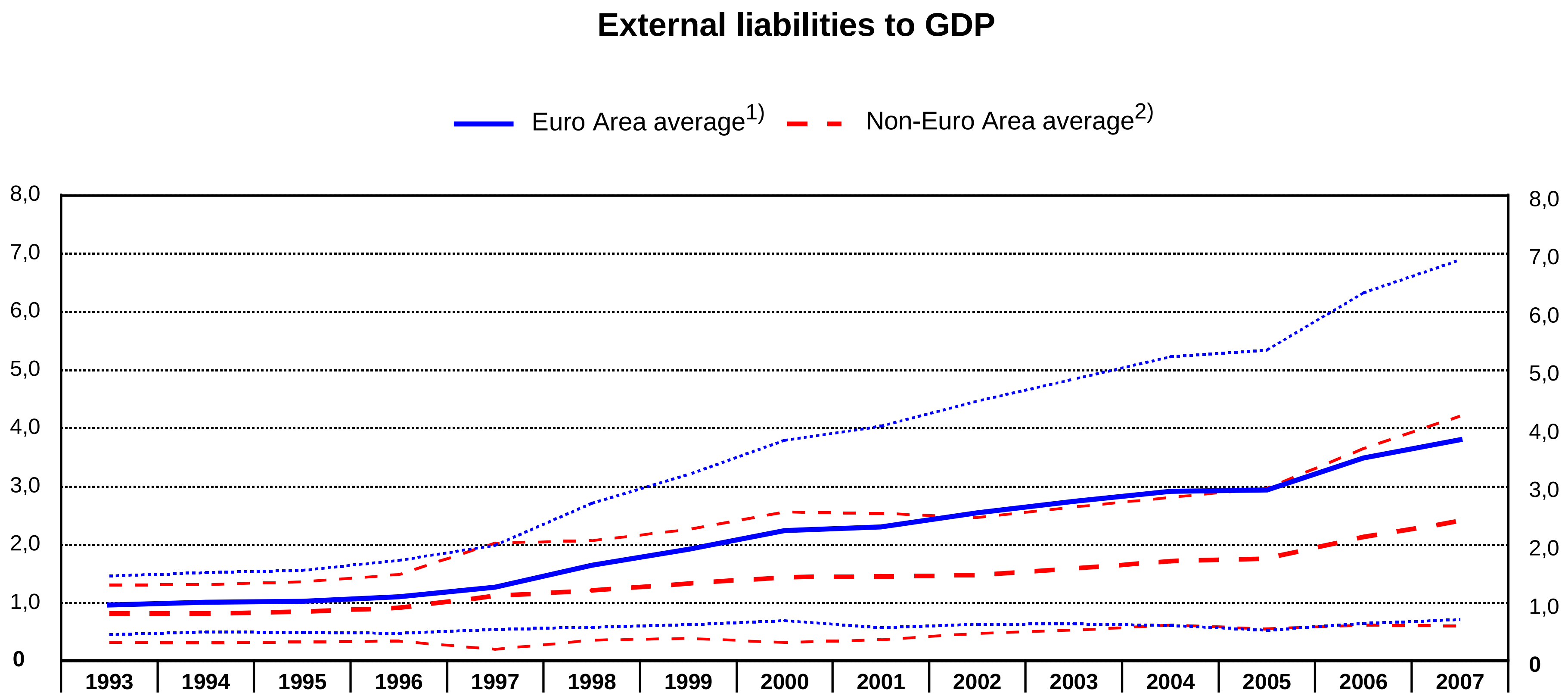
   How to deal with existing risks on banks' balance sheets?

The Present:

How are risks allocated in Europe’s Banking Markets?

The increase in external liabilities in the Euro Area has been above-average …

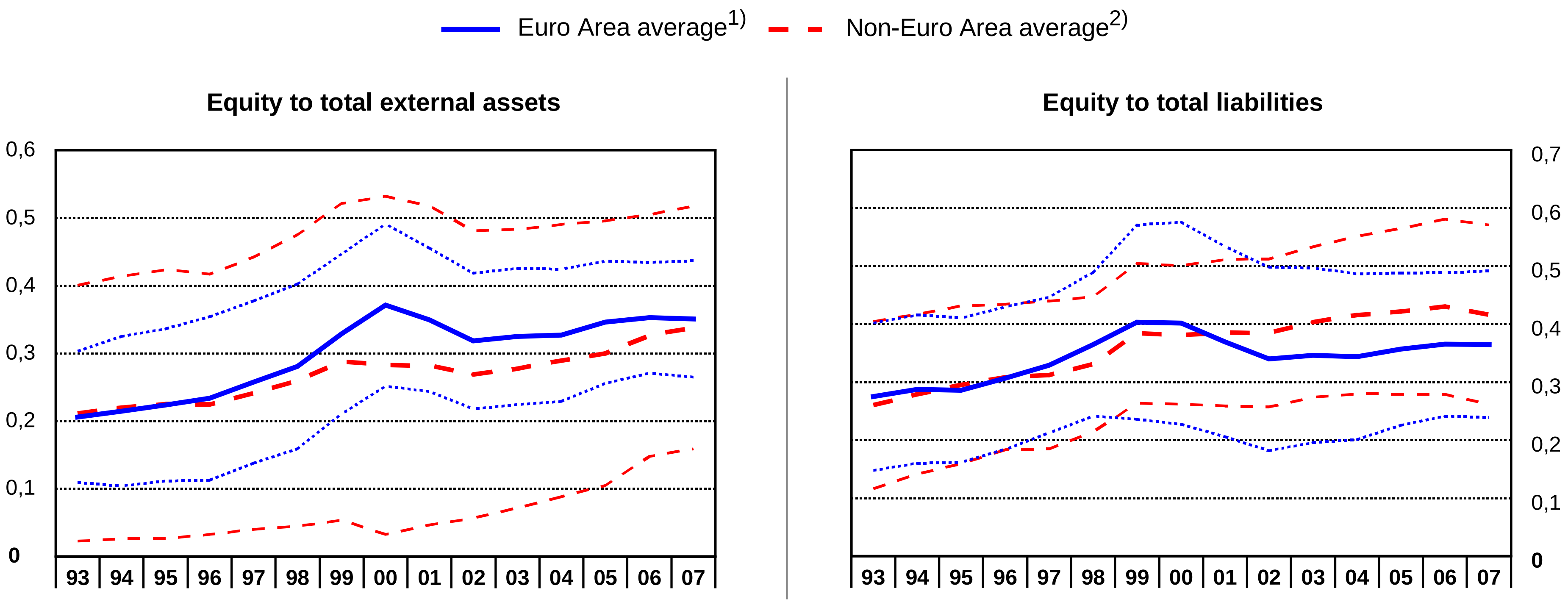
Institut für Wirtschaftsforschung Halle



1) Euro Area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain.– 2) Non-Euro Area: Australia, Canada, Cyprus, Czech Republic, Denmark, Estonia, Hungary, Iceland, Israel, Japan, Korea, Latvia, Lithuania, Malta, Mexico, New Zealand, Norway, Poland, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, United Kingdom, United States. Dotted lines denote the average ±1 standard deviation.

… but the share of equity in total cross-border assets has been below-average.

Institut für Wirtschaftsforschung Halle

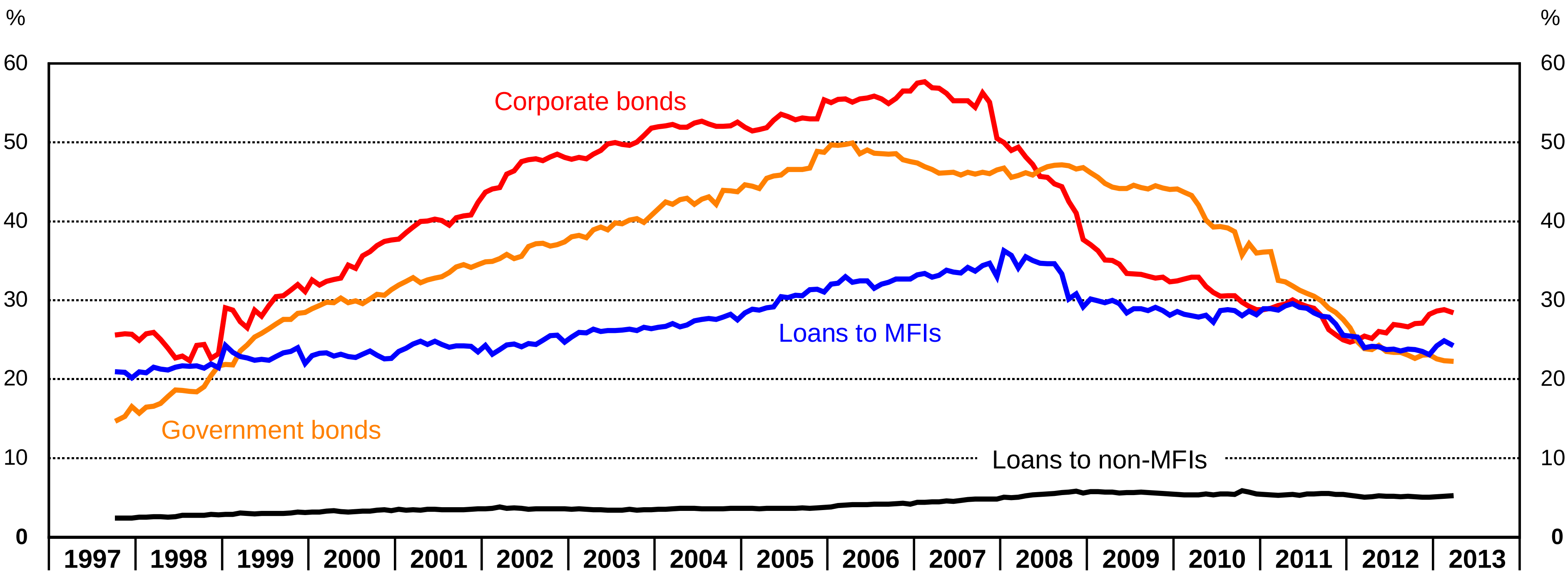


1) Euro Area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain.– 2) Non-Euro Area: Australia, Canada, Cyprus, Czech Republic, Denmark, Estonia, Hungary, Iceland, Israel, Japan, Korea, Latvia, Lithuania, Malta, Mexico, New Zealand, Norway, Poland, Singapore, Slovak Republic, Slovenia, Sweden, Switzerland, United Kingdom, United States. Dotted lines denote the average ±1 standard deviation.

European financial markets have become increasingly fragmented.

Institut für Wirtschaftsforschung Halle

Share of cross-border holdings of assets of Euro Area MFIs[1)2)]



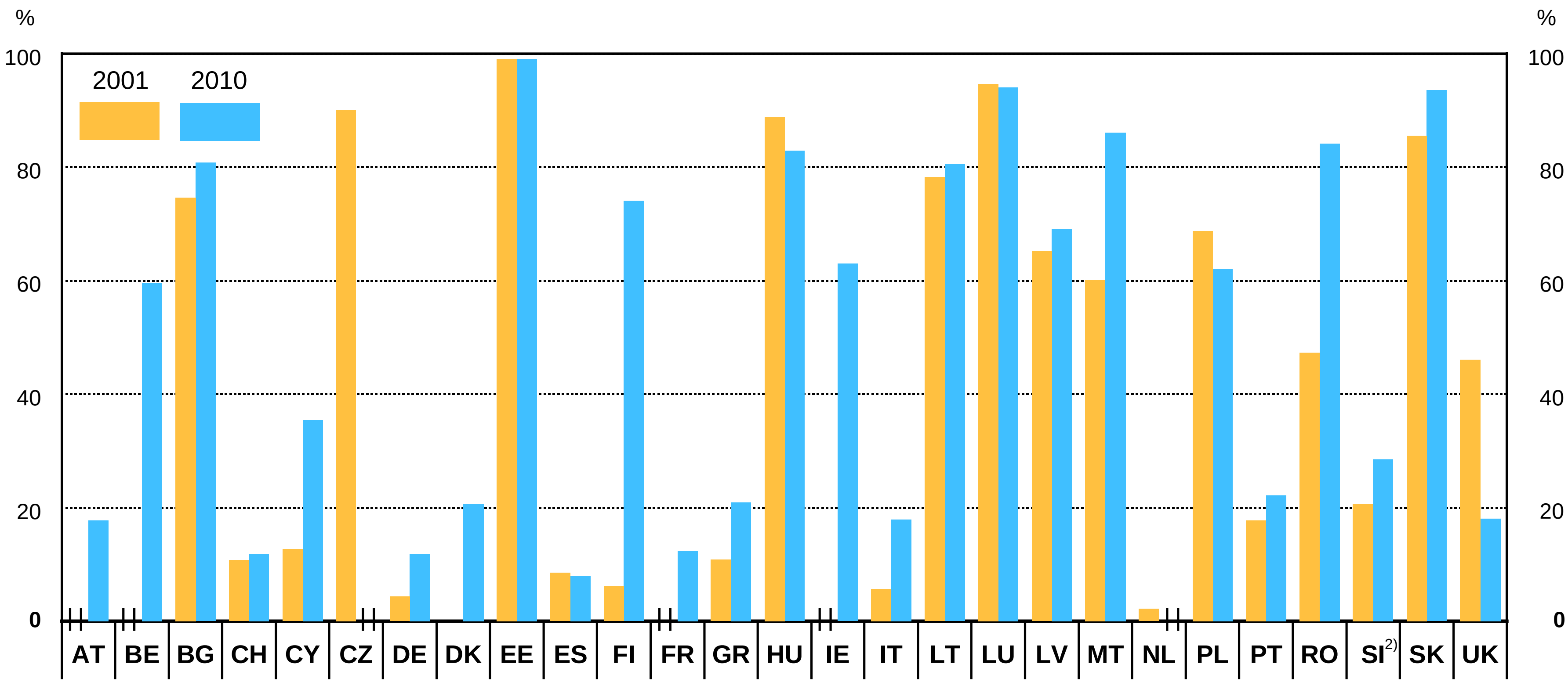
1) Excluding the Eurosystem.– 2) Share of cross-border intra-Euro-Area positions in sum of cross-border intra-Euro-Area and domestic positions.

Source: ECB

Cross-border ownership of bank assets in Europe is very heterogeneous.

Institut für Wirtschaftsforschung Halle

Foreign ownership of banking system assets[1)]

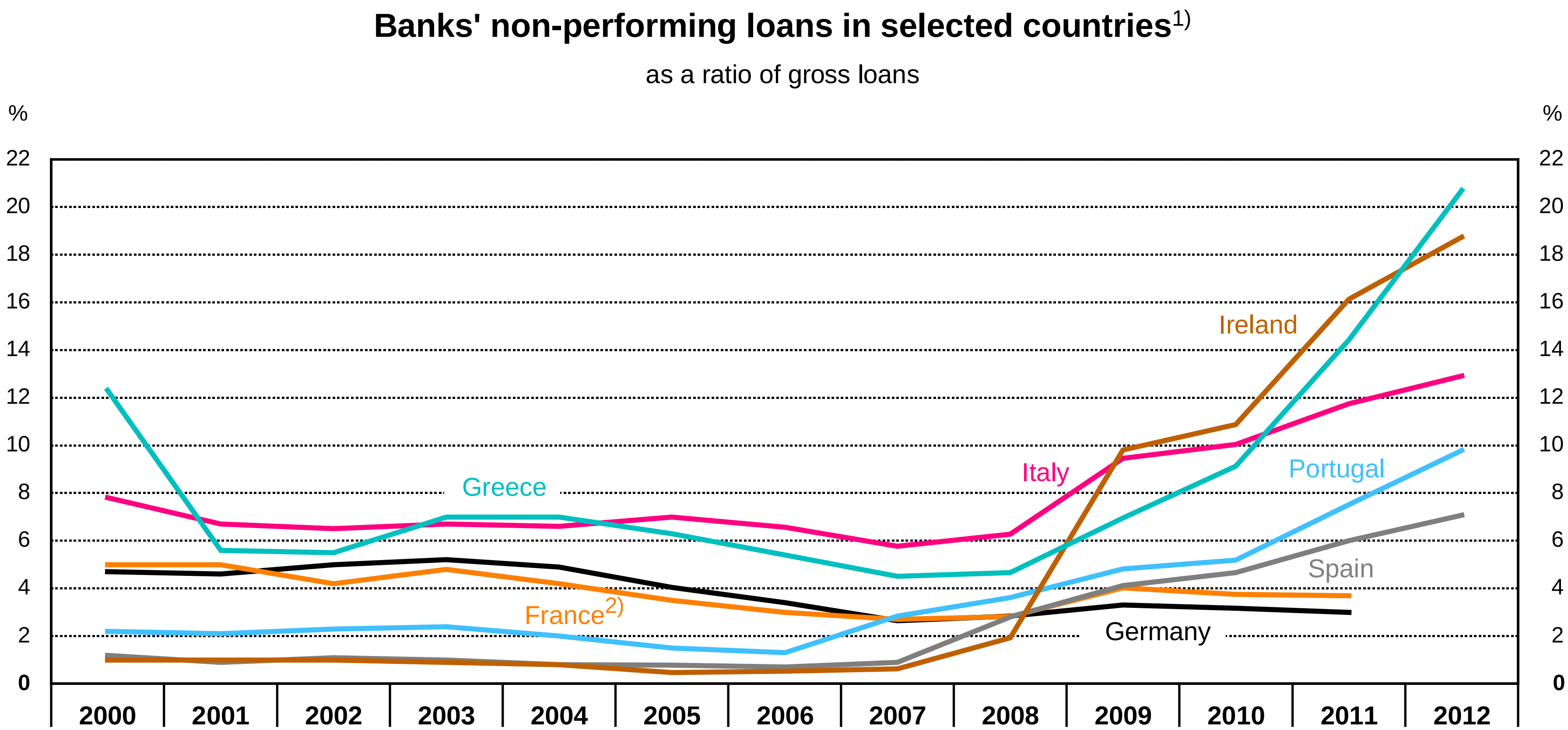


1) Percent of the banking system's assets in banks that were foreign-controlled (where foreigners owned 50 % or more equity) at the end of the year. AT-Austria, BE-Belgium, BG-Bulgaria, CH-Switzerland, CY-Cyprus, CZ-Czech Republic, DE-Germany, DK-Denmark, EE-Estonia, ES-Spain, FI-Finland, FR-France, GR-Greece, HU-Hungary, IE-Ireland, IT-Italy, LT-Lithuania, LU-Luxembourg, LV-Latvia, MT-Malta, NL-Netherlands, PL-Poland, PT-Portugal, RO-Romania, SI-Slovenia, SK-Slovakia, UK-United Kingdom.– 2) For 2001: As of 31 December 2002

Source: World Bank

Banks in the crisis countries are in distress …

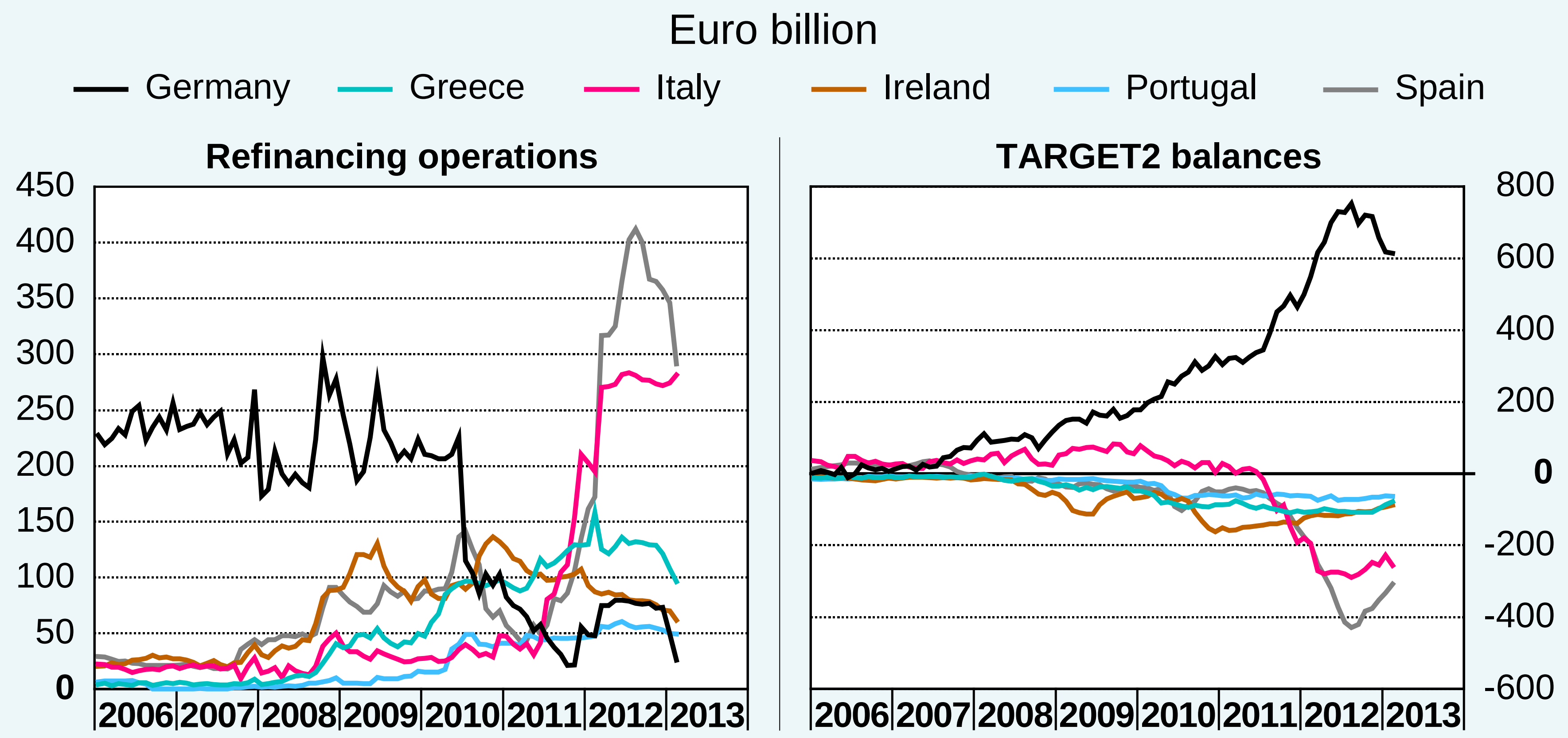
Institut für Wirtschaftsforschung Halle



1) The definition of non-performing loans differs from one country to the next. For this reason it is harder to compare figures between countries than within a single country over time.– 2) For the year 2011, status: as at Q2.

Source: IMF

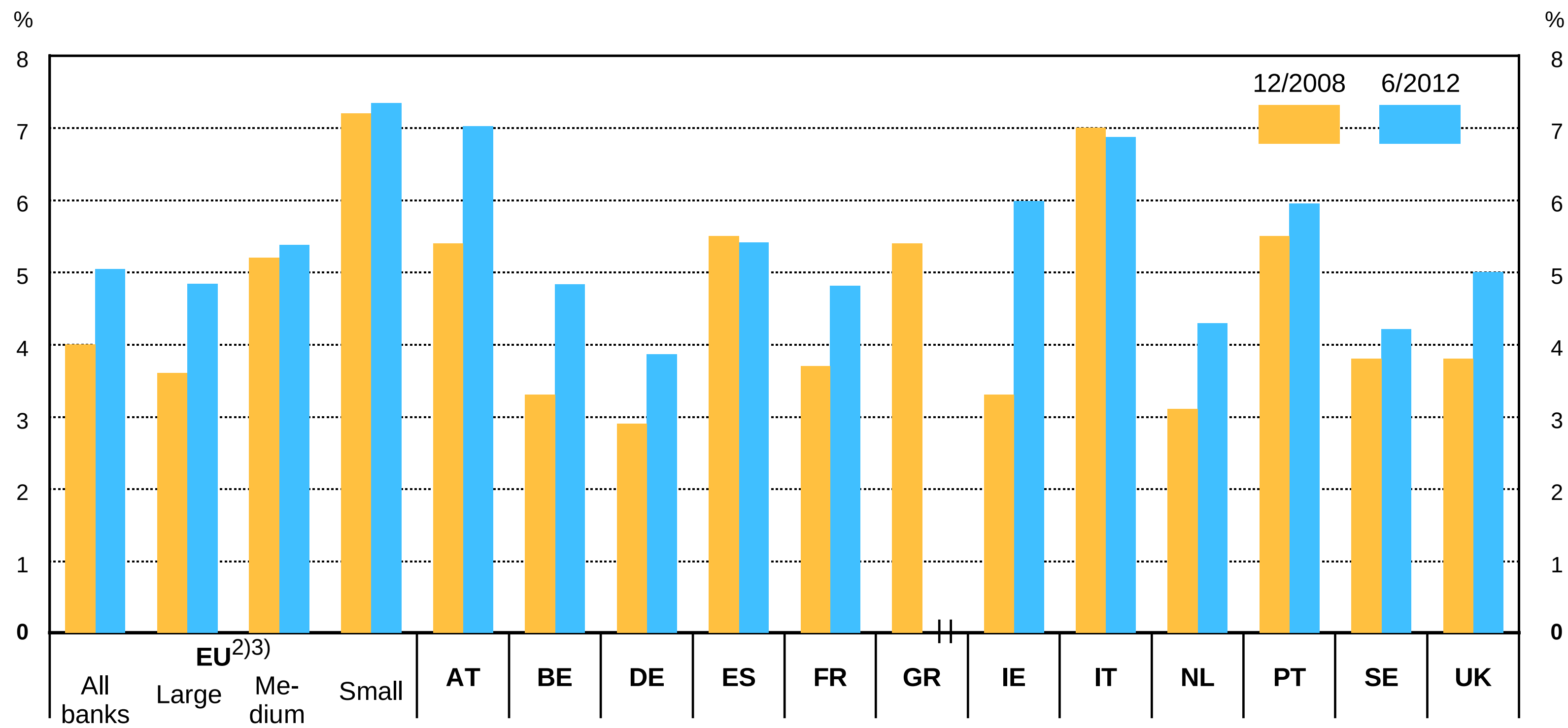
… and rely on central bank borrowing.



European banks are weakly capitalized.

Bank equity in selected countries[1)]

as a ratio of total assets



1) The data are consolidated on a cross-border basis (data on branches and subsidiaries located outside the domestic market are consolidated in the data reported by the parent institution) and a cross-sector-basis (branches and subsidiaries of banks that can be classified as „other financial institutions" are included). AT-Austria, BE-Belgium, DE-Germany, ES-Spain, FR-France, GR-Greece, IE-Ireland, IT-Italy, NL-Netherlands, PT-Portugal, SE-Sweden, UK-United Kingdom.– 2) Excluding foreign (i.e. non-EU) banks.– 3) Large / medium / small banks with total assets of more than 0.5% / between 0.005% and 0.5% / less than 0.005% of the total consolidated assets of EU banks of the previous year.

Source: ECB

The Long-Run:

How can the Banking Union contribute to improved risk-sharing?

How can the Banking Union contribute to improved risk-sharing?

- Prevention of risk-taking and reduced regulatory forbearance through the Single Supervisory Mechanism.
- Improved management of bank distress through rules for the restructuring and resolution of banks:
  - Equity owners need to bear risk.
  - Explicit rules for the bail in of creditors.
  - Fiscal backstops.
- Strengthening of the lender-of-last-resort function of the ECB by closing insolvent banks.
- Improved cross-border risk sharing to higher equity capital and more cross-border equity ownership.

Implications for the Single Supervisory Mechanism

- **Incentives to shift risks require comprehensive competence at the European level.**
  - Liability and control need to be at the same level.
  - European supervisor needs clear regulatory competence for all banks and – ideally – all countries in the Single Market.
- **Stricter banking regulations need to be enforced.**
  - Leverage Ratio should become mandatory.
  - Privileges for government bonds should be abolished.
- **Supervision and monetary policy need to be clearly separated to prevent conflicts of interest.**
  - Basing the Single Supervisory Mechanism on Article 127 (6) of the European Treaty has severe shortcomings.

Governance Structure in the Single Supervisory Mechanism (SSM)

Supervisory Board

Members
- Chair (not member of the ECB Governing Council)[2)]
- Vice-Chair (member of the ECB Executive Board)[2)]
- One representative from the supervisory authority of each participating member state[3)]
- 4 representatives of the ECB[4)]
- One representative of the European Commission may participate in meetings as observer upon invitation

Decision making
- Simple majority, with each member having one vote
- In case of draw, the Chair has the casting vote

Draft decision[1)] → **ECB Governing Council**

ECB Governing Council → **Objects to draft decision** → **Mediation Panel**

Mediation Panel
- One member per participating state[3)], chosen among the members of the Supervisory Board or the Governing Council
- Decisions by simple majority, with each member having one vote

Steering Committee → **Preparatory tasks** → **Supervisory Board**

Steering Committee
- Established by the Supervisory Board from among its members
- Maximum 10 members, rotation
- Chaired by the Chair of the Supervisory Board
- No decision-making powers

Implications for the Single Resolution Mechanism

- **European banking supervision is not sufficient but needs to be complemented by authority to restructure and resolve banks.**
  - Covered by the Treaty?
- **Financing mechanisms are required**
  - European bank resolution fund financed by a European bank levy
  - Fiscal backstop through the ESM
  - Ex ante mechanism for fiscal burden sharing
  - But: National deposit insurance systems

Implications for Deposit Insurance

- **European deposit insurance is not necessary and would set the wrong incentives.**
  - Deposit insurance and funding mechanism differ.
  - There are significant implicit guarantees for banks.
  - Banks are burdened with legacy assets, which should not be mutualized.
- **Is FDIC a good role model?**
  - Yes: FDIC has closed more banks after the crisis than European authorities.
  - But: The Institutional structure differs: FDIC has resolution powers, and it can borrow from the Ministy of Finance.
- **Deposit insurance first needs to be reformed at the national level.**

The Design of the Banking Union

Institut für Wirtschaftsforschung Halle

	Supervision	Restructuring	Financing
European level	European supervisory authority • Microprudential supervision – Issuance of banking licences – Ongoing supervision – Early intervention • Macroprudential supervision – Identification of systemic risks – Specification of additional capital buffers	European restructuring authority • Restructuring and resolution if the stability of the European financial system is at risk	European restructuring fund • Financing of bank restructuring and resolution measures • Funded by European bank levy • Fiscal backstop, for example through the ESM
National level	National supervisory authorities • Ongoing microprudential supervision at the request of the European supervisory authority • Early intervention in coordination with the European supervisory authority	National restructuring authorities • Restructuring and resolution at the request of the European restructuring authority • Restructuring and resolution if the stability of the national financial system is at risk; in coordination with the European restructuring authority	National deposit guarantee schemes • Compensation of depositors in the context of – Resolution by European and/or national restructuring authorities – Insolvency proceedings • Funded by harmonized, risk-based insurance premiums

Institut für Wirtschaftsforschung Halle

The Transition:

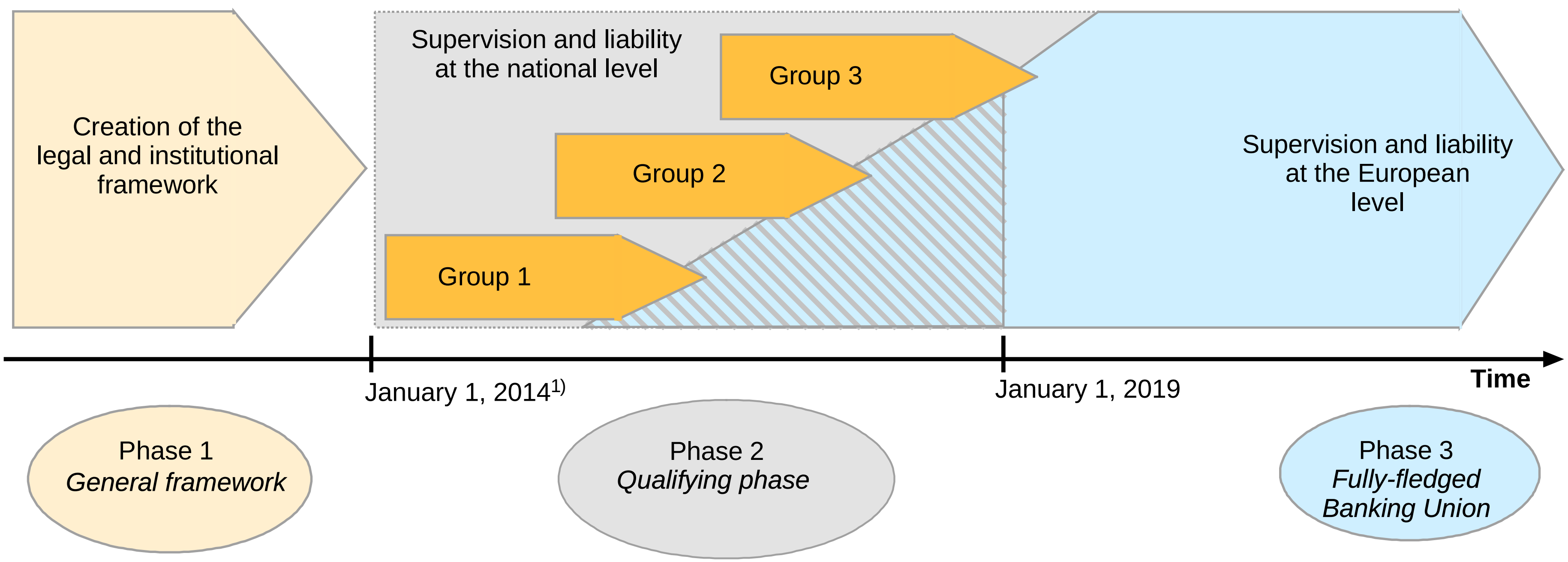
How to deal with existing risks on banks' balance sheets?

Two main obstacles block the road to full Banking Union

1. **Incomplete institutional and legal framework.**
   - Basing the Single Supervisory Mechanism on Article 127 (6) of the European Treaty has severe shortcomings.
   - Both, competences for supervision *and* restructuring must be transferred to the European level.
   - Sufficient separation between monetary policy and banking supervision must be ensured.
2. **Legacy assets.**
   - Exiting bad debts on banks‘ balance sheets should not be mutualized.
   - Governments should be liable for bank recapitalization funds through the ESM.

➢ **Transition into the Banking Union should proceed in three steps.**

Concept of the GCEE for the transition to a banking union



1) If the legal and institutional preconditions - including the modification of the EU treaties - are not fulfilled as of 1 January 2014, phases 2 and 3 will start later, accordingly.

Summing up

- **ECB interventions have stabilized the situation but the debt crisis in Europe is not yet over.**

- **Further steps towards a new institutional framework are required:**
  - Pillar for fiscal stability („Maastricht 2.0")
  - Crisis management
  - Enhanced financial stability and banking regulation

- **Crisis management is crucial – but without jeopardizing the transition to a stable long-run framework.**
  - The Banking Union is not a crisis management tool.
  - It can contribute to improved monitoring and management of risks.
  - Risk-sharing needs to be enhanced through higher equity capital and the bail in option.

The European Debt Crisis and the Banking Union Proposal

Claudia M. Buch (IWH Halle & University Magdeburg)

Tobias Körner (German Council of Economic Experts)

Benjamin Weigert (German Council of Economic Experts)

Boston College/DIW Summer School

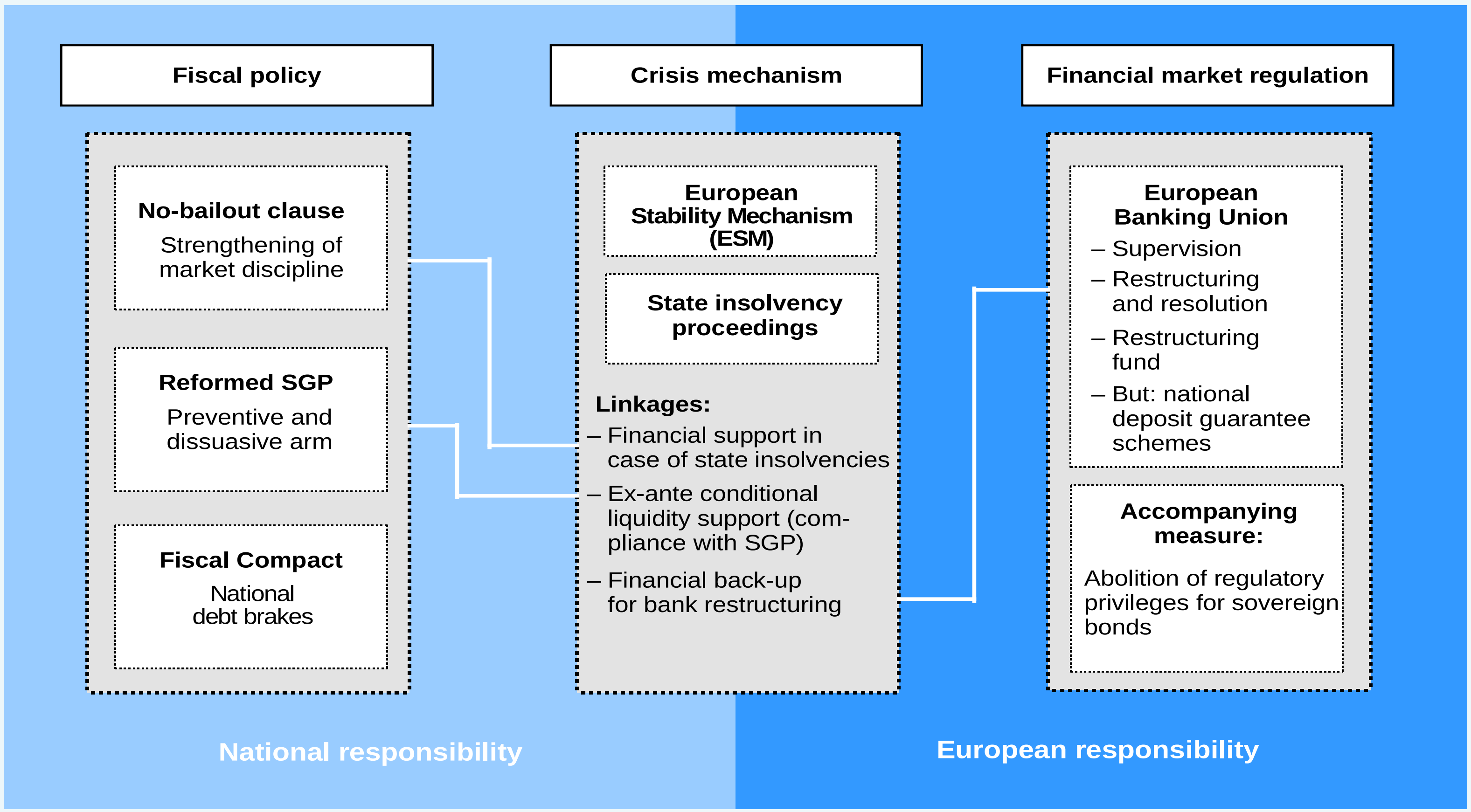
June 11, 2013

Institut für Wirtschaftsforschung Halle

Backup

Institut für Wirtschaftsforschung Halle

Long-run institutional framework for the euro area



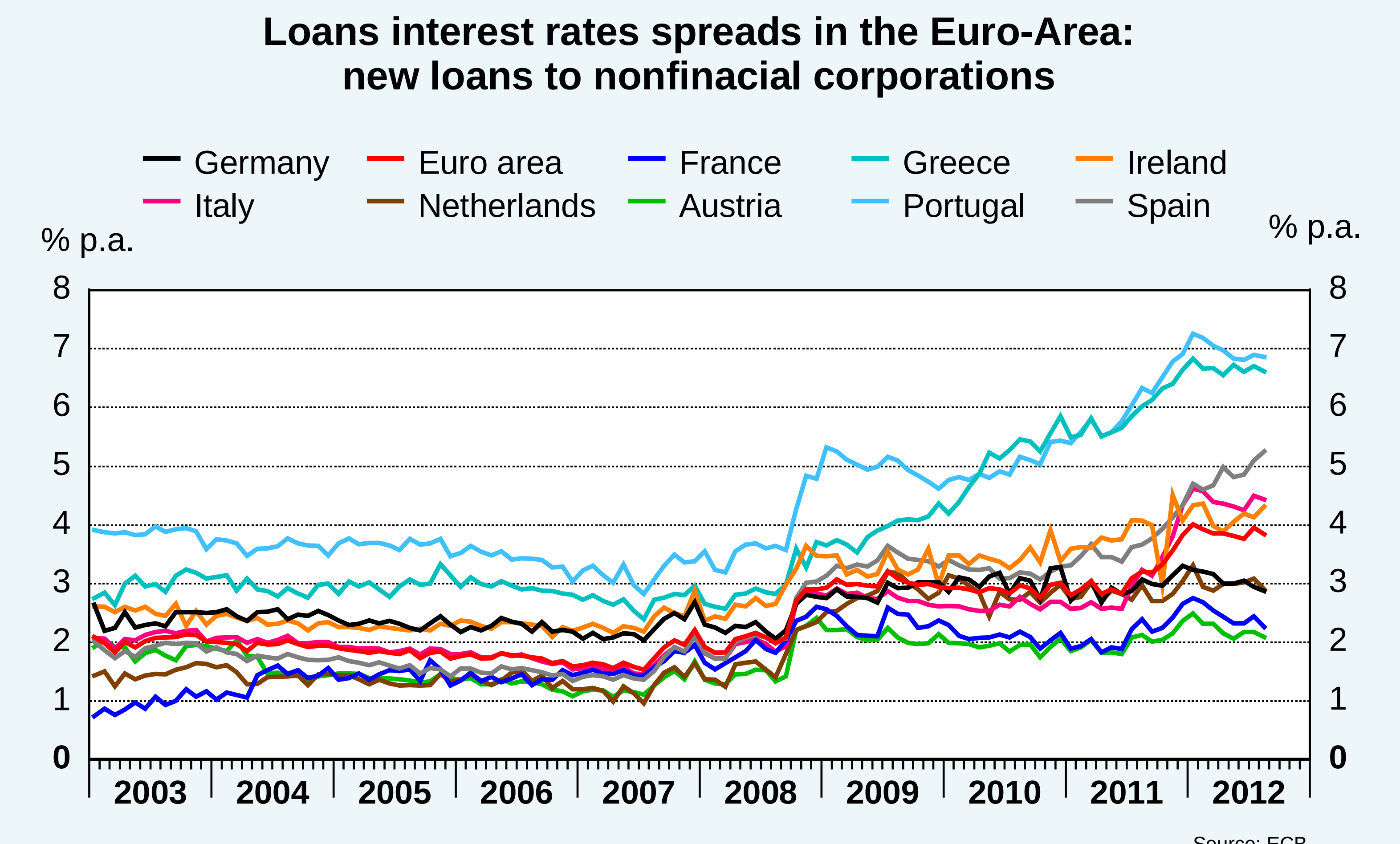
From the internal market to a banking union

Banking Supervision in the Internal Market and the Banking Union

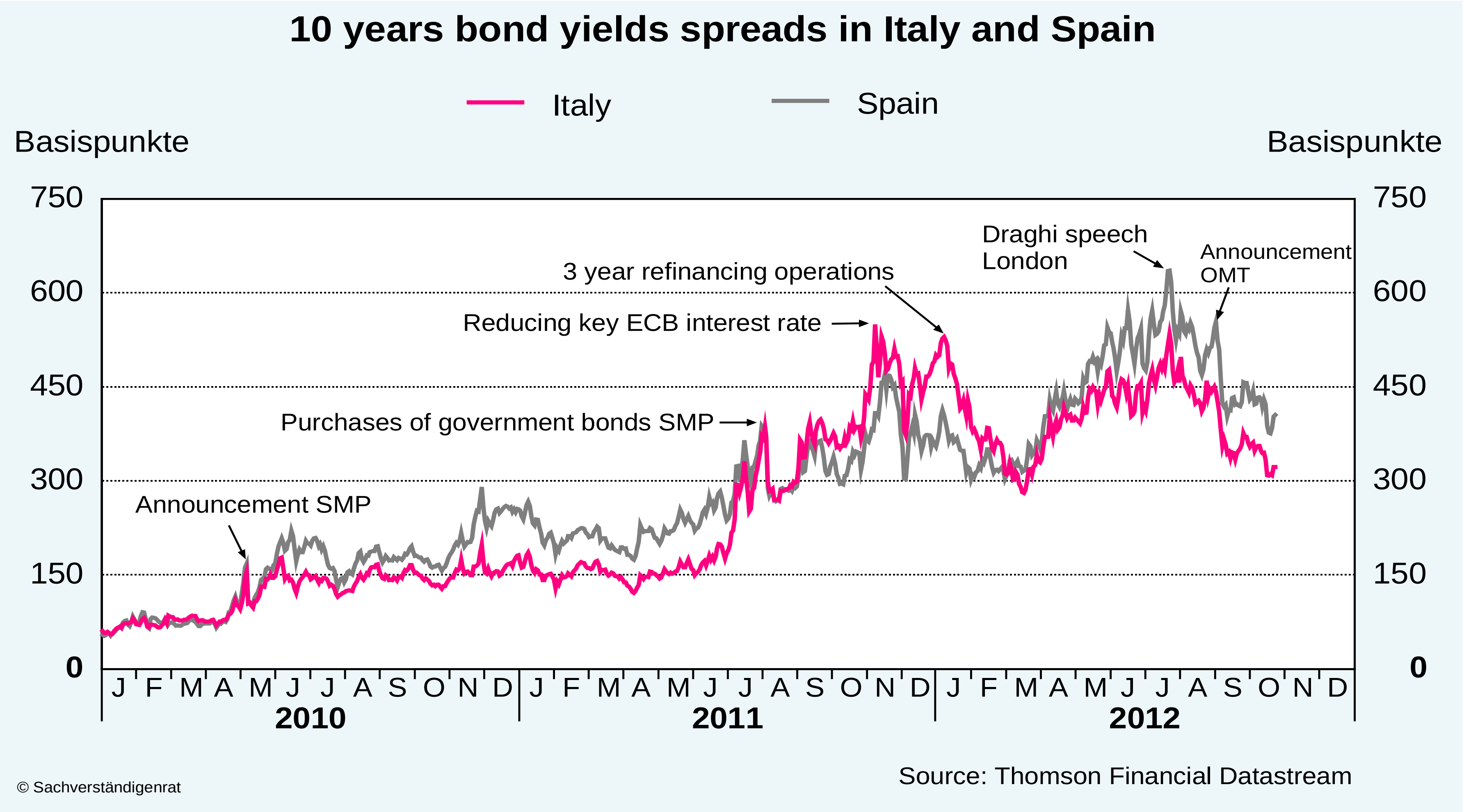
Control \ Liability	Decentralized	Centralized
Decentralized	I. Current concept of the Internal Market – Minimum Harmonization – Home Country Control – Mutual Recognition ESM with liability of single member states	II. Financing illiquid and insolvent banks through the central bank ESM with direct recapitalization of banks without sufficient transfer of control rights
Centralized	III.	IV. Banking Union – centralized supervision – centralized restructuring competence and financing mechanism (e.g. through the ESM) – national deposit insurance

Interest rate differentials reveal structural problems in the European banking sector.

Institut für Wirtschaftsforschung Halle



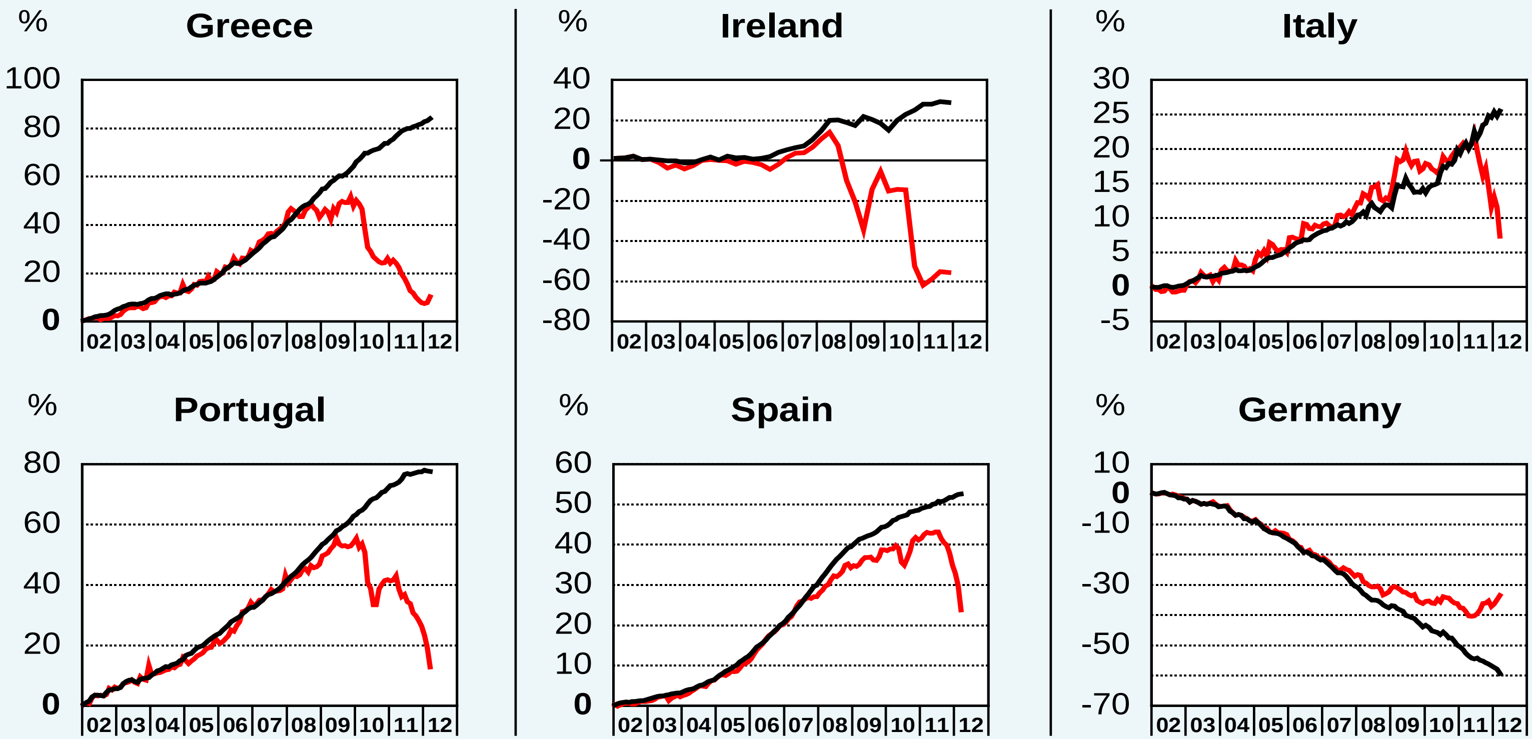
Interest rate spreads have narrowed but remain at a high level.



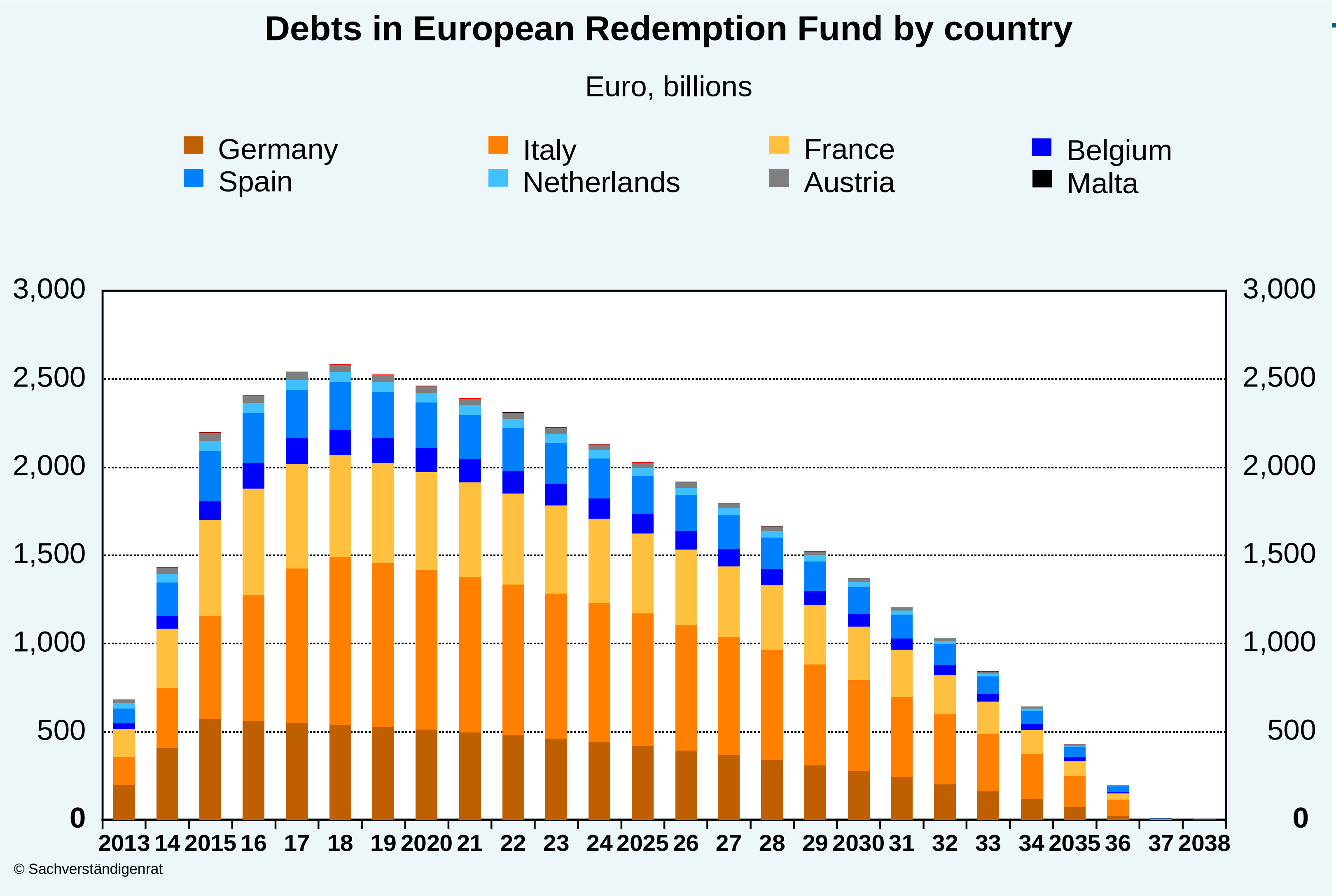
Cumulated financial account balances for selected countries

as a percentage of GDP (2007)

Total net finacial imports — Private net financial imports



Source of basic data: Thomson Financial Datastream


Debts in European Redemption Fund by country
Euro, billions
Germany
Spain
Italy
Netherlands
France
Austria
Belgium
Malta
3,000
2,500
2,000
1,500
1,000
500
0
2013 14 2015 16 17 18 19 2020 21 22 23 24 2025 26 27 28 29 2030 31 32 33 34 2035 36 37 2038
© Sachverständigenrat

The debt crisis affects both, public and private creditors.