



Fixing & Completing the European Banking Union

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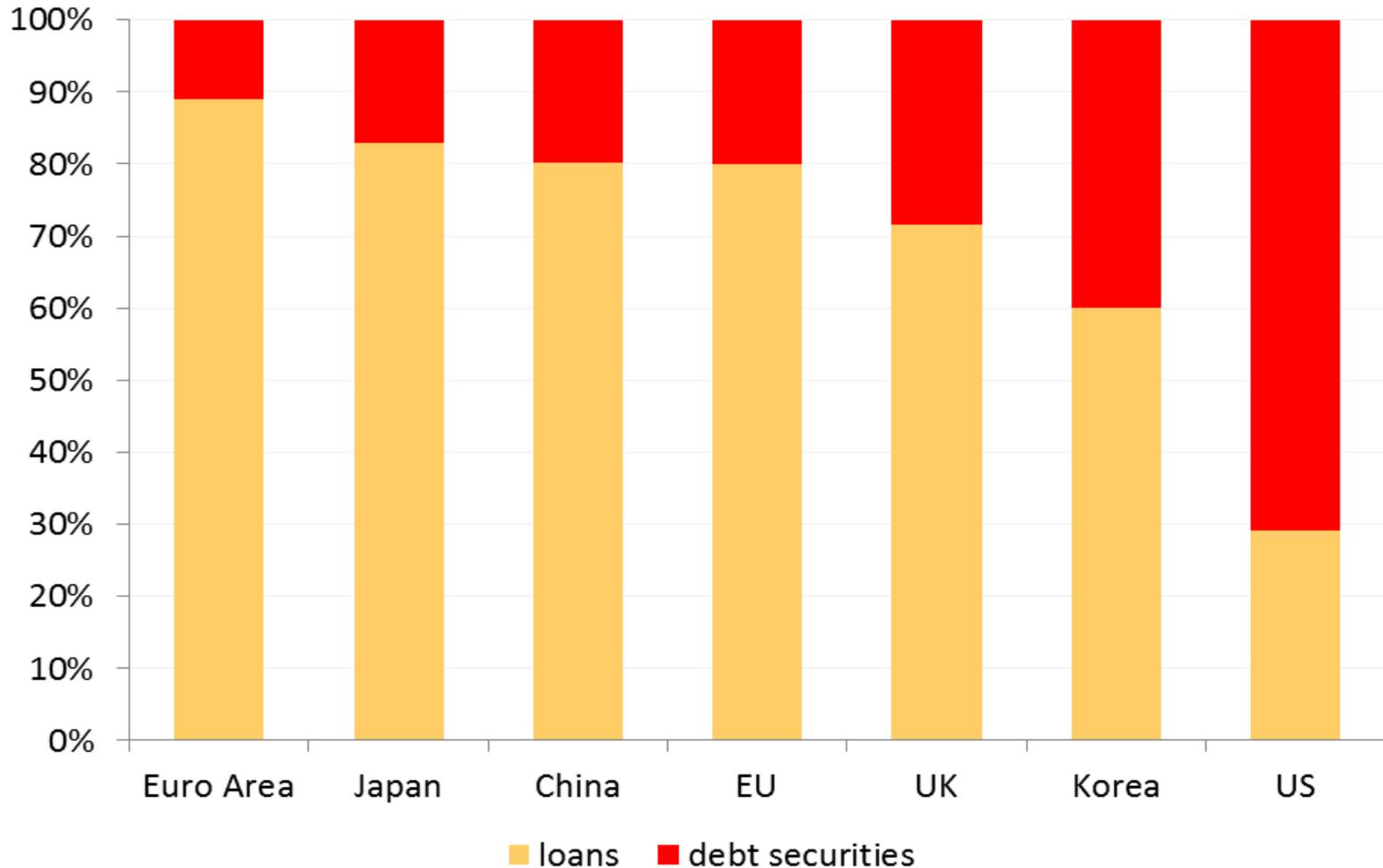
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Financial System Structures



Percentage of total debt of non-financial companies. Source: Merler & Véron (2015)

The Vision

- Breaking bank-sovereign vicious circle
- Creating true single market
- All banking policy at European level
 - Prudential regulation & supervision
 - Resolution & deposit insurance
 - LOLR, government guarantees, recapitalization
 - Bank insolvency, accounting, auditing; taxation
 - Conduct supervision / customer protection
 - Macroprudential
 - Business model determinants: e.g. policies for housing finance, pensions, corporate & personal insolvency

In Practice

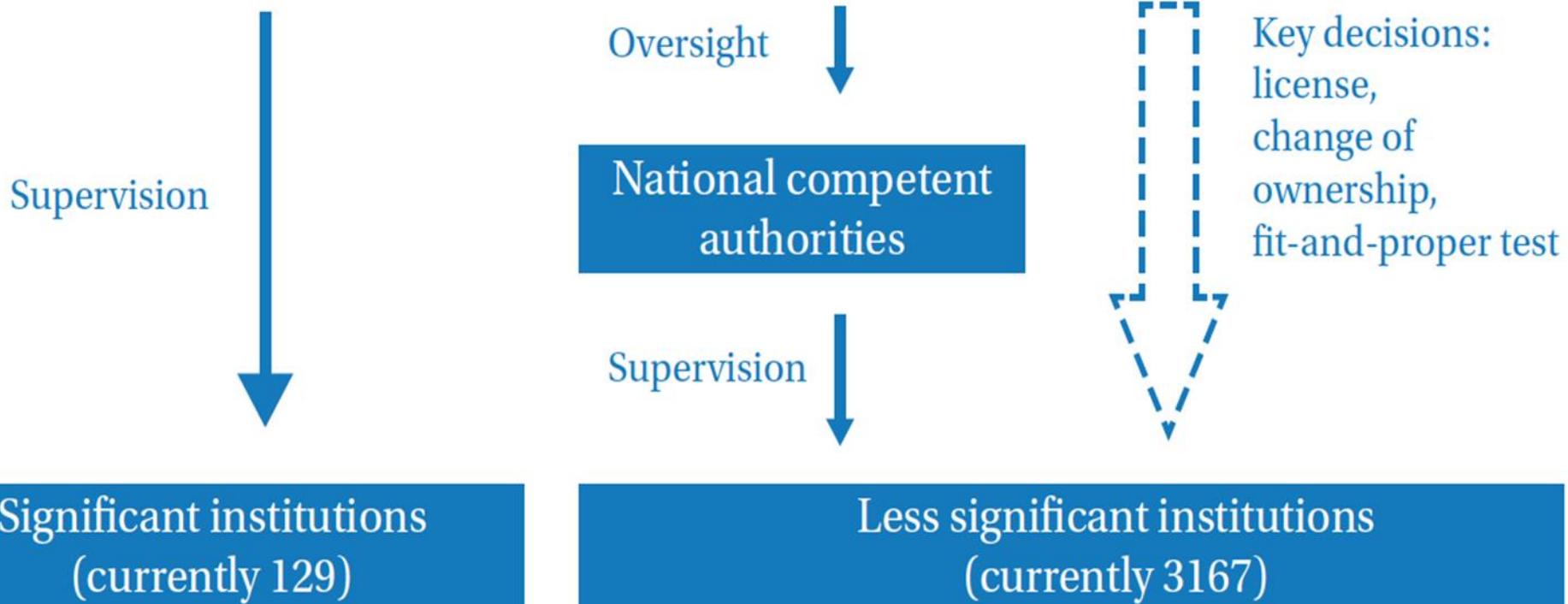
- European Banking Supervision (Nov. 2014)
- “Single” Resolution Mechanism (Jan. 2016)

→ “Half Banking Union”

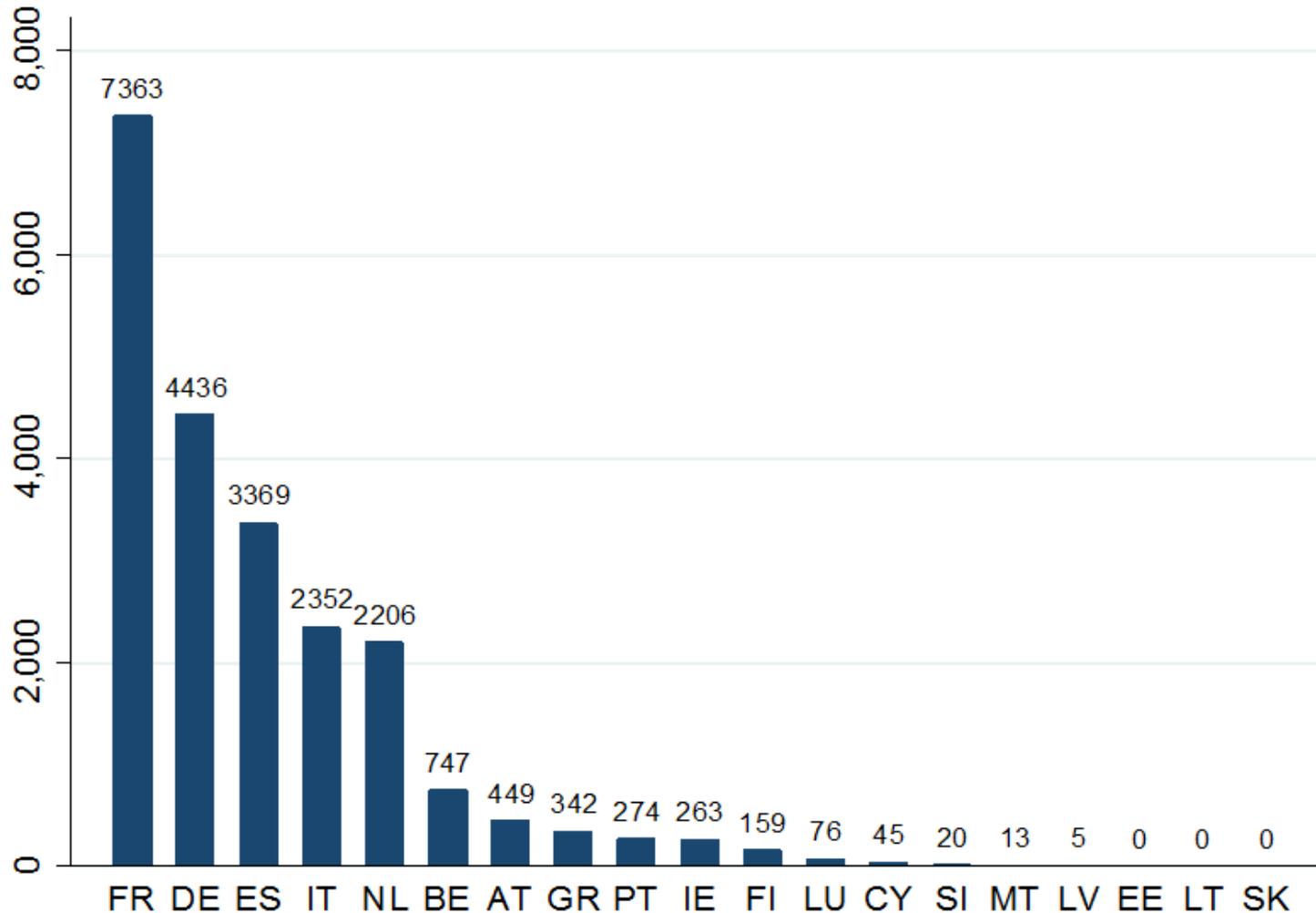
- Monetary Union (MU) + $\frac{1}{2}$ BU = much more resilient than MU alone

European Banking Supervision

ECB banking supervision



Significant Institutions

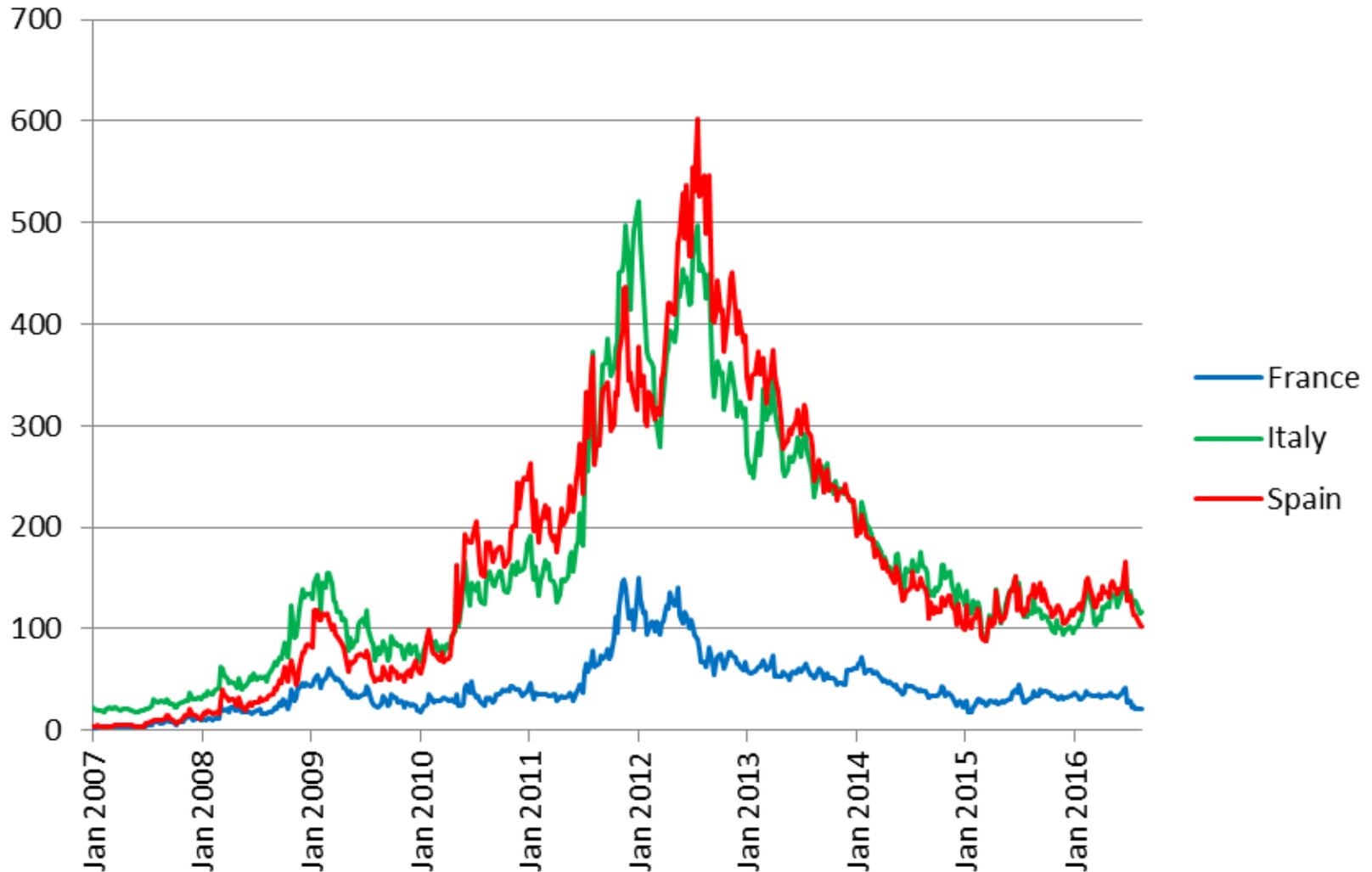


Aggregate assets of SIs by home country, €bn (Schoenmaker & Véron, 2016)

Early Assessment

- **European Banking Supervision**
 - Up and running, “tough and fair” (SIs), impactful
 - Transition still unfinished
 - Areas for improvement: governance, transparency
 - Supervisory oversight (LSIs) barely started
- **Resolution framework**
 - Parallel reforms: SRM, BRRD
 - Still untested; yet to establish credibility
- **Bank-Sovereign Vicious Circle: attenuated but not broken**

Practical Impact



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

Banking Union and OMT

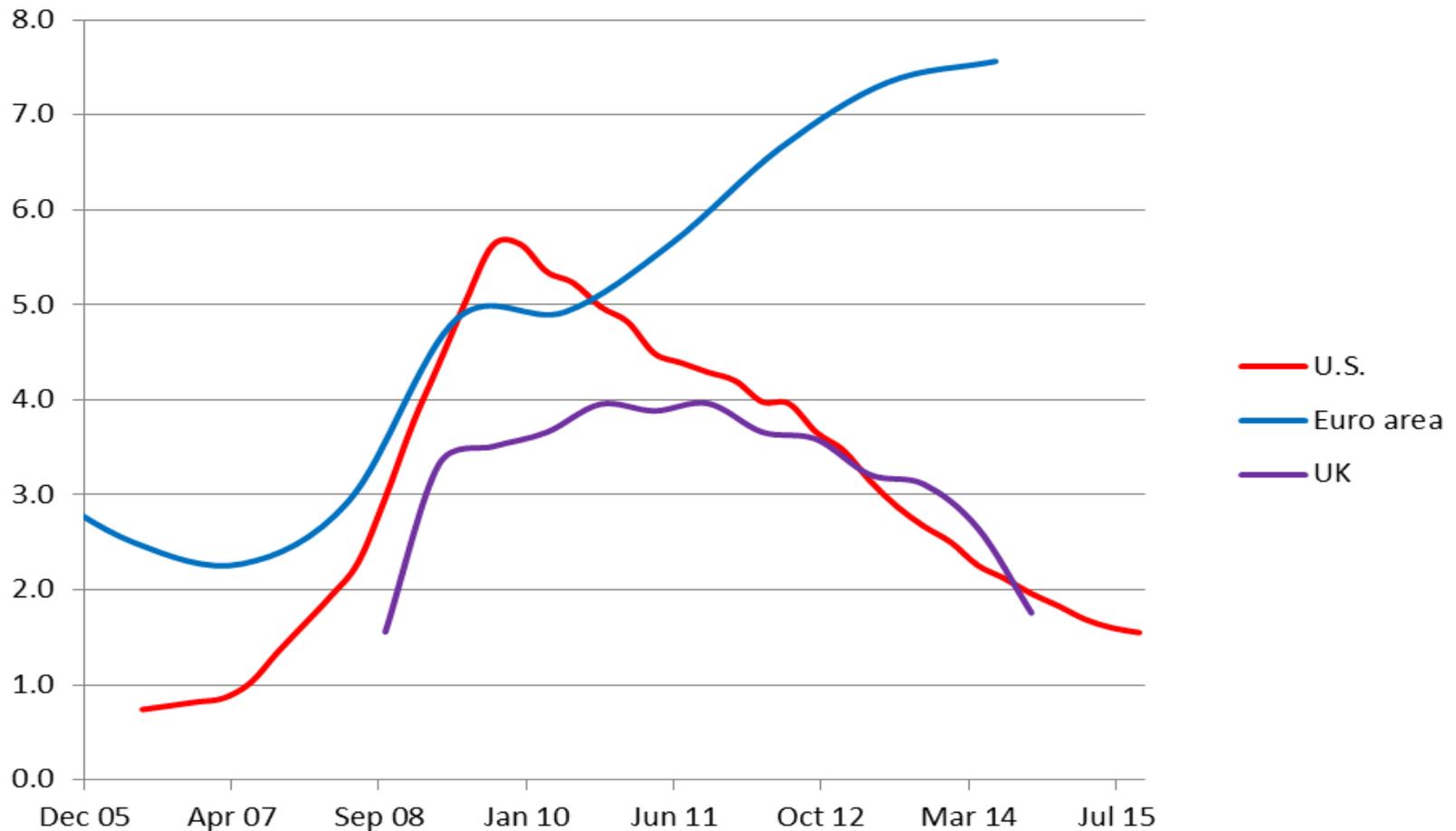
“The June 2012 summit was perhaps the most important European Council of my five years in office. (...) I will never forget, a couple of hours later on that Friday, Mario Draghi walking into my office, right before the start of the summit’s last working session. A man under huge pressure, for the first 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 Single Supervisory Mechanism, Frankfurt, 20 November 2014

Time Horizons

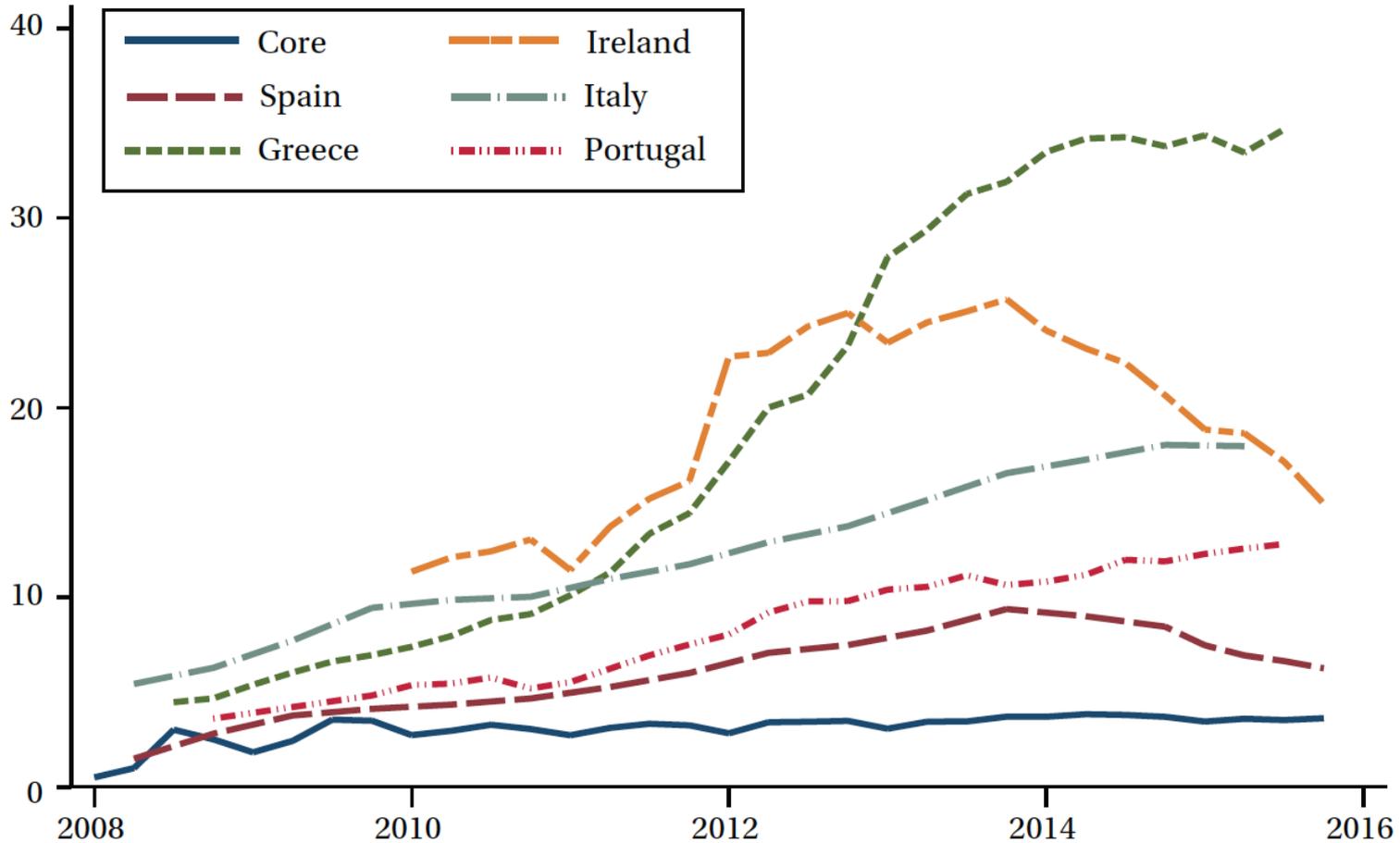
- “Dealing with euro area crisis legacy”
 - May involve national legislation, not EU
 - 12 months?
- “Strengthening banking union”
 - EU legislation; no treaty change
 - 3 years?
- “Completing banking union”
 - EU legislation; treaty change
 - 10 years?

Non-Performing Loans



% of total loans. Source: Christian Odendahl (Centre for European Reform, London) based on Fed/FRED & IMF/FSI databases

Non-Performing Loans



% of total loans. Source: IMF/FSI database, Schoenmaker & Véron (2016).

Stylized Landscape

- Belgium, Finland, France, Germany (most), Netherlands: strong balance sheets
- Ireland, Spain: advanced recovery
- Cyprus, Greece: high NPLs but strong B/S
- Italy, Portugal, German public banks: unfinished restructuring
- Profitability challenges everywhere
 - Depressed share prices of listed banks
 - Need for further consolidation / restructuring

Italian Banking Sector

- Many small banks, politicized governance
- Limited clean-up so far
- Public authorities' reluctance to act
 - Atlas Fund is latest in sequence of “sticking-plasters”
 - “Convoy” approach threatens largest banks
 - Damaging public differences with ECB & EU authorities
- Need for thorough process of triage / recapitalization / restructuring
 - Including critical number of Less Significant Institutions
 - With credible process to resolve any insolvent banks

The Bail-in Question

- Financial instability \neq political risk
- Recognize massive policy failure
 - Resolution / bail-in framework outlined as early as 2009, became very explicit in 2010-11
 - Authorities could/should have encouraged buy-backs
 - Link with banks' ownership/governance structures
- Jr debt bail-in now routine in EU; Sr less so
 - Sub debt: AT, CY, DK, ES, GR, IE, NL, PT, SI, UK...
 - Senior: AT, DK, PT... Novo Banco vs Amagerbanken
- Legal aspects / BRRD
 - “Remedy a serious disturbance in the Italian economy”?

References on Resolution

- European Commission Communication COM(2009) 561 “An EU Framework for Cross-Border Crisis Management in the Banking Sector”, 20 October 2009
- European Commission Communication COM(2010) 579 “An EU Framework for Crisis Management in the Financial Sector”, 20 October 2010

Brexit Impact

- Too early for certainties
- Relocation / future of EBA
- Wholesale market migration?
 - Operational challenges
 - Implications for market / conduct policy framework
- Acceleration of close cooperations?

“Strengthening Banking Union”

- Conditional on progress with “legacy”
 - Italy, Portugal are key; especially Italy
- Preliminary discussions on building blocks
 - European Commission proposal for EDIS (Nov. 2015)
 - Early discussions on sovereign exposures
 - Technical work on FSB/Basel & harmonization
- “Package approach” appears inescapable
 - Current stalemate: e.g. ECOFIN 17 June
 - Minimalist alternative: ONDs, TLAC

Sovereign Exposures

- Defining the problem
 - Specific to euro area
 - Not in countries that have own currency (incl. in EU)
 - Not overall size of sovereign debt portfolios
 - Not limited to (near-)insolvent states
 - e.g. Spain 2012
 - Both in “crisis” and in “normal times”
- focus on Home Bias

Sovereign Risk Weighting

- Global issue
- Sovereign debt is “safe asset”
- Challenge of risk measurement
 - Market indicators; credit ratings, instant or averaged
 - Official risk scores: e.g. ICERC in United States
 - Pillar 2 judgment
- Transparency / Pillar 3
- Complements leverage ratio
- Does *not* address Home Bias problem

Sovereign Exposure Limits

- Direct response to Home Bias problem
- Independent from risk-weighting
- Unprecedented, thus experimental
 - case for well-designed safeguards

Sov. Exp. Limits: Choices

- Risk-adjusted?
- Home or all?
- Only national level?
- Ratio?
- Hard limits?
- Calibration?
- Crisis waiver?

Baseline Suggestions

- Risk-adjusted? Same for all MSs
- Home or all? All [€A] sovereigns
- Only national level? All levels of govt debt
- Ratio? Sov. exposure to CET1
- Hard limits? Soft limits
- Calibration? 25% but low RW to 50%
- Crisis waiver? No crisis waiver

Sov. Exposures: Transition

- Grandfathering, phase-in
- Front-loading under market pressure?
- Smoothing mechanism?
 - Buyer/seller of sovereign bonds during transition
 - e.g. ESM or ad hoc SPV, if not ECB QE

Steady-State Price Impact

- Price adjustments possible
 - But no reliable modelling
- Harder fiscal discipline
 - Complement to existing fiscal framework
- More procyclical?
 - Banking union is shock-absorber
 - No Irish / Spanish scenario

“Completing Banking Union”

- Missing pieces
 - Accounting & auditing
 - Conduct & consumer protection
 - Bank insolvency regime
 - Making the SRM “single”
 - Fully-fledged fiscal backstop
- Institutional streamlining
 - SSM, SRB, ESRB, EBA, DG COMP, DG FISMA, ESM
 - “ECB demerger”?
 - Global level: membership e.g. Basel Committee, FSB

Concluding Comments

- Euro area banking sector not yet back to soundness despite policy achievements since 2012; Italy is main piece of unfinished transition
- Global impact: withdrawal of euro-area banks from international investment banking market
- Plausible baseline scenario of successful banking sector restructuring, repair and cross-border M&A in next 3-5 years
- Brexit impactful but likely not critical (absent further adverse developments)



Thank You For Your Attention

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