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"Fixing and Completing the European Banking Union: What Needs to be Done"

FeBAF, 1 September 2016

Keynote Speaker – Nicolas Véron

DISCUSSANT

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- Draft Speaking Notes -

Table 1 - A complex system (network) representation of macro prudential and other economic policies in the EU

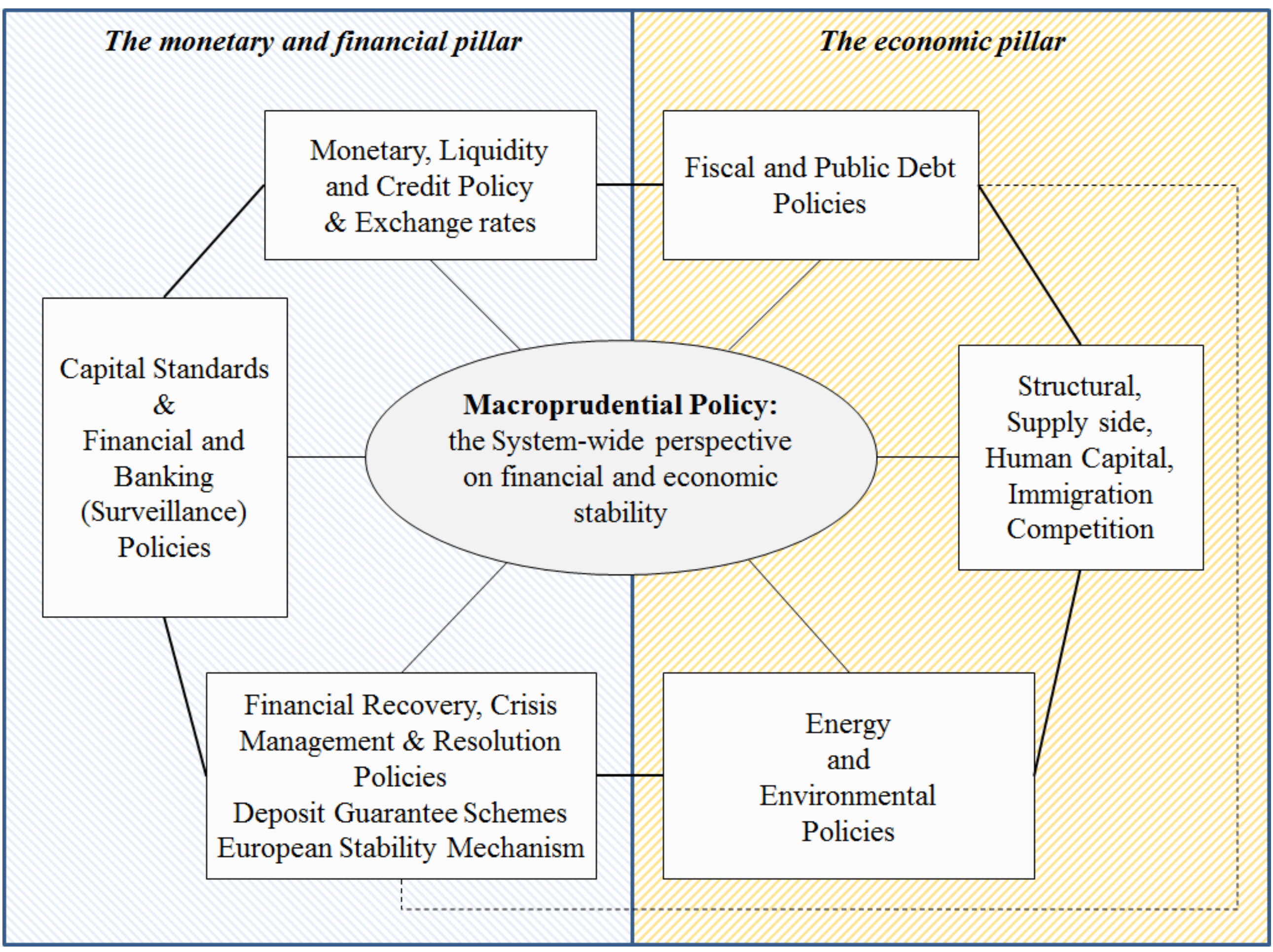

Table 2 – The EU banking Union approach

BANKING UNION

SINGLE SUPERVISION	SINGLE RESOLUTION	EUROPEAN DEPOSIT INSURANCE SCHEME
The Single Supervisory Mechanism (SSM) places the European Central Bank (ECB) as the central prudential supervisor of financial institutions in the euro area (including approximately 6000 banks) and in those non-euro EU countries that choose to join the SSM. The ECB directly supervises the largest banks, while the national supervisors continue to monitor the remaining banks. The main task of the ECB and the national supervisors, working closely together within an integrated system, is to check that banks comply with the EU banking rules and to tackle problems early on.	The Single Resolution Mechanism (SRM) applies to banks covered by the SSM. In the cases when banks fail despite stronger supervision, the mechanism will allow bank resolution to be managed effectively through a Single Resolution Board and a Single Resolution Fund, financed by the banking sector. Its purpose is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy.	The European Deposit Insurance Scheme (EDIS) would apply to deposits below 100.000 euros of all banks in the euro area. When a bank is placed into insolvency or in resolution and it is necessary to pay out deposits or to finance their transfer to another bank, the national deposit guarantee schemes and EDIS will intervene. At the final stage of the EDIS set up, the protection of those deposits will be fully financed by EDIS, supported by a close cooperation between EDIS and national DGS. Given that national DGS may remain vulnerable to large local shocks, the purpose of EDIS is to ensure equal protection of deposits through the Banking Union regardless of the Member State where the deposit is located.

SINGLE RULEBOOK

The single rulebook is the foundation of the banking union. It consists of a set of legislative texts that all financial institutions (including approximately 8300 banks) in the EU must comply with. These rules, among other things, lay down capital requirements for banks, ensure better protection for depositors, and regulate the prevention and management of bank failures.

Source: European Commission (2016)

http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm

↘ For a more complete and forward looking analysis of the Banking Union, the reference is to the very important slide presentation made today by Nicolas Véron (2016).

Table 3 – The Banking Union: a broad approach

↘ The EU framework (Tab. 2) takes a narrow approach which leaves out monetary, liquidity and credit policies.

↘ The contention here is that a broader framework has to be taken into account, which comprises in the first place liquidity creation and liquidity support of the Central Bank and, notably, the function of lender of last resort (LOLR).

↘ LOLR functions should become the direct responsibility of the ECB, which may imply a revision of Art. 14.4 of the ESCB Statute and of the ELA ECB decision of 18 October 2013 (the contrary arguments developed by Praet (2016) can be challenged).

↘ Additionally, the links between capital and other regulatory standards and monetary and credit processes are of primary importance and, therefore, Banking Union and the Monetary Policy functions cannot be isolated.

↘ Account must also be taken that: i) the one-size-fits-all approach and ii) the operations of the SSM and the SRM imply significant disadvantages for small banks and hence for credit channels, notably to the SME sector.

↘ Both the EDIS (with its possible mutualisation implications) and the ESM may affect fiscal policies. The links with the fiscal side are even more significant: arguably, the lack of TARP and GSE securitisation schemes of non-performing and performing assets of commercial banks had a very significant role in the rapid overcoming of the Banking crisis in 2007-2008 in the United States. A similar approach could not be followed in the EU not only for its public account implications, but also for alleged distortions in competition.

↘ More generally, the financial stability overarching goal and the macroprudential policy approach represent a fundamental departure from both the traditional (Tinbergen, 1952 and Theil, 1956) instrument and policy framework and the separation principle in central banking (Cour-Thimann and Winkler, 2012) between, on the one hand, monetary policy and, on the other, credit and interest rate policies. The one objective/one instrument/one authority paradigm (sum of the parts) gives way to a complex system approach which blurs borders between instruments, goals and authorities to pursue financial stability and to prevent systemic risk (Masera, 2015; Goodhart and Schoenmaker, 2014).

↘ The complex system approach has also fundamental implications for risk analysis. The traditional exogenous/fundamental risk / normality assumptions must be broadened to analysis of fundamental and systemic risks, with tipping points and cusp/extreme value theory stochastic models (Danielsson and Shin, 2003).

Table 4 – Why it is impossible to separate Banking Union from monetary and credit policies

↘ As indicated in Tab. 3, Monetary and Banking Unions are necessarily intertwined.

1. The Classical approach to the equation of exchange ($B \cdot m \cdot V = P \cdot Y$)[1] underlines the links between the intermediate objectives of price stability and support to the economy and base and deposit money creation.
2. Lender of last resort is a vital function of a central bank. In the EU, this function continues to be formally left to the individual central banks and not to the ECB. Emergency liquidity assistance (ELA) and LOLR responsibilities for liquidity provisions are an integral part of the conduct of monetary policy (the credit approach of the European System of Central Banks[2]). The ECB faces institutional and legal constraints in providing LOLR, which should arguably be removed (Lastra, 2010).
3. Paradoxically, negative interest rates and quantitative easing reduce liquidity in the key sovereign bond markets, mainly as a result of the huge acquisitions of public debt by the ECB itself (as measured, for instance, by the decline in market depth in public bond futures contracts).
4. Bank credit supply and deposit creation respond jointly to monetary policy and capital requirements: the latter have taken an overwhelming role.
5. Capital and other constraints are inspired in the EU by a one-size-fits-all approach (contrary to the tiered system adopted in the US). The lack of regulatory proportionality and the very impact of negative interest rates force unwarranted and undesired structural changes in the banking system, with the gradual demise of the smaller banks.

↘ These are the principal reasons why analysis of the Banking Union must be broadened to the whole monetary and financial pillar (left-hand side) of Table 1.

↘ This is implicitly recognized also by the Five Presidents' Report[3] with its integrated approach to Financial Union.

[1] See Issing O. (2008) and Praet P. (2016).
[2] See Praet P. (2016).
[3] Juncker *et al.* (2015).

Table 5 – Why the ECB should reconsider its basic tenet of a generally verifiable relationship between the monetary base, money supply and prices

↘ A fundamental criticism of the ECB monetary policy resides in the lack of a reassessment in the economic dogma of the links between monetary base injections, money/credit creation processes and price increases.

↘ A key insight had been offered, already the outset of the ECB, by Paolo Sylos Labini (1998). He propounded a radically different approach: his main point was that wages/unit labour costs from emerging market economies would act, in a global economy setting, as a powerful restraining factor for wage and price increases in advanced economies.

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