A Banking Union for the Euro Area

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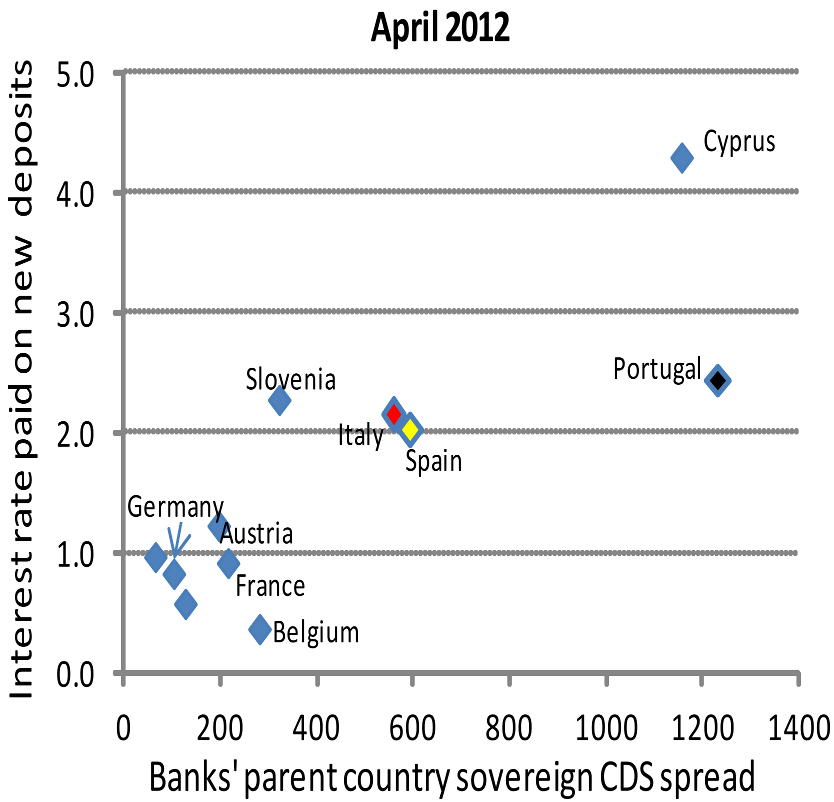
An incomplete financial architecture

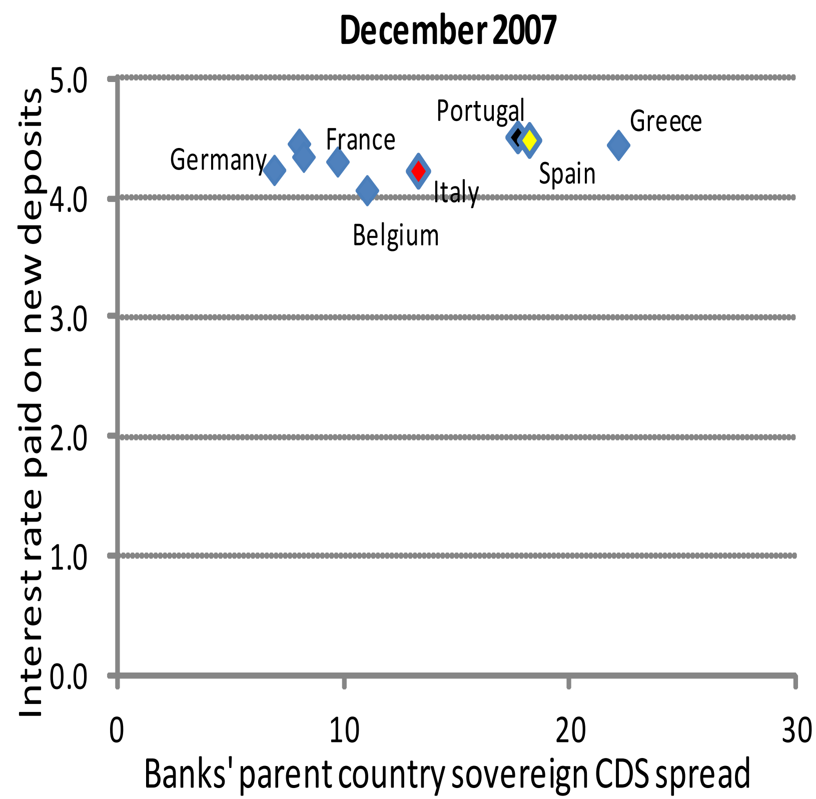
- Single market, Single currency, nation-bound supervision/resolution/safety nets

- It worked fine for a while
  - Uniform interbank market, Increasing financial integration/diversified portfolios

- Then the crisis came:
  - Vicious spirals sovereign/bank/real-sector
  - Re-fragmentation
  - Impaired monetary policy transmission mechanism
  - Problems with cross-border resolution

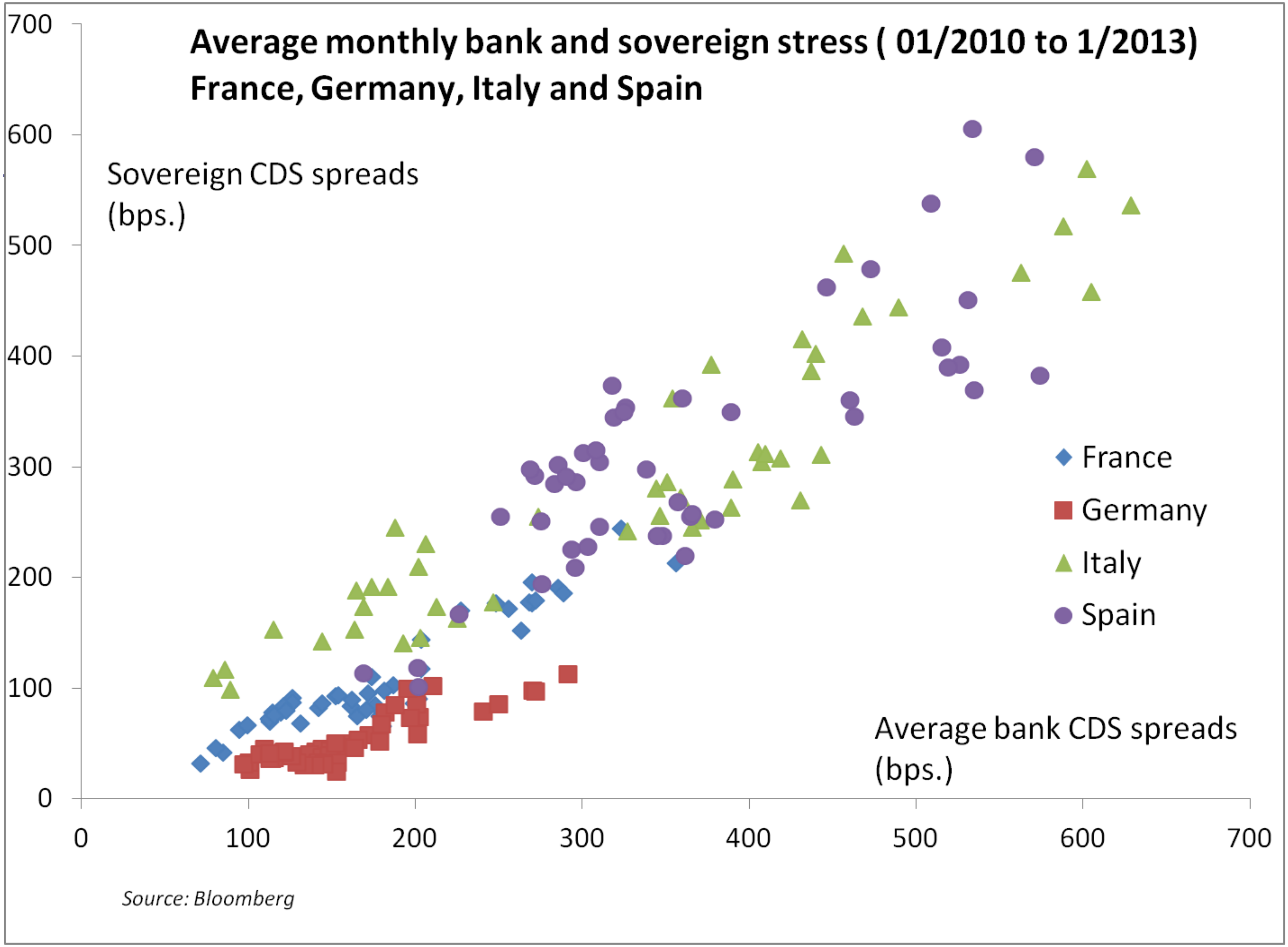
In a crisis deposit rates reflect the perceived strength of the safety net 1/





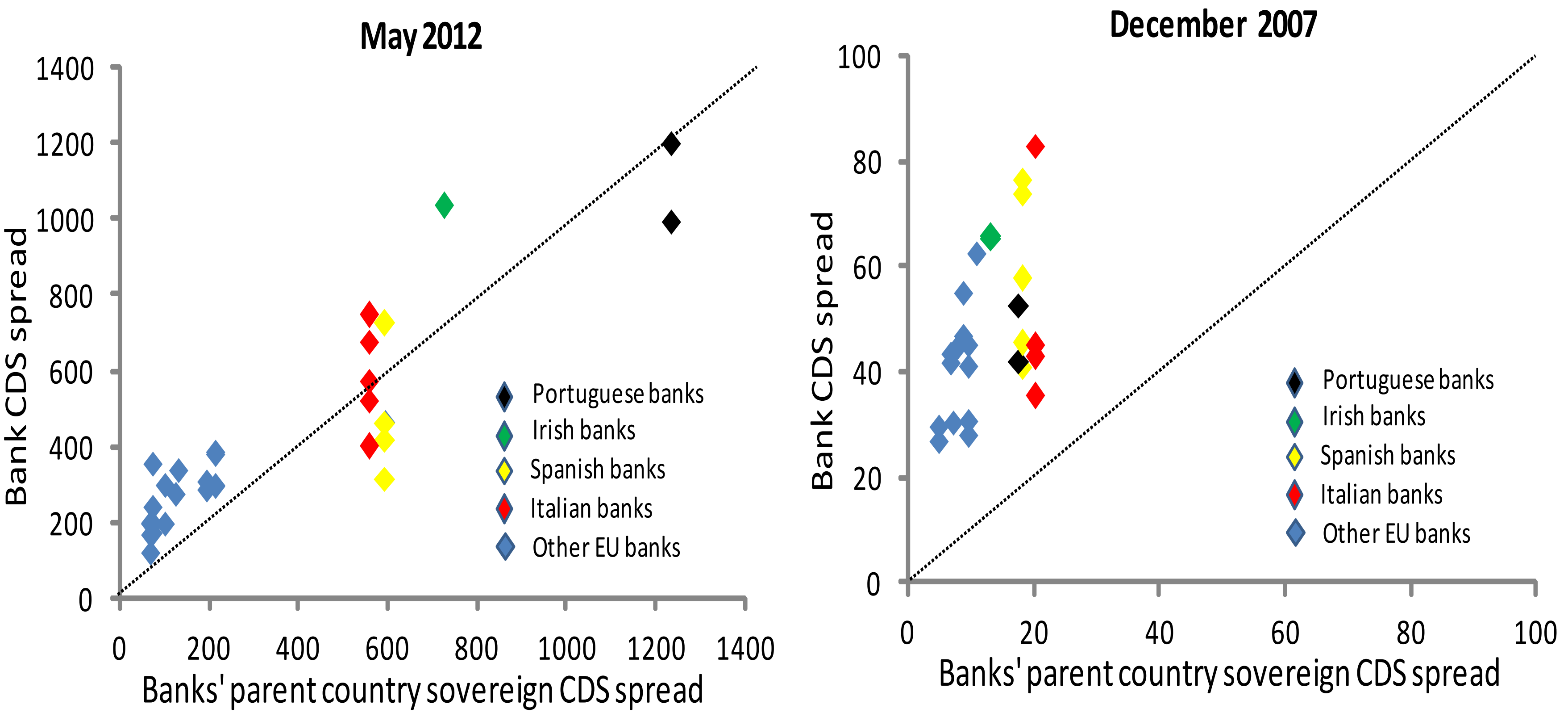
Source: ECB, Bloomberg, and IMF staff calculations.

Notes: 1/ Average interest rate paid by MFIs on new deposits with agreed maturity up to 1 year. Available data for Greece in April 2012 are not plotted due to being far away of the rest of the sample (the avg. interest rate was 4.8 and the sovereign greek CDS spread was 8751 bps).



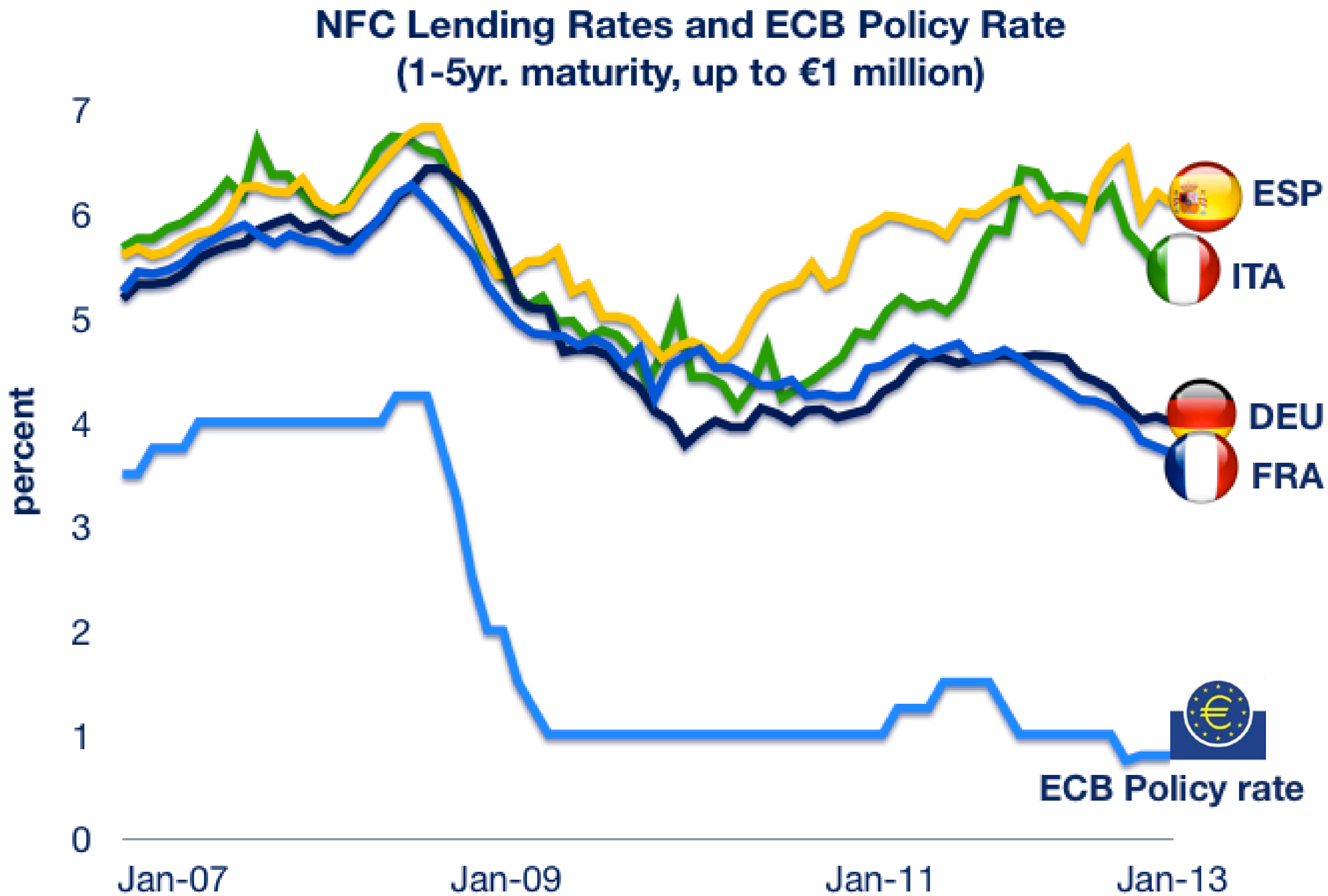
Average monthly bank and sovereign stress (01/2010 to 1/2013)
France, Germany, Italy and Spain
Sovereign CDS spreads
(bps.)
Average bank CDS spreads
(bps.)
France
Germany
Italy
Spain
0
100
200
300
400
500
600
700
Source: Bloomberg

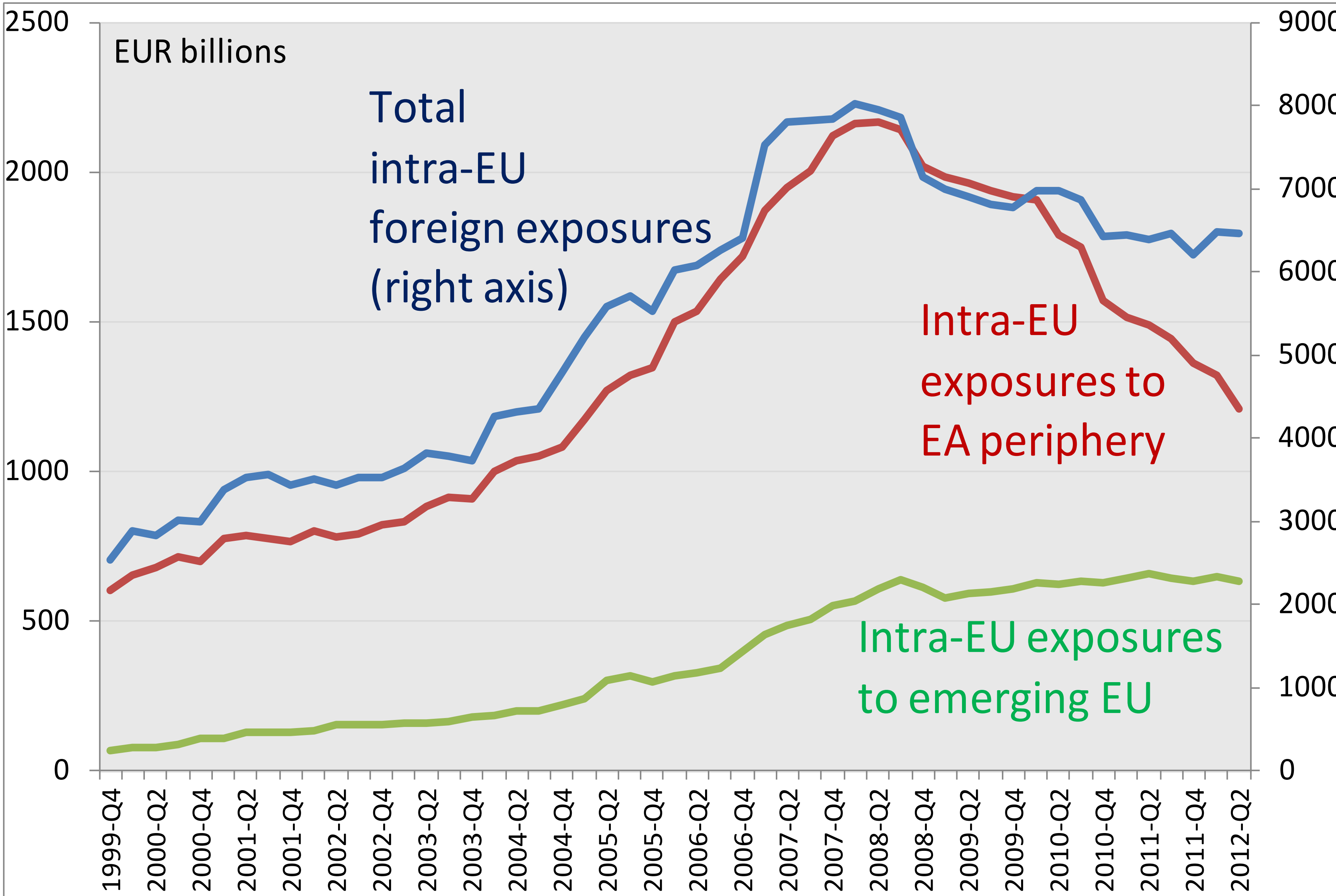
Bank CDS spreads cluster along country lines during crises 1/



Source: Bloomberg and IMF staff calculations

Notes: 1/ The sample includes all 31 banks in the 2010 EU-wide EBA stress test for which CDS data (end of month) were available in Bloomberg. Available data for Greece in 2012 are not plotted due to being far away of the rest of the sample (the CDS spreads of two greek bank spreads were 1990 bps and 2027 bps, and the sovereign greek CDS spread was 8711 bps as of May 2012).


NFC Lending Rates and ECB Policy Rate
(1-5yr. maturity, up to €1 million)
percent
7
6
5
4
3
2
1
0
Jan-07
Jan-09
Jan-11
Jan-13
ESP
ITA
DEU
FRA
ECB Policy rate



BIS consolidated banking statistics, immediate risk basis

Note: Ireland and Finland not included due to breaksin data reporting

Bank Cross-border claims in percent of reporting country’s GDP

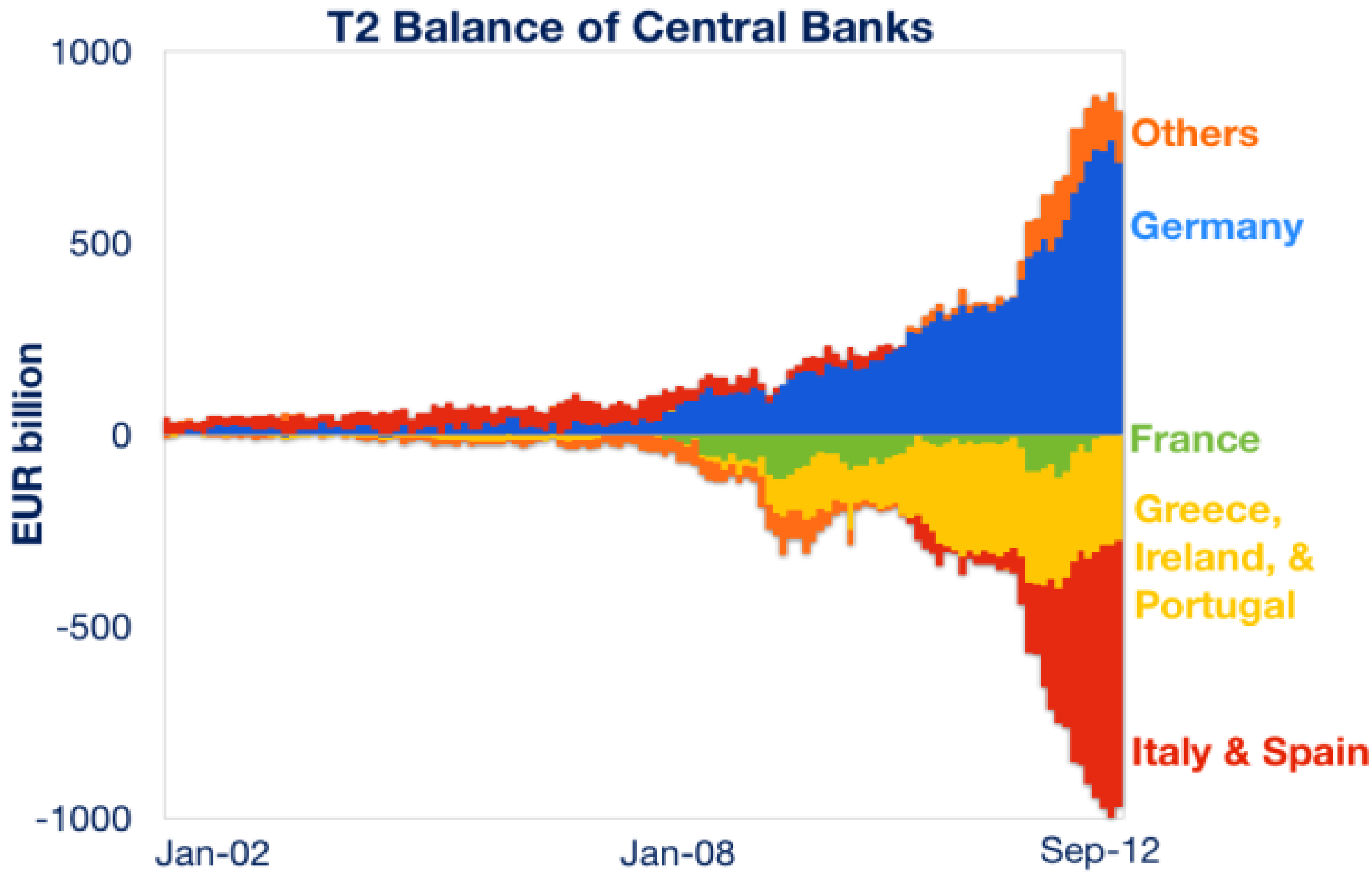
2008 Q1

REPORTING COUNTRY \ COUNTER-PARTY	DEU	NLD	FRA	ITA	ESP	PRT	IRL	GRC
DEU		21	9	11	19	20	83	13
NLD	6		7	7	8	7	17	6
FRA	8	19		22	13	13	31	22
ITA	11	4	2		2	4	11	3
ESP	2	7	2	2		32	8	0.4

PERCENT
> 15
10 - 15
5 - 10
2.5 - 5
< 2.5

2012 Q2

REPORTING COUNTRY \ COUNTER-PARTY	DEU	NLD	FRA	ITA	ESP	PRT	IRL	GRC
DEU		20	7	6	9	11	41	2
NLD	5		2	2	4	2	6	1
FRA	6	20		17	8	8	13	15
ITA	7	2	2		2	1	5	0.4
ESP	2	3	1	2		33	3	0.3



T2 Balance of Central Banks
1000
500
0
-500
-1000
EUR billion
Jan-02
Jan-08
Sep-12
Others
Germany
France
Greece,
Ireland, &
Portugal
Italy & Spain

A banking union

- Three essential elements
  - Single supervisor
  - Single resolution authority/process
  - Common safety nets (deposit insurance/fiscal backstops)

Main rationale

- Common safety nets to weaken sovereign/bank/real-sector spirals
  - Moral hazard with common backstops
- → Common supervision
  - Supervision needs resolution powers to be effective
- → Single resolution authority
  - Needs funding to operate effectively

Additional benefits

- Reduced regulatory capture
- Improved cross-border resolution
- Level playing field / competition policy

Scope

- What banks should be covered?
  - SIFIs
  - Large banks in small countries
  - Correlated risks
  - Avoid regulatory arbitrage
  - $\longrightarrow$ All banks
- What countries?
  - Essential for eurozone
  - Open to other EU but issues with multiple CB, LOLR, currencies
  - Pegs first?

How to get there

- Ideal sequencing
  - Standardize national supervision/Equalize safety nets
  - Pass necessary laws/Build common institutions
  - Transfer powers
- But we are not in tranquil times
  - Short-cuts/Costs to be accepted
  - Yet, clear path and end game will help
- Constrained sequencing
  - Gradual take-over (priority banks)
  - ESM injections
  - Multinational teams

Risks and problem issues

- Stalled or incomplete reforms
  - Poor design may be worse than status quo
  - Incentive compatibility
- Governance
  - Within ECB (functions)
  - Between ECB and national regulators
- Changes in financial structure
  - TBTF
  - Cross-border imbalances

A concern about macroprudential policy

- How many agencies in charge of MaP/MiP?
  - Is it conceivable to keep macroprudential and microprudential regulators separate?
  - MaP could set level of certain ratios over the cycle
  - MiP enforcement and bank level variations
- Yet, things are more multidimensional and there can be conflicts
  - Set $P(X)$=probability that bank X fails
  - Then probability of joint failures: $P(X \cap Y)=P(Y|X)P(X)=P(X|Y)P(Y)$
  - So you could have measures that lower $P(X)$, $P(Y)$, but increase $P(X \cap Y)$
- Think about completely separated versus integrated systems (Allen/Gale)
  - Hedging across banks/Cross-border links
  - What kind of strategic game can emerge between MiP and MaP agencies?

Cross-border issues with MaP

- Macroprudential policy with open k-accounts?
  - Cyclical CARs vs Basel I
  - Borrower or activity based measures
  - Risk of circumvention
  - Especially an issues within currency areas

- Need for greater coordination of MaP

ESM direct recapitalization

- Risk sharing mechanism (could eliminate tail risks for sovereigns)
- Not a loss sharing mechanism
- “Legacy assets”: expected losses borne by sovereign
- Operational framework: access, governance, accountability, instruments

Establishing SSM: challenges

- Crisis resolution:
  - Bank restructuring: national authorities may be ill equipped

- Implementation:
  - ECB reputation: slippages before actual power transfer
  - Ensure incentive compatibility within the SSM, for information sharing and cooperation
  - ECB must be able to intervene in a timely manner in any bank as deemed necessary
  - Non-euro area countries: ensure attractive opt-ins

Single Resolution Mechanism

- Supra-national centralized resolution authority for all SSM banks
  - Effective decision-making, with common backstops

- Mandate and powers:
  - Early intervention and least cost resolution
  - In line with "FSB Key Attributes".

- Resolution tools/powers

- Systemic risk exception?

Burden sharing and backstops

- Backstops and safety net:
  - Common resolution fund
  - ESM recapitalization
  - Earmarked contingent euro-area taxation (for systemic events)
  - ECB line of credit (with guarantees)

- Lender of Last Resort centralized at the ECB