

Course title: International financial regulation

Lesson 5. The EU Banking Union

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The EU banking union

- A common European regulatory system was set up at extraordinary speed in the last years.
- EBA, national regulators and SSM will enforce
 - EC legislation on Basel III
 - The new banking union framework
- A vast transition and an extended mandate
- Transitional and novel issues are emerging

Once rules are set

To enforce rules and standards, regulators require **policy principles** supported by analytical capacity, to

- Incorporate lessons learned
 - Endogenous risk creation
 - Interaction of banks, shadow banks and markets
- Identify novel sources of risk
 - How intermediaries and markets respond to rules
 - How sustained loose monetary policy shapes risk

Main lesson from the crisis

- Basel II rules focused on a static view of risk.
- Their effectiveness is eroded by market adaptation.
- Policy needs to be preventive to contain endogenous risk creation, via
 - Anticipating risk incentives
 - Macro prudential adjustment to micro prudential policy (also via Pillar 2)

Forward looking insight is needed

- Large regulatory changes
 - Unanticipated consequences will arise from
 - spillovers across sectors
 - evolving business models, financial innovation
- Risk incentives from loose monetary policy
 - Both from low rates and abundant liquidity
- Unfinished regulatory business

Unfinished business

- Banking
 - EU adoption of NSFR standards
 - Use of liquidity buffers (LCRs)
 - CRD4 liquidity charges
- Markets and Shadow Banks
 - Policy on monitoring encumbrances (FSB)
 - Margins on uncleared derivatives
- Capital ratios over the cycle
 - Going concern convertible capital
 - Capital charges on funding risk

CEPR Financial Regulation Initiative

Banking and Capital Markets

- Bridge between CEPR fellows, supervisors, industry; analytical foundations for independent advice
- Identify areas of regulatory concern, elaborate themes for focused initiatives
 - Conferences, summer schools, research projects
- Some themes for the first initiatives
 - Bank Equity over the Cycle
 - Reaching for Yield Risk Incentives
 - New Forms of Liquidity Risk

Measuring financial stability

- Transparency: evolving indicators
- Credit to GDP and LTV, leverage ratios and maturity mismatch (also for nonbanks)
- Evolution of correlated risks
 - In asset choice (esp real money investors)
 - Funding choices (esp leveraged intermediaries)

Measuring the quality of capital over the cycle

- Prevention versus risk absorption characteristics
 - Going-concern contingent capital design
 - Identity of investors holding long term financial bail-inable debt
- Triggers for countercyclical capital buffers
- Countercyclical policy on LTV in real estate finance

Liquidity risk

- Admissible use of liquidity buffers
- Encumbrances
 - Analysis of collateral pledging in distress banks
 - Risk management in central clearing platforms
 - Treatment of uncleared derivatives (eg for ETF)
- Collateral shortage ?

New sources of risk and spillovers

- Asset manager leverage, maturity and liquidity mismatch via derivatives, collateral swaps and security lending
- Correlated investment strategies (eg in ETFs)
- Concentration of tail risks and bail-inable debt
- Effects of capital flows upon reversal of loose policies

Eight reasons for the sovereign debt crisis

1. Member States did not fully accept the political constraints of being in EMU
2. Transition to permanent lower interest rates
3. Economic surveillance too narrow
4. Methodological problems with calculating structural fiscal balances
5. Insufficient control of data by Eurostat
6. Financial market supervision too lax and mainly national
7. Institutional gaps, no crisis resolution mechanism
8. Biggest financial crisis in 80 years

A comprehensive response to the euro crisis

1) **Significant fiscal consolidation and structural reforms at national level**

- Macroeconomic imbalances are disappearing

2) **Improved economic policy coordination in the euro area**

- More comprehensive and stricter rules for policy coordination

3) **Institutional innovations: financial backstops and OMT**

- EFSF and ESM have disbursed €222 bn to Ireland, Portugal, Greece, Spain and Cyprus
- Potential concerted ESM – ECB intervention possible

4) **Reinforcing the banking system**

- European banks have Core Tier 1 capital ratio of 9% or more
- Moving towards Banking Union

EFSF/ESM programme countries are the reform champions

- **Greece, Ireland, Portugal and Spain** are in top 5 of 34 **OECD countries** with regard to implementation of **structural reforms**

Ranking in OECD report
1. Greece
2. Ireland
3. Estonia
4. Portugal
5. Spain

“Euro area countries under financial assistance programmes are among the OECD countries whose responsiveness [to the OECD’s structural reform recommendations] was highest and also where it most increased compared with previous period.”

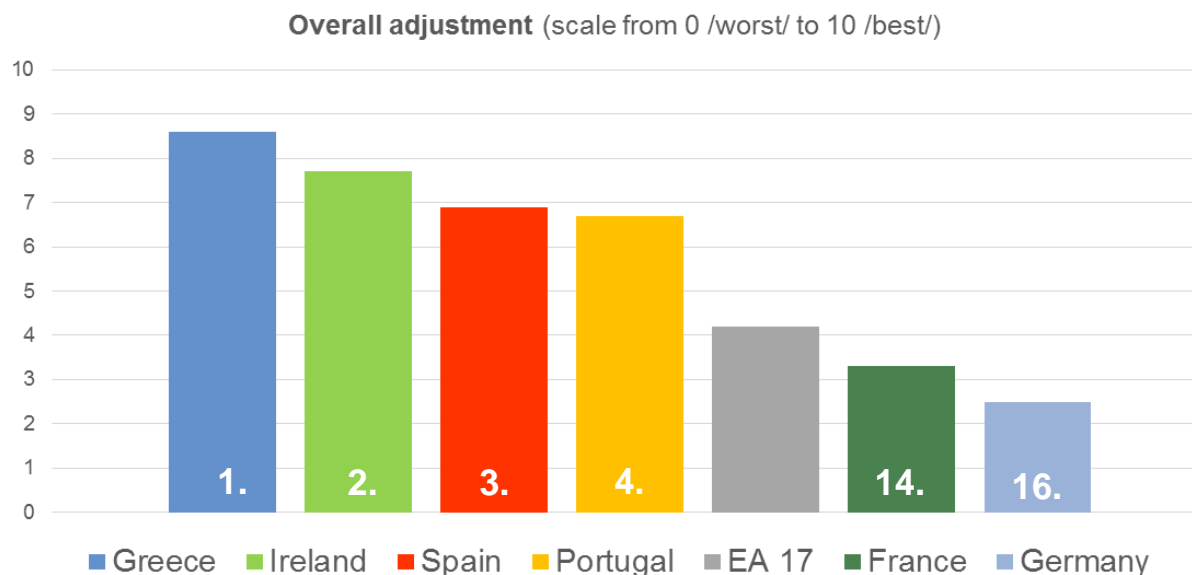
- *Going for Growth 2013* (OECD Report)

Source: OECD report *Going for Growth 2013*
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas

EFSF/ESM programme countries are the reform champions (2)

- Lisbon Council: **Greece, Ireland, Spain and Portugal** ranked highest in overall measure of 4 key medium-term adjustment criteria:

- Rise in exports
- Reduction of fiscal deficit
- Changes in unit labour costs
- Progress in structural reforms



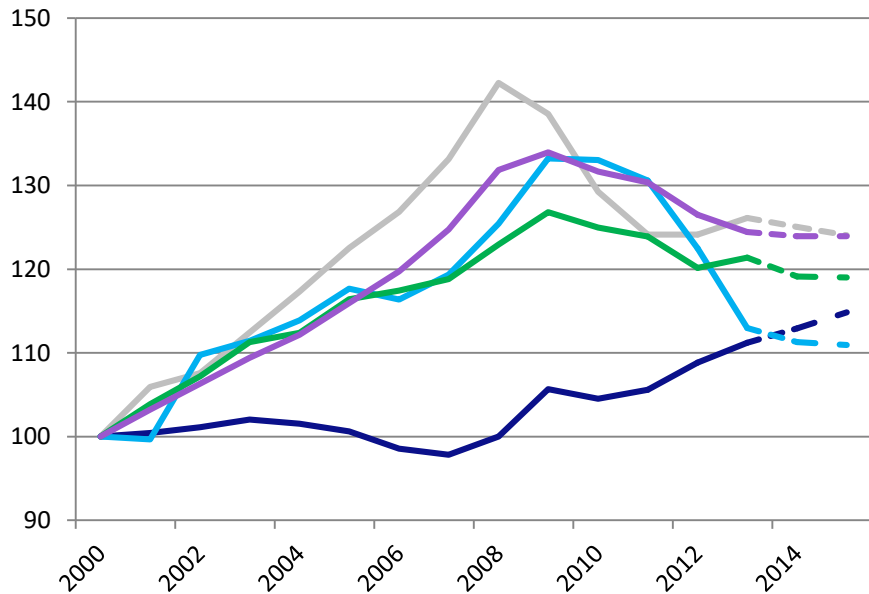
Source: "Adjustment Progress Indicator" in 2013 *Euro Plus Monitor* published by the Lisbon Council

The ranking comprised 17 euro area countries + UK, Poland and Sweden

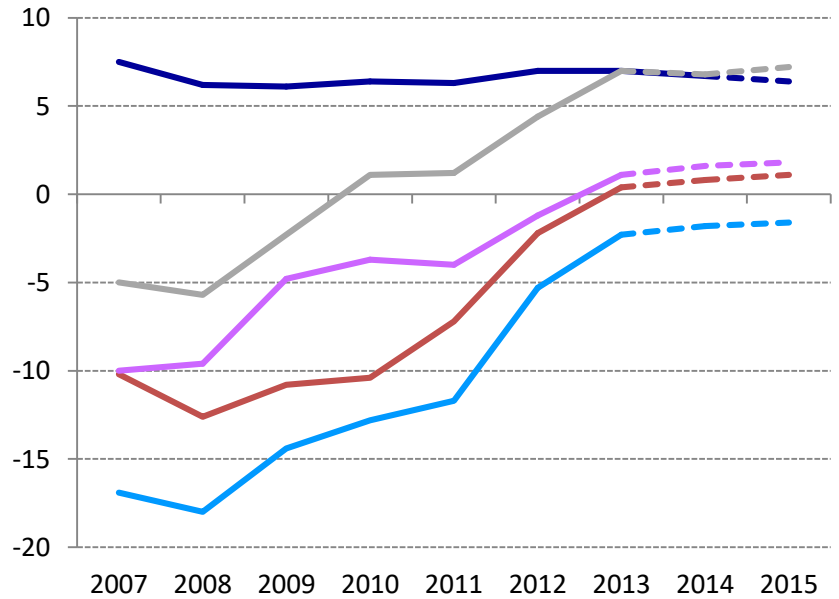
The strategy is delivering results - competitiveness

- Divergences within EMU are declining
- Competitiveness is improving in all Member countries that have borrowed from EFSF/ESM

Nominal unit labour costs, whole economy
(2008=100)



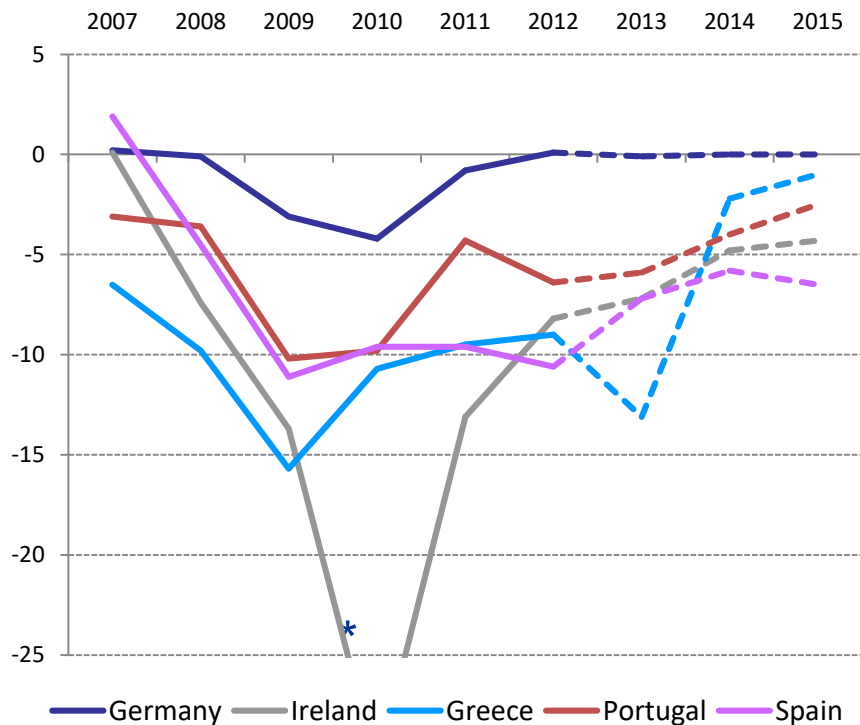
Current Account Balance (as % of GDP)



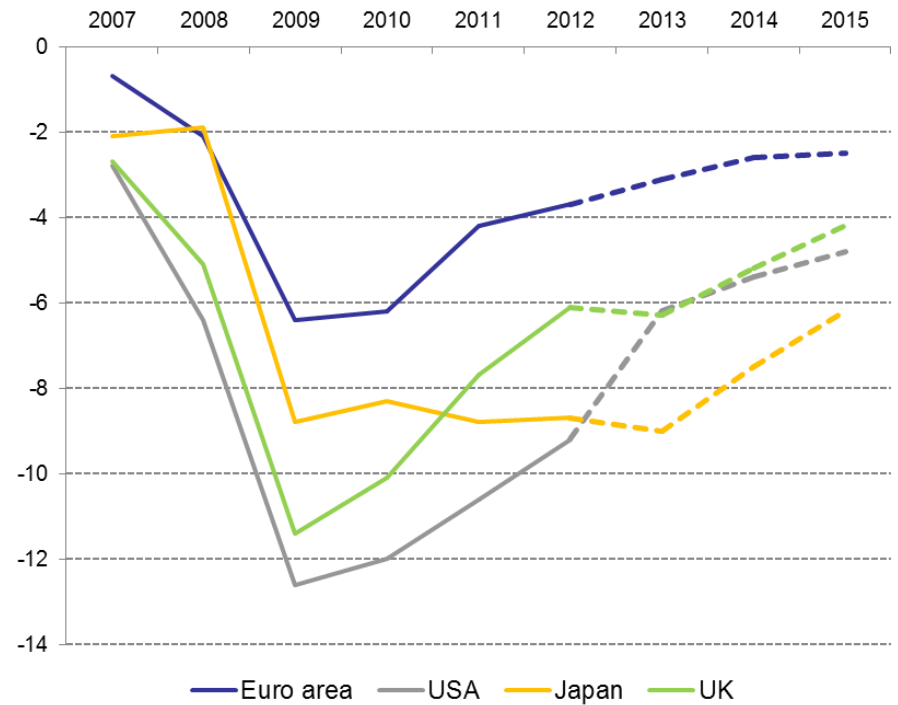
Germany Ireland Greece
Portugal Spain

The strategy is delivering results - fiscal

Fiscal balance, euro area Member States (as % of GDP)



Fiscal balance, Euro area vs USA and Japan (as % of GDP)



Source: European Commission, European Economic Forecast – Winter 2014

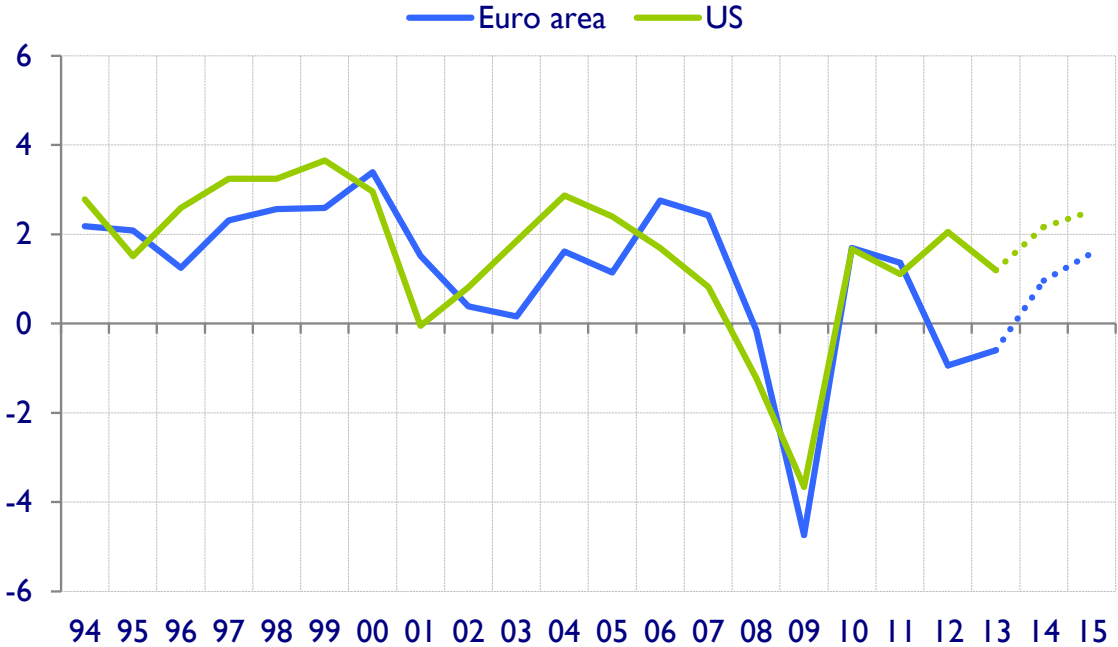
* Actual figure for Ireland in 2010: -30.6%

Risks and issues moving forward

- Economic growth
- Deflation
- Debt sustainability

GDP per capita growth almost identical in the euro area and US

GDP per capita growth annual % change



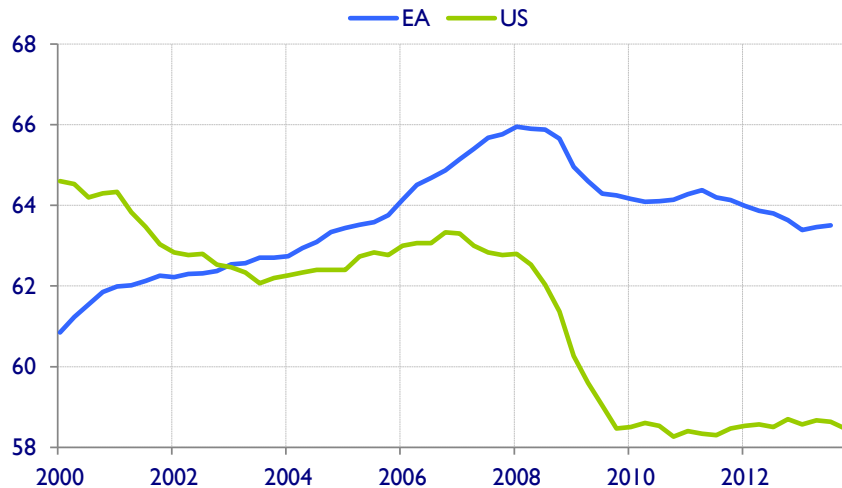
Average GDP growth per capita, 1994-2013

euro area	1.1
US	1.1

Labour markets in the euro area and US

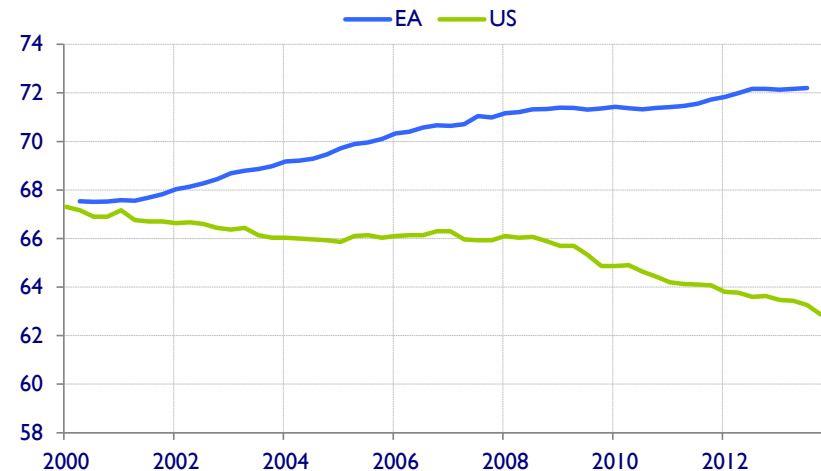
- During the last decade employment and participation rate have increased strongly in the euro area but fallen in the US

Employment rate



Unit: %
Latest observations: Q3 2013 for euro area, Q4 2013 for US
Source: Eurostat and BLS

Participation rate



Unit: %
Latest observations: Q3 2013 for euro area, Q4 2013 for US
Source: Eurostat, BLS and ESM calculations

Creditless recovery?

- Declining bank credit does not necessarily constrain economic recovery following a financial crisis, according to research by the **BIS**
- In Europe, the share of bank lending in total financial flows is **falling**
- More **mid-size companies** obtain funding from the market
- **Alternative sources** of funding are developing: P-2-P, direct lending

Is deflation a real threat?

- We are currently experiencing an extended period of low inflation, but not deflation
- According to IMF models, the risk of deflation in the euro area is 10-20%
- Falling prices and wages in EFSF/ESM programme countries are welcome; this is temporary
- Recent data from Eurostat show an acceleration in wage increases (1.9% in Q4 2013)
- Economic recovery is gaining pace in Europe

Debt sustainability?

- The EFSF and ESM introduced a new framework for providing financial assistance: very **low rates** at very **long maturities**
- Thus **debt service payments** are a better indicator of a country's debt burden than the debt/GDP ratio
- Especially evident in the case of **Greece**:
 - Official sector institutions hold 2/3 of Greek government debt
 - Greece's interest payments to EFSF deferred for 10 years; no repayment of capital in the next 25 years
 - As a result, Greece saves annually 4.7% of GDP on its debt payments
 - Haircut of 14.1% of GDP in NPV terms
 - No debt overhang

Debt sustainability: Portugal and Ireland

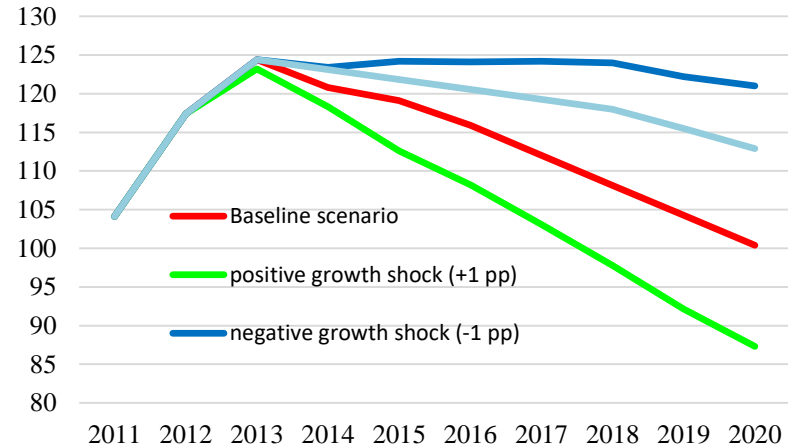
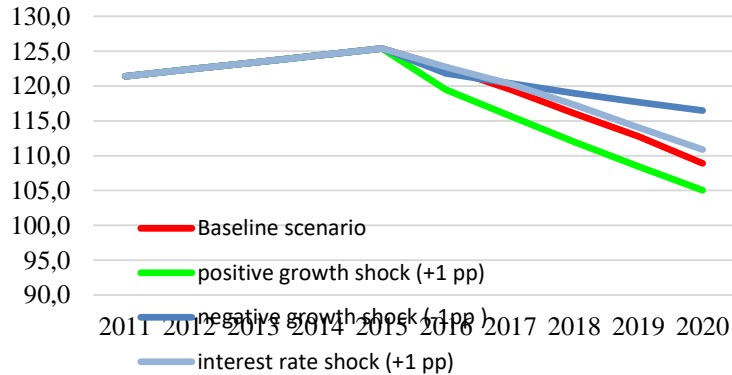
Portugal

- According to the troika, government debt peaked in 2013 and should decline to 110% by 2020

Ireland

- According to the troika, Government debt peaked at 122% in 2013 and is projected to decline to 102% by 2020

Government debt projections



Conclusions: The euro crisis is not over yet . . .

. . . but the end is in sight:

- The reasons for the crisis have been addressed
- The euro area has moved out of recession
- Macroeconomic imbalances within the euro area are shrinking fast
- Countries under conditionality are adjusting
- Economic policy coordination much broader and stricter
- Institutional gaps in the initial design of EMU have been closed
- Banks in Europe are becoming stronger

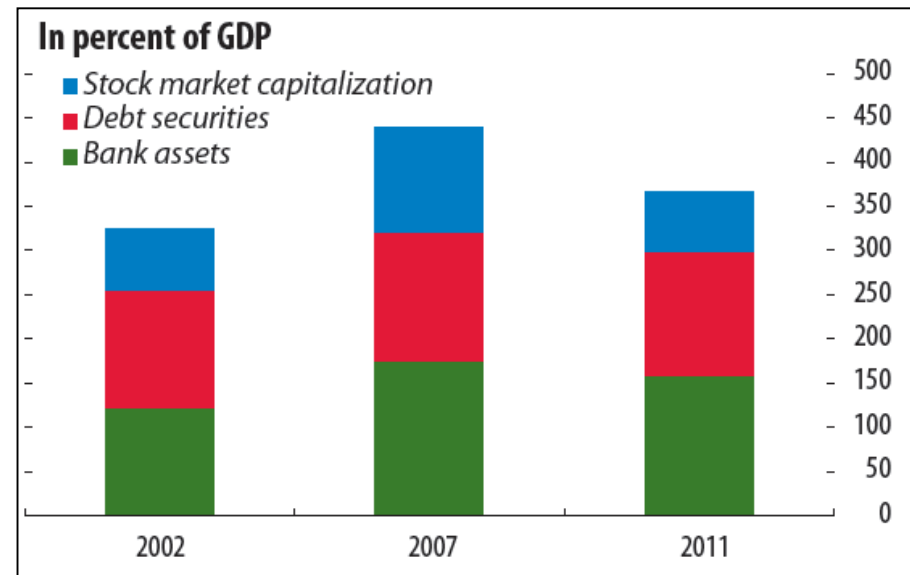
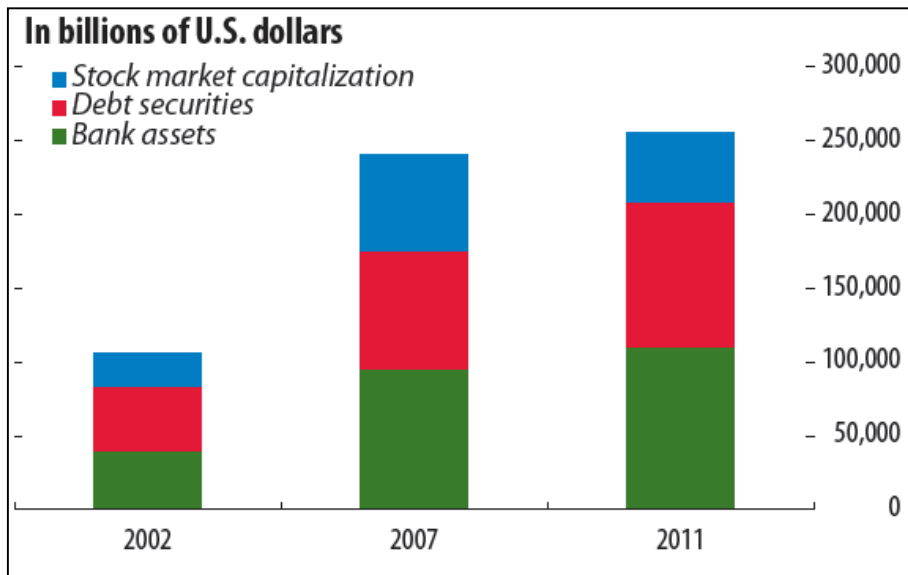
Conclusions: Certain risks to economic recovery are still present

- Borrowing countries need to continue their **difficult adjustment**
- Some of them need continued **financial support**
- **Financial markets** in Europe are **fragmented**
- Potential growth in Europe will be **limited**

Yet we should keep in mind that . . .

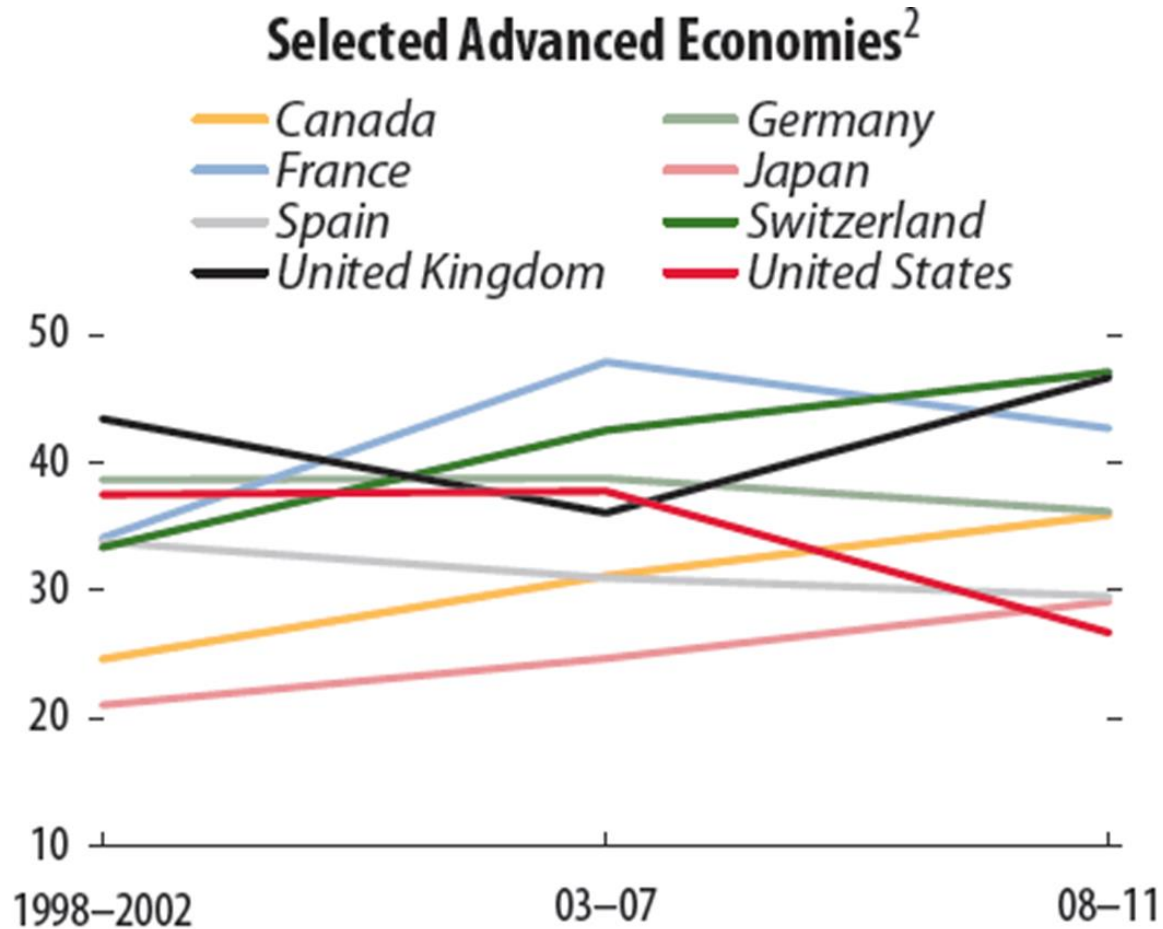
- History shows that crises generally trigger **positive changes**
- This is also true in Europe: monetary union **will emerge stronger** when the crisis is over

SIZE OF THE GLOBAL FINANCIAL SYSTEM

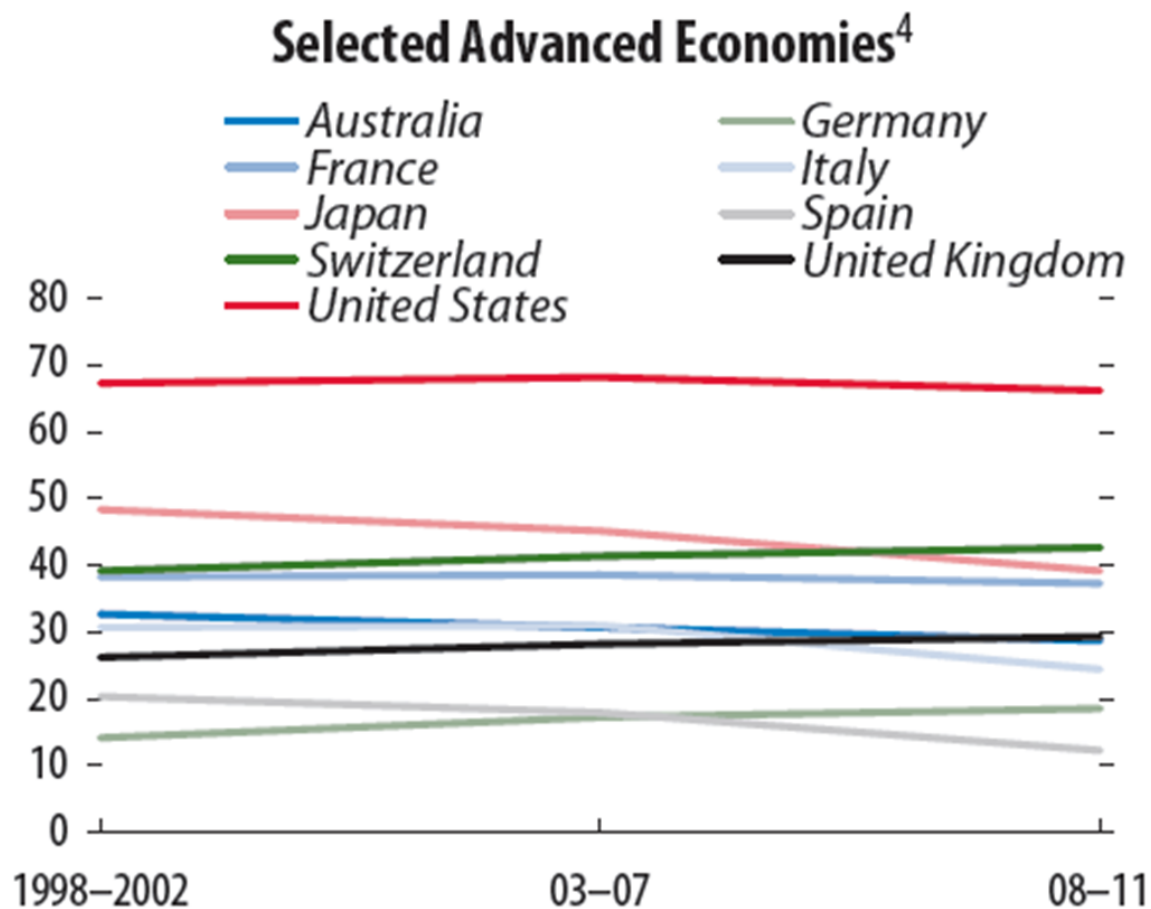


Sources: Bank for International Settlements; Bankscope; Bloomberg L.P.; and World Federation of Exchanges.

RELATIVE SIZE OF TRADITIONAL TO TOTAL BANKING ACTIVITIES

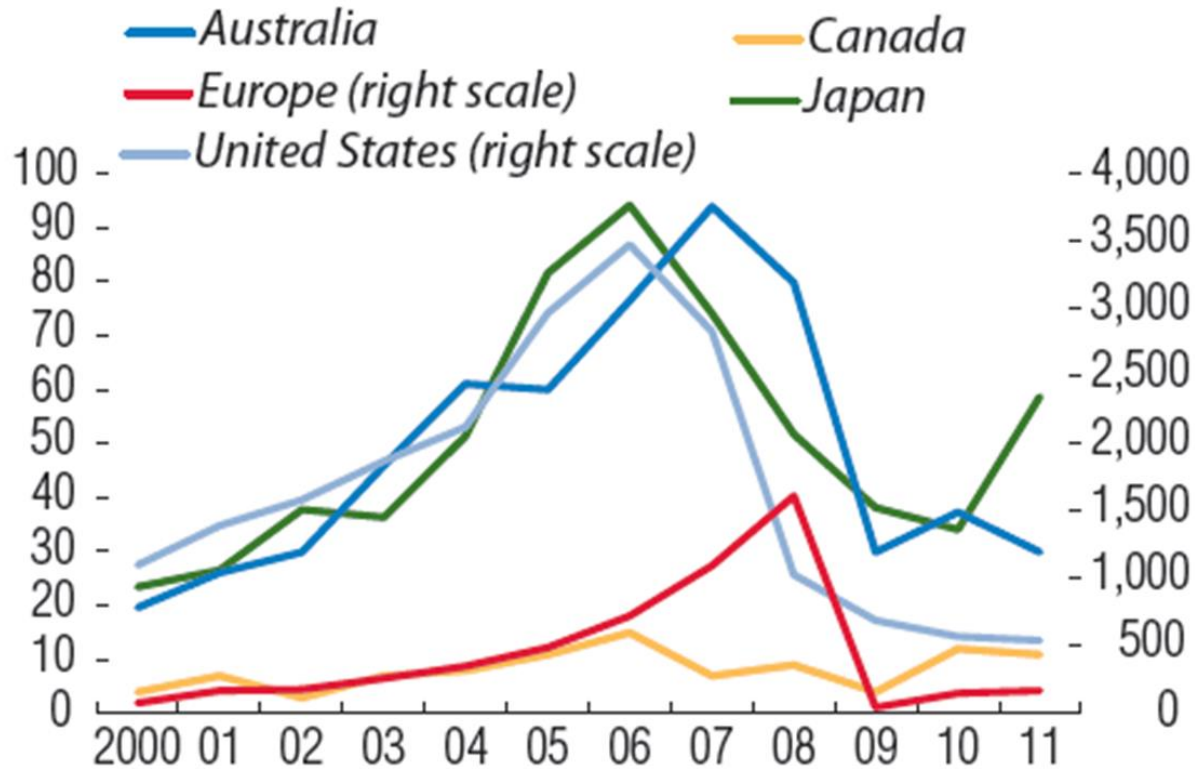


SHARE OF TOTAL LOANS AND BONDS BY NON-BANK INSTITUTIONS



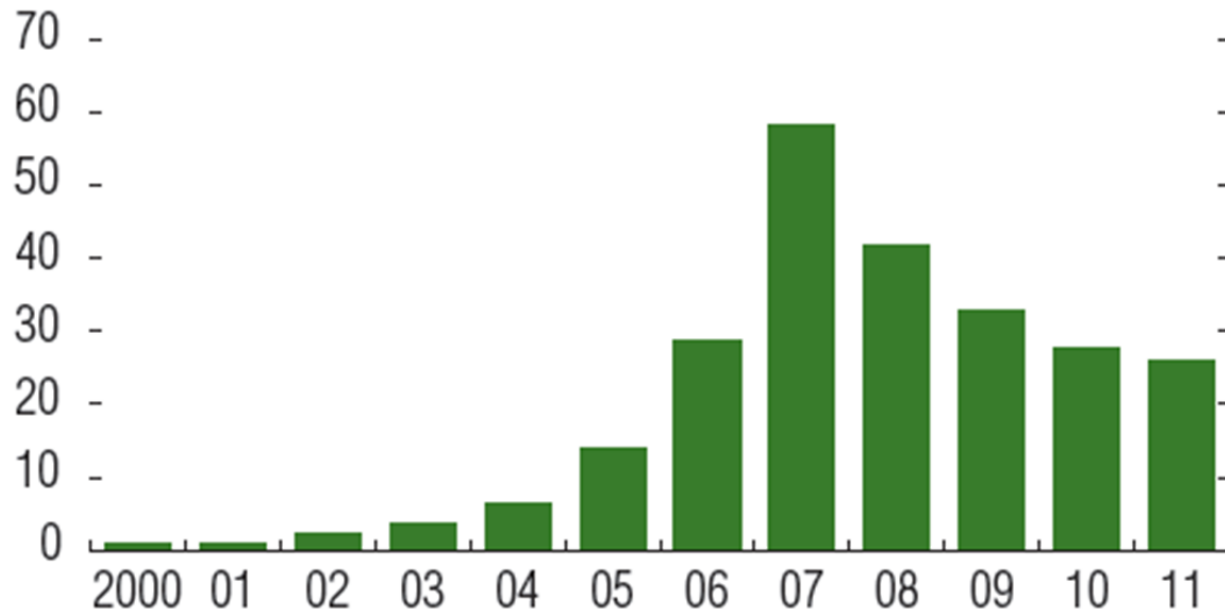
GLOBAL SECURITIZATION

Global Securitization¹
(In billions of U.S. dollars)



OUTSTANDING OVER-THE-COUNTER CREDIT DERIVATIVES

Outstanding Over-the-Counter Credit Derivatives
(In trillions of notional dollars)



OTC DERIVATIVES

- Counterparty Risk: The AIG Rescue
- Central Clearing Mandates
- Minimum Margin Requirements
- Data Reporting Requirements

HAS THE STRUCTURE OF THE FINANCIAL SYSTEM BECOME SAFER?

- Market-Based Financial Intermediation Remains Important
- Financial Systems Remain Dependent on Wholesale Funding
- Globalization Has Not Been Much Affected
- Official Interventions Have Made “Bail-In’s” Less Credible

RESOLUTION OF GLOBAL SIFI'S

- Core Elements of a Resolution Framework
- Statutory Authority to Convert Claims into Equity
- Recovery and Resolution Plans
- Crisis Management Groups

GLOBAL POLICY RESPONSE

- Capital Requirements for Global SIB's
- Counter-Cyclical Capital Buffers
- Liquidity Rules
- Multiple Channels for Reform