



Banking Union:

Next Steps on a Path of Collective Discovery

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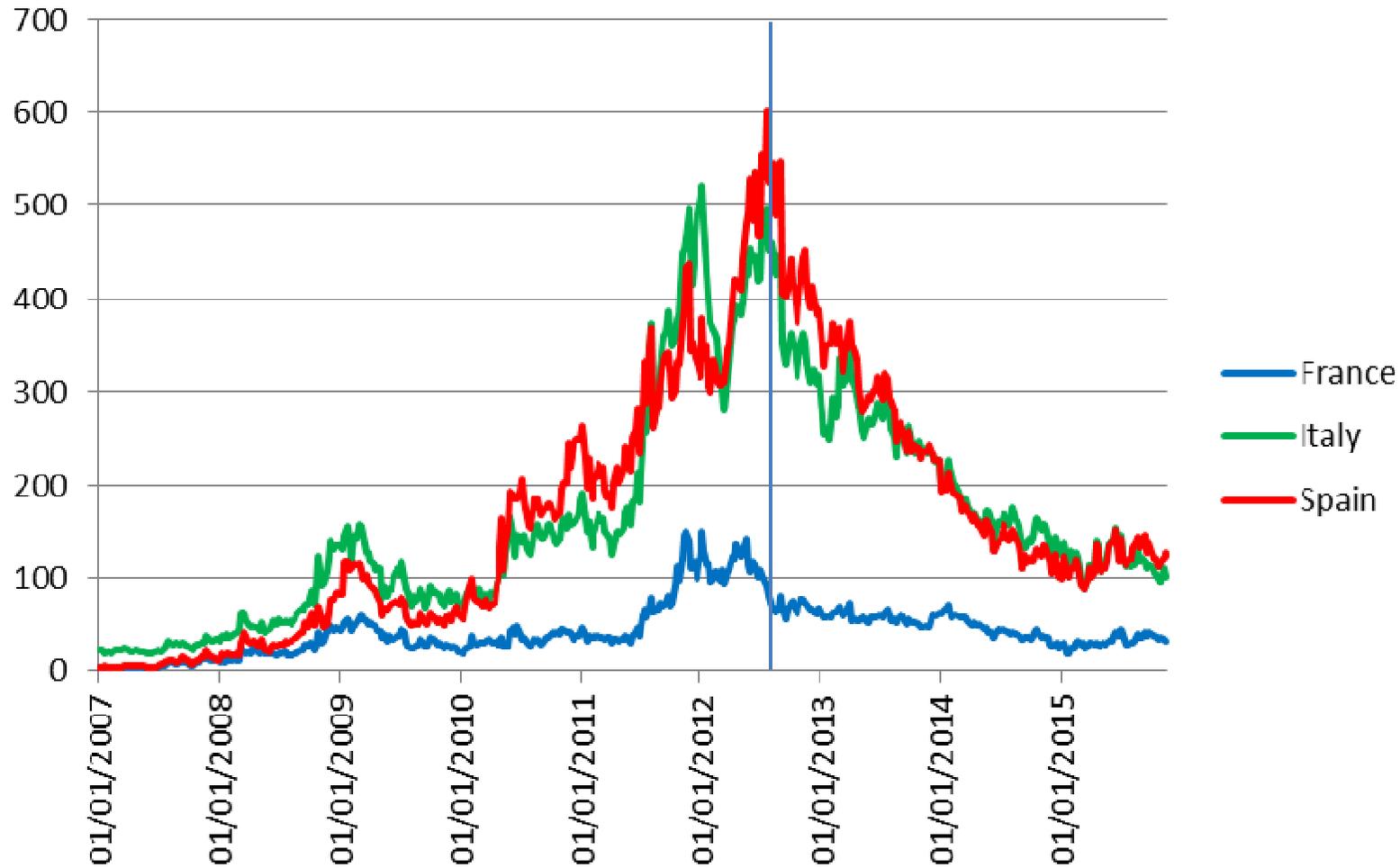
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Bank-Sovereign Vicious Circle

- Sovereign guarantees of banks; banks' exposures to sovereigns; macro linkages
- Plus: political economy / governance / ownership / barriers to entry / tax...
- More vicious in euro area: no devaluation / accelerator of redenomination risk
 - And almost no mitigation through capital markets
- Central driver of euro area crisis
 - Mostly sovereign to banks: Greece, Portugal
 - Mostly banks to sovereign: Ireland, Cyprus
 - Contagion to core in 2011-2012

Euro Area Crisis Summary



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

The Mid-2012 Breakthrough

- Crisis escalation / breakup risk
- Fiscal Union tried/failed in late 2011
- ESM Direct Recapitalization: June 2012
 - German response: matching control with liability
- Euro Area Summit Statement 29 June 2012
 - “Break the vicious circle between banks and sovereigns”
 - Single Supervisory Mechanism, then ESM direct recap
- Later developments
 - OMT and “positive contagion”
 - Bail-in doctrine replacing ESM direct recapitalization
 - But policy momentum: SSM Reg (Sept.); SRM (Dec.)⁴

BU So Far: Legislation

- Banking Union Area (possibly > euro area)
- Single Supervisory Mechanism
 - ECB sole licensing authority since 4 Nov 2014 (all banks)
 - Delegation to national authorities for “day-to-day” supervision of “less significant institutions” (DE, IT, AT)
- Single Resolution Mechanism / Board
 - SRB decides on “resolution schemes” since 1 Jan 2016
 - SRB manages Single Resolution Fund (SRF)
- European Deposit Insurance Scheme?
 - European Commission Proposal: November 2015

BU So Far: Operations

- **Single Supervisory Mechanism**
 - Organizational buildup / “Joint Supervisory Teams”
 - Comprehensive Assessment 2014
 - Supervisory Review & Evaluation Process (SREP)
 - Two rounds: early 2015 (transitional); late 2015
 - Greece
 - Novo Banco

- **Single Resolution Mechanism**
 - Related BRRD transposition / SRF IGA ratification
 - Organizational buildup / “Internal Resolution Teams”
 - Resolution planning
 - No responsibility in HETA, BANIF / Novo Banco, Italy 6

BU Outlook: Geography

- No Close Cooperation yet
- Interest in Central / Eastern Europe
- Pivotal position of Denmark

BU Outlook: Supervision

- Operations
 - SSM relation with national authorities
 - Internal balance: e.g. DGs I & II vs DG IV
 - Turf definition with DG COMP, SRB, EBA, BoE...
 - Information systems, supervisory transparency
- Governance: Supervisory Board
- Policy stance
 - “Tough but fair” / capture
 - Tolerance of diversity / new entrants
 - Global impact: Basel III compliance, BCBS governance

BU Outlook: Resolution

- Operations / governance of SRB
- Massive uncertainty
 - Bail-in especially of senior debt (& uninsured deposits)
 - Balance SRB / national resolution authorities
 - Resolution funding
 - SRF compartments / procyclical effects / backstop
 - ESM direct recapitalization
 - Other national (and European) funding?
 - Legacy narrative reversed in future?
 - Future division of labor DG COMP / SRB (/ ECB)
 - Judicial review
- Outcomes will be path-dependent

BU Outlook: Deposit Insurance

- European Commission proposal Nov. 2015
 - Re-insurance: until 2019
 - Co-insurance from 20 to 80 percent: 2020-2023
 - Federal insurance / full mutualization: from 2024 on
- No consensus yet
 - Pro: Commission, ECB, “periphery”, FR, [NL?]
 - Anti: Germany
 - General stance on risk-sharing
 - Specific interests linked to 3-pillar system
 - Political context / election timetable
- Outlook: “risk sharing” vs “risk reduction”

Sovereign Exposures

- Main (not only) item of “risk reduction”
- Home-country debt portfolios
 - Particularly in Spain, Italy, Germany
- Policy options
 - Definitions: e.g. includes market-making?
 - Exposure limit: same for all countries? 25 percent?
 - Risk weighting: determined by whom?
 - Transition arrangements: overlap with QE?

Geographical Ring-Fencing

- SSM practice
 - Country-specific + entity-specific requirements
 - Stress test scenarios don't reward geogr. diversification
- National authorities
 - Own resol./ dep. insurance mandate, e.g. Germany
 - Votes in ECB supervisory board and SRB plenary
- Cross-border banking sector consolidation
 - Incentives
 - Transactions vetting by ECB
 - Transactions vetting by national authorities?
- Internal market enforcement / legislation

Mutual Protection Schemes

- “Private-sector bail-outs”
 - Germany 3 pillars
 - Institutional protection schemes of savings banks
 - Institutional protection schemes of cooperative banks
 - BDB fund: e.g. Düsseldorfer Hypothekenbank March 2015
 - Italy: BRC July 2015, four small banks Dec. 2015
 - Institutional Guarantee Fund for cooperatives
 - Ad hoc fund financed by UniCredit, Intesa Sanpaolo, UBI with guarantee from Cassa Depositi e Prestiti
- Probably more to come
 - Supervision of “virtual groups”?
 - State aid?
 - Only national, or also cross-border?

Accounting & Auditing

- Accounting
 - National standards (non-listed banks)
 - IFRS enforcement
- Auditing
 - Auditor responsibility
 - Audit firm supervision
- Link with Capital Markets Union agenda

Insolvency Legislation

- Resolution: No Creditor Worse Off
 - SRM “single” in name only
- National insolvency law reform
 - Germany: juniorization of senior debt
 - Other approaches: new tier of bailinable instruments
 - Future practice on MREL / TLAC assessments
- Supranational bank insolvency regime?
 - Harmonization
 - Enforcement
 - Link with CMU agenda?

Beyond The Horizon

- New themes will emerge
- LOLR assistance / ELA
- Conduct / customer protection
- Housing finance
- Bank taxation
- Governance / institutional architecture
 - Streamlining of SRM
 - Separation SSM / ECB?
 - Future role of EBA?
- And probably more



Thank You For Your Attention

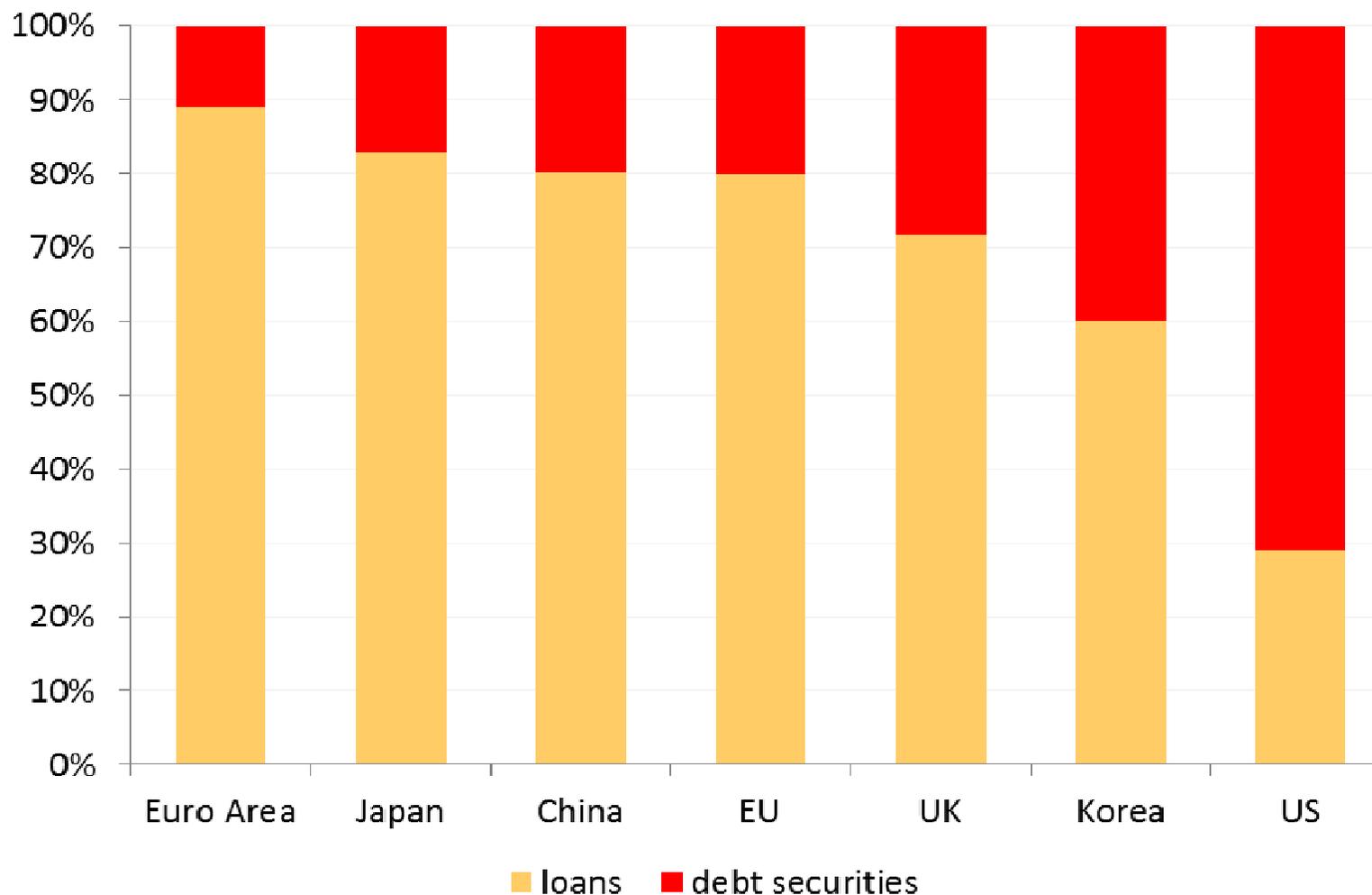
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Annex

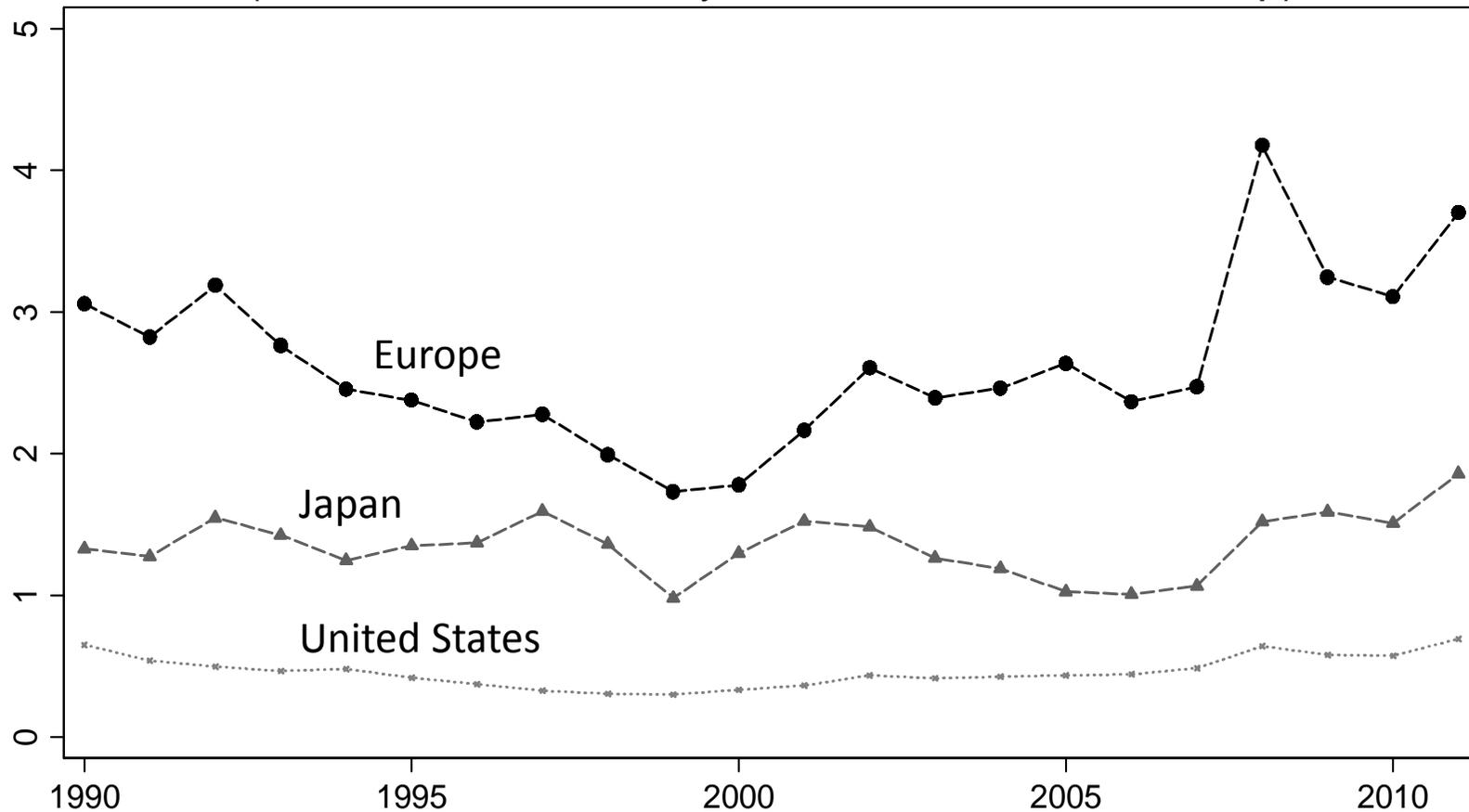
Financial System Structures



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

Financial System Structures

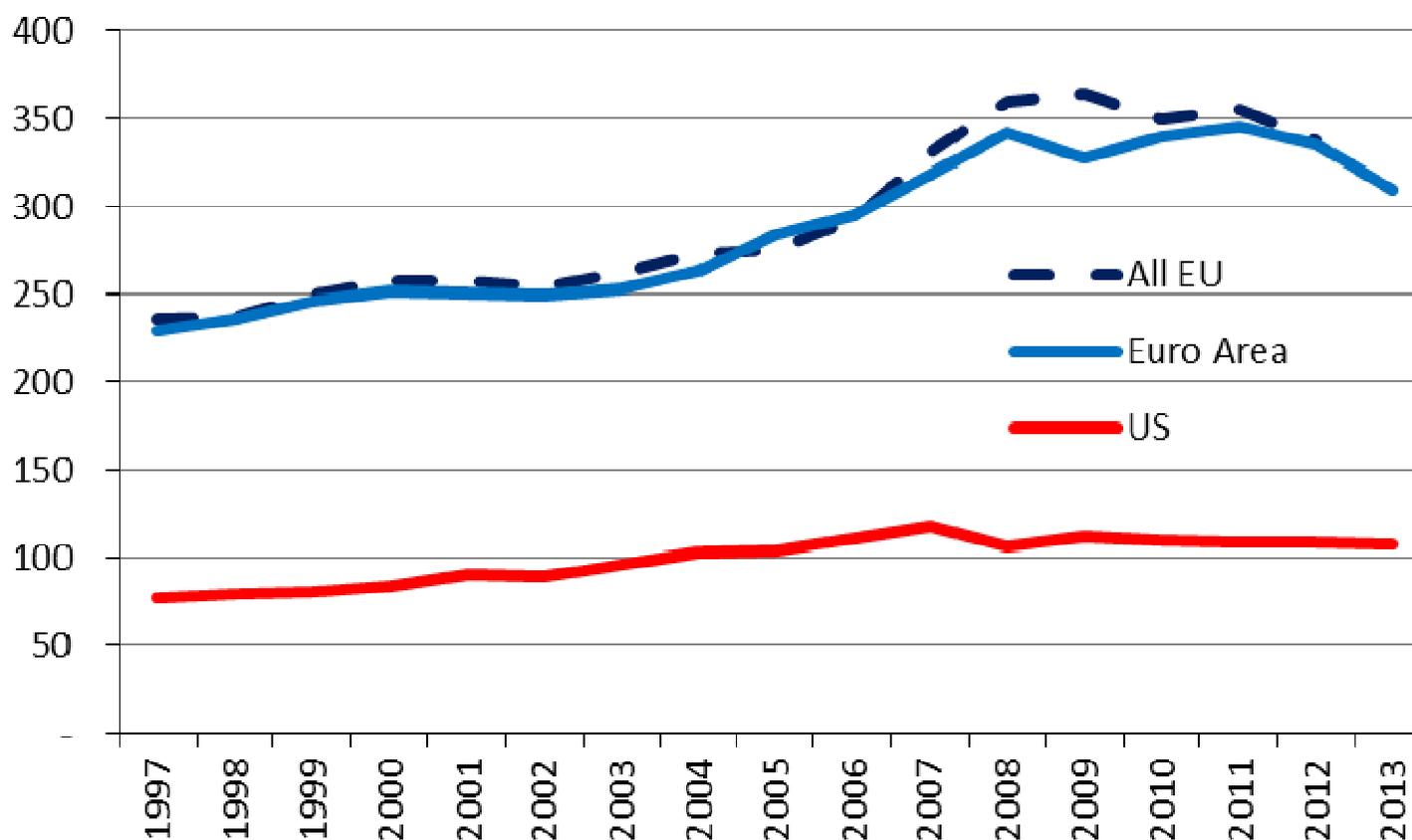
Bank-market ratio
(bank assets divided by stock and bond market cap)



Langfield & Pagano, "Bank bias in Europe: Effects on systemic risk and growth", ECB, 2015

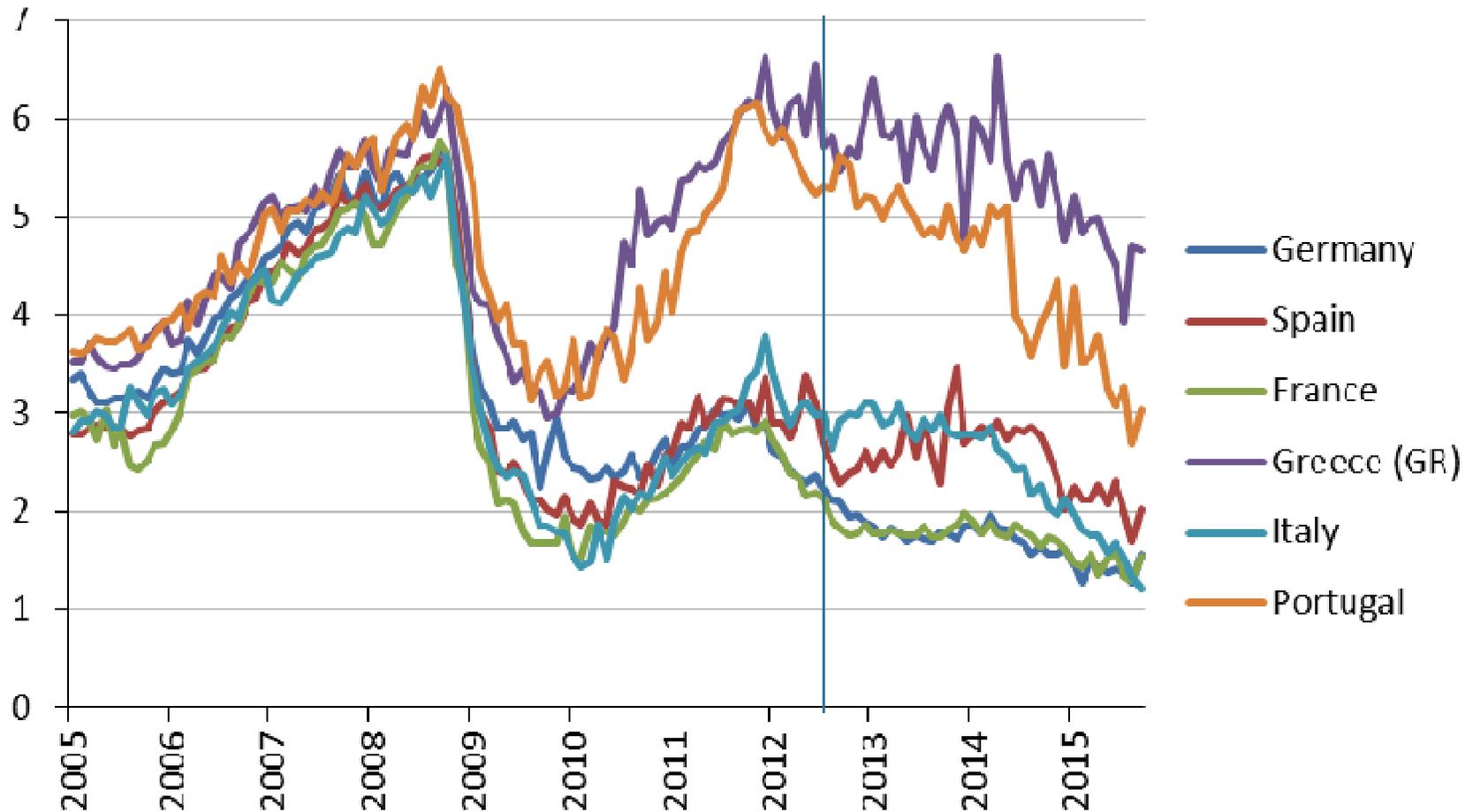
Pre-Crisis Expansion

Total Banking Assets (% of GDP)



US figures include broker-dealers. Sources: European Central Bank, Eurostat, Federal Reserve Board, US Bureau of Economic Analysis; author's calculations with help from Anish Tailor

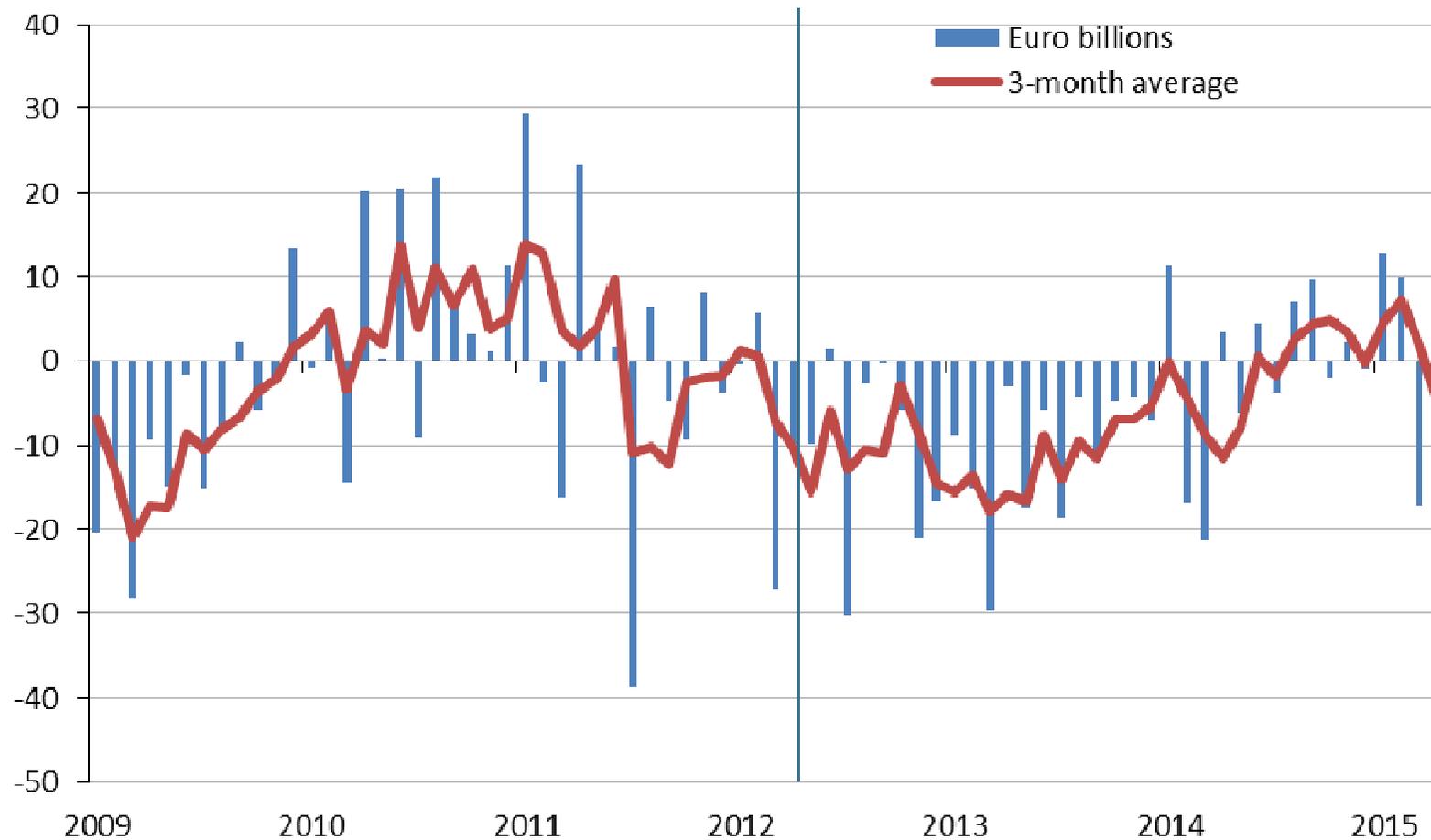
Market Fragmentation



Interest Rate on loans over 1 million EUR to non-financial corporates (percent) Source: ECB

Credit Cycle

Euro Area: loans to non-financial corporations



Source: ECB , April 2009 to September 2015; Amounts adjusted for sales and securitization