Banking Union
and
Nexus between Banks and Sovereigns

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Breaking the vicious circle

- European Council – conclusions of June 2012 meeting:
  - … key priority is to complete the Banking Union … it is imperative to break the vicious circle between banks and sovereigns …
- Since then, the focus has been primarily on the semi-circle
  - pre-empting any further banking sector bail-out with its adverse impact on public finance and associated feedback effect
- Nevertheless, the vicious circle between sovereign and bank debt is a rather complex phenomenon:
  - The sorry state of public finances may also destabilize the banking sector and set up a feedback effect.
  - The loop between private sector debt, government debt and the banking sector should not be forgotten.

Sources of the nexus

- Weak banks
  - with poor quality of loans or suspicion thereof.
- Expectations of large-scale banking sector bail-outs
  - leading to a deterioration of public finances.
- Weak government
  - close to fiscal unsustainability or suspicion thereof.
- Undermined credibility of the state in giving support to troubled banks:
  - One way of making banks stronger if needed is impaired.
- Exhausted capacity of banks to take more government debt on balance sheet:
  - One way of getting public finances out of problems if needed is impaired.
- Uncertainty regarding the ability of lenders of last resort to step in
  - This applies to central banks, international financial institutions, crisis management arrangements.

Some important numbers

Euro area, 2013, EUR trillions (thousands of billions, rounded):

- GDP: €9.5tn
- government debt: €9tn (95% of GDP)
- government securities outstanding: €7tn
- total MFI assets: €30tn (of which €5 tn interbank assets)
- MFI exposure to government securities: €1.7tn
- MFI loans to private sector: €10.5tn

- size of resolution fund: €0.06tn + ?
- assistance available from ESM: €0.06tn + ?

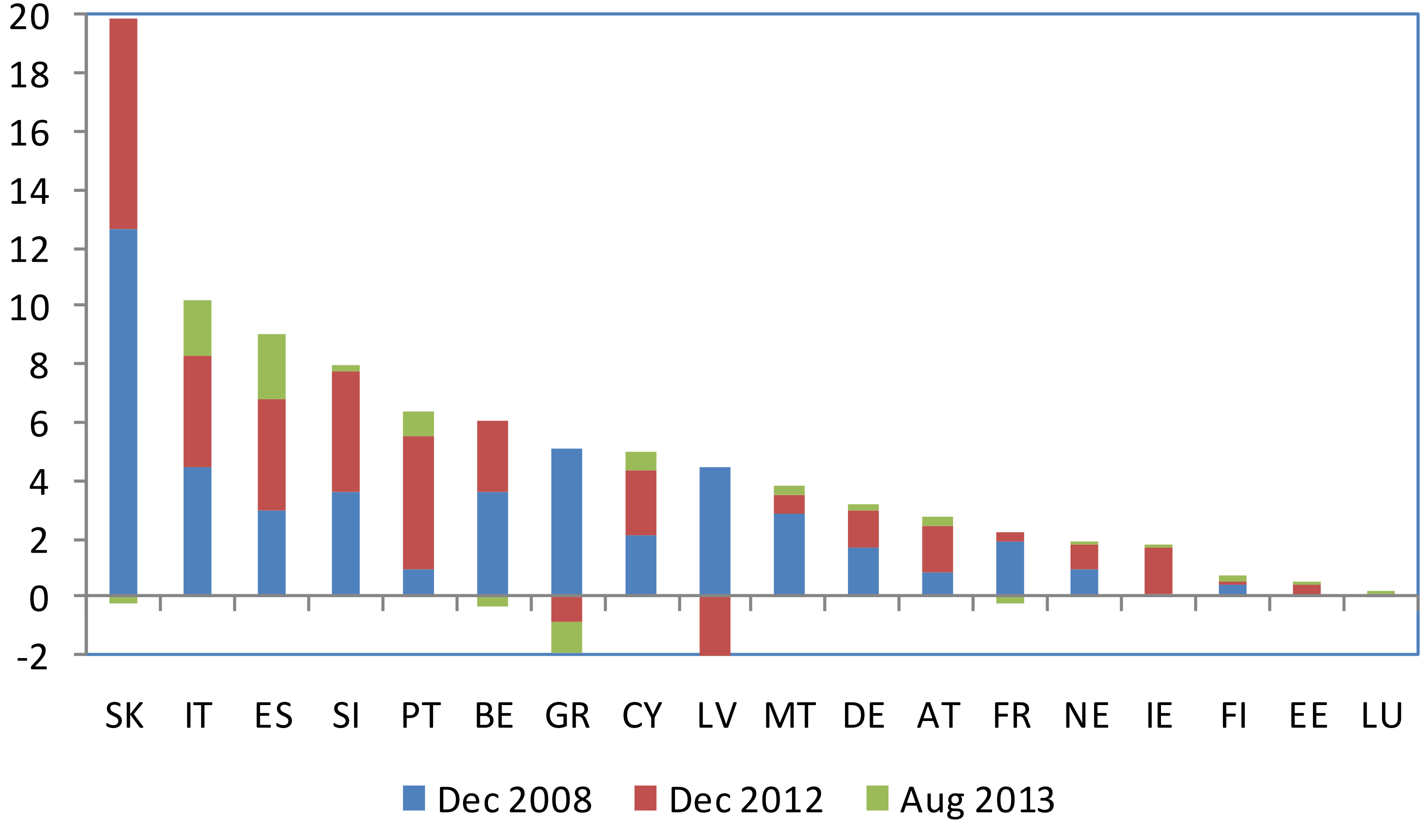
Banks and their sovereign exposures (1)

- Lower exposure to government debt would also reduce the potential for a vicious circle.
- However, current regulations provide strong incentives for banks to add even more government bonds to their books (not a single one acting in the opposite direction).
- Capital charges on sovereign exposures range from low to zero:
  - The debate on the appropriateness of such preferential treatment has been put on hold in the EU (until after the crisis).
  - Higher government bond holdings represent a simple way to lower RWAs and capital charges in the face of stricter capital regulation.
- New liquidity regulations (LCR, NSFR) make the role of government bonds even more central:
  - Government bonds in domestic currency will serve as prime High Quality Liquid Assets.
  - These will also serve as a key source of collateral for operations with central banks.

Banks and their sovereign exposures (2)

- The share of government bonds in banks' balance sheets differs a lot, but it has generally been growing.

Comparison of MFIs´ domestic sovereign exposures (% of total assets)

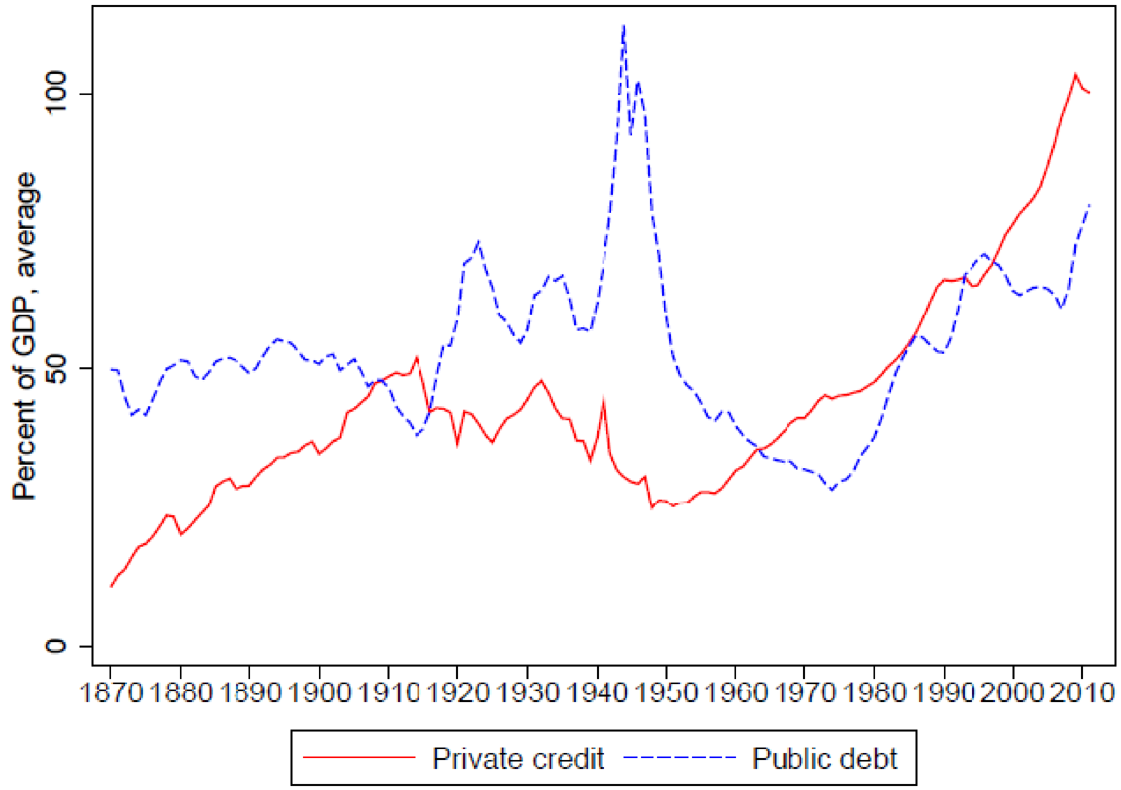


Source: ECB, CNB calculation

Public debt should not be viewed in isolation from private debt (could even be substitutes)

- Private credit/debt is extremely high in historical terms in advanced economies.
- The euro area is leading in debt, with public debt at 95% of GDP and private debt at 125% of GDP.

Figure 1: Public debt and bank credit to private non-financial sector, 1870–2011



Notes: The sample period is 1870–2011 and the annual averages are shown for 17 advanced countries. Total private credit is proxied by total bank loans to the nonfinancial sector, excluding interbank lending and foreign currency lending based on Schularick and Taylor (2012) and updates thereto. Public debt is the face value of total general government debt outstanding.

Source: Jordá, Schularick and Taylor (2013)

SSM and SRM (1)

- The setting-up of the Single Supervisory Mechanism (SSM) is at an advanced stage:
  - From November 2014, the ECB is expected to directly supervise 130 credit institutions (almost 85% of total banking assets in the euro area).
  - ECB is checking the books now and communicates that it will be tough.
  - The remaining credit institutions (6,000 or so) will still be supervised by the national authorities with a role for the ECB as well.
- The Single Resolution Mechanism (SRM) is a set of rules and procedures for the resolution of distressed banks.
  - Under preparation, some issues are still to be agreed, but a resolution fund will be created for sure.
  - A Single Resolution Board (SRB) will work on resolution plans and assess the resolvability of banks, while the national authorities will be responsible for the practical aspects of the resolution.
  - A Single Resolution Fund (SRF) will be established and funded over a period of 10 years with contributions from the banks on national levels.

SSM and SRM (2)

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- A bail-in tool should apply from 1 January 2016 so as to reduce the need for public funds for resolution purposes.
- The rules regarding bail-in and the use of the SRF look rather strict:
  - The SRF may cover losses and help to recapitalize institutions if a bail-in of at least 8% of total liabilities has previously taken place.
  - Contributions from the SRF should not exceed 5% of the total liabilities of the bank (with some flexibility in systemic cases).
  - If 5% is not enough to fill the hole, funding may be sought from other sources such as the ESM.
- How much money is available?
  - National levies of at least 1% of covered deposits would provide up to EUR 55 bn over 10 years to the SRF.
  - Even after 10 years, the SRF will thus be unable to handle major failures without a further backstop.
  - The ESM is expected to provide up to EUR 60 bn to recapitalize weak banks.

Complexity of regulatory and supervisory structures (1)

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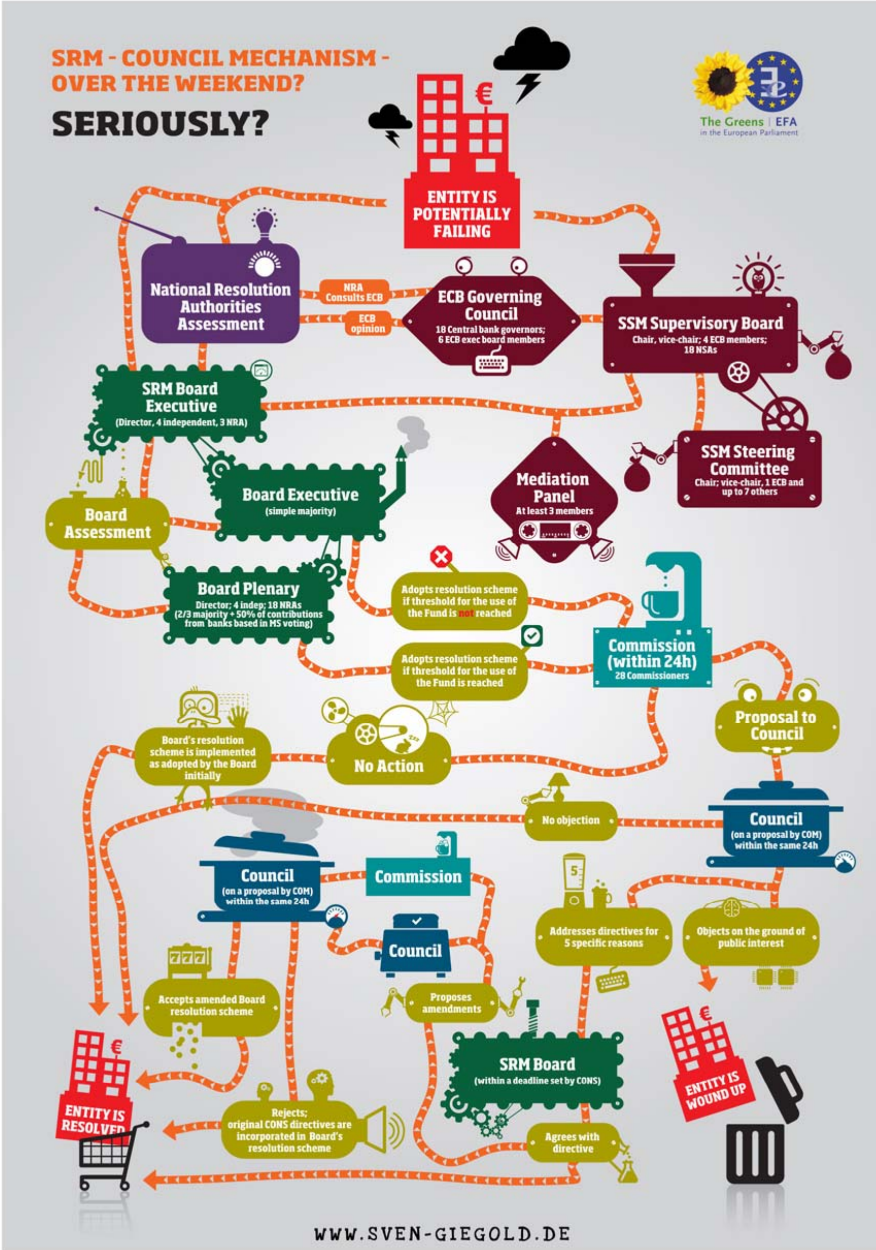
- The system is becoming too complex to make sure it won't happen again:
  - Too many bodies involved (EU structures, national authorities, ECB+SSM+SRB+SRF+ESM+EBA+ESMA+EIOPA, …).
  - The capacity of key experts and decision-makers will be consumed by communication, coordination, information sharing, travelling: will they have time to do their homework?
  - The interplay of the kind outlined between the ECB and national authorities in supervising large banks is untested.
  - The two-tier approach to less important banks may also be a slow-going process.
  - The Single Resolution Mechanism does not promise speed with so many parties who have a say (see the next slide).

Complexity of regulatory and supervisory structures (2)



Is BU breaking the waves? (1)

- BU is not starting from a clean table, the initial conditions do matter.
  - Significant “legacy” assets to be shared (mutualized).
  - A large scale of debt in all sectors.
- The initial wishful thinking was to break the nexus by moving excessive debts up to the EU level and creating quasi-U.S. fiscal status.
  - There has never been willingness to share these debts.
- In a monetary union without a fiscal union, with feeble economic growth, with large public/private debt and a bulky banking sector, the vicious loop can hardly be broken by declarations without securely funded schemes.
  - A working approach to get out of a banking crisis has historically been cleaning balance sheets first, reducing indebtedness, and setting up a new framework afterwards.
  - The euro area is attempting to do it in the opposite order, which is time-consuming (remember the crisis started in summer 2007).

Is BU breaking the waves? (2)

- On paper, the bail-in tool looks like a step in a good direction, but …
  - may not work so well in practice, bail-out could sometimes be easier;
  - may be suited to isolated cases, not so much to a systemic crisis;
  - could have potentially harsh unexpected impacts if implemented on a larger scale;
  - will change the behaviour of (potential) creditors and shareholders in a way that is difficult to estimate.

Is BU breaking the waves? (3)

- The banking union may be no panacea, because …
  - it addresses only some sources of the nexus (bail-in and the resolution fund may reduce future contingent fiscal liabilities; better supervision may reduce credit risk in some cases),
  - some sources are not addressed (such as sovereign exposures), and being under the illusion that they are may turn out costly,
  - the idea that banks will be supervised at the banking union level and resolved at the national level is far from risk-free,
  - there is no credible mechanism that would restrict less responsible governments from issuing more debt in good times.

- Breaking the vicious circle between banks and their domestic sovereigns thus remains a long-term objective for the euro area.

Is BU breaking the waves? (4)

- What can break the nexus if not the banking union as agreed now?
  - Financial repression (CNB FSR 2010/2011, Box 1, pp. 23–24).
  - Central banks – monetization and higher inflation.
  - Accelerated economic growth.
  - Agreement on mutualization combined with mechanisms above.

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