



OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

EMU Architecture and Governance of Finance

POLICY PERSPECTIVES FOR EUROPEAN INTEGRATION

wiiw seminar series

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“The parallels between Europe in the 1930s and Europe today are stark, striking, and increasingly frightening. We see unemployment, youth unemployment especially, soaring to unprecedented heights. Financial instability and distress are widespread. There is growing political support for extremist parties...”

Bradford DeLong and Barry Eichengreen 2012

Structure

Why were European Banks so Heavily Affected by the Crisis?

Design Features of the Euro Area and the Role of Banks

Governance and Regulatory Reform in EMU

Regulatory Reform – Overview and Assessment

Banking Union

Capital Market Union

Overall Assessment

Challenges Ahead

Why were European Banks so Heavily Affected?

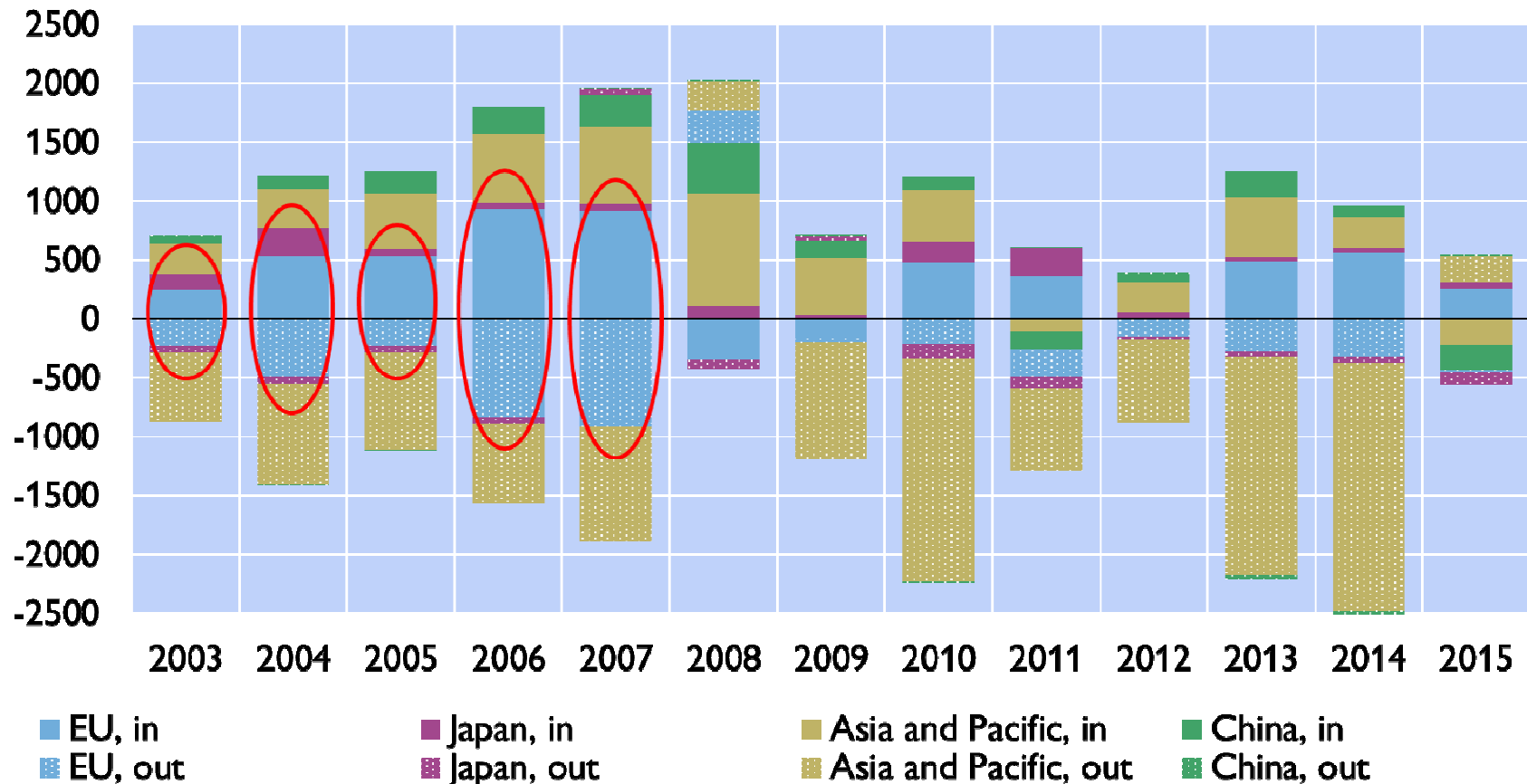
- **Fundamental transformation process** towards the development of **liquid, securitized financial markets**, supported by a large-volume integrated **wholesale market** and **off-balance sheet vehicles** that were used by banks to leverage up their balance sheets at low cost
 - **Relative weight of activities of (large) banks has shifted from deposit taking and lending towards market making activities and own account trading**
 - **Loans to households and firms as well as deposits of non-banks made up less than 1/3 of the aggregate balance sheet of EU banks**
 - **This was accompanied by a sharp growth in shadow banking activities, a rise in complex derivatives and repo markets, increased interconnectedness and leverage**

Why were European Banks so Heavily Affected?

- Global European banks increasingly engaged in round-tripping across the Atlantic

Gross Capital Flows to and from the US

in bn. USD

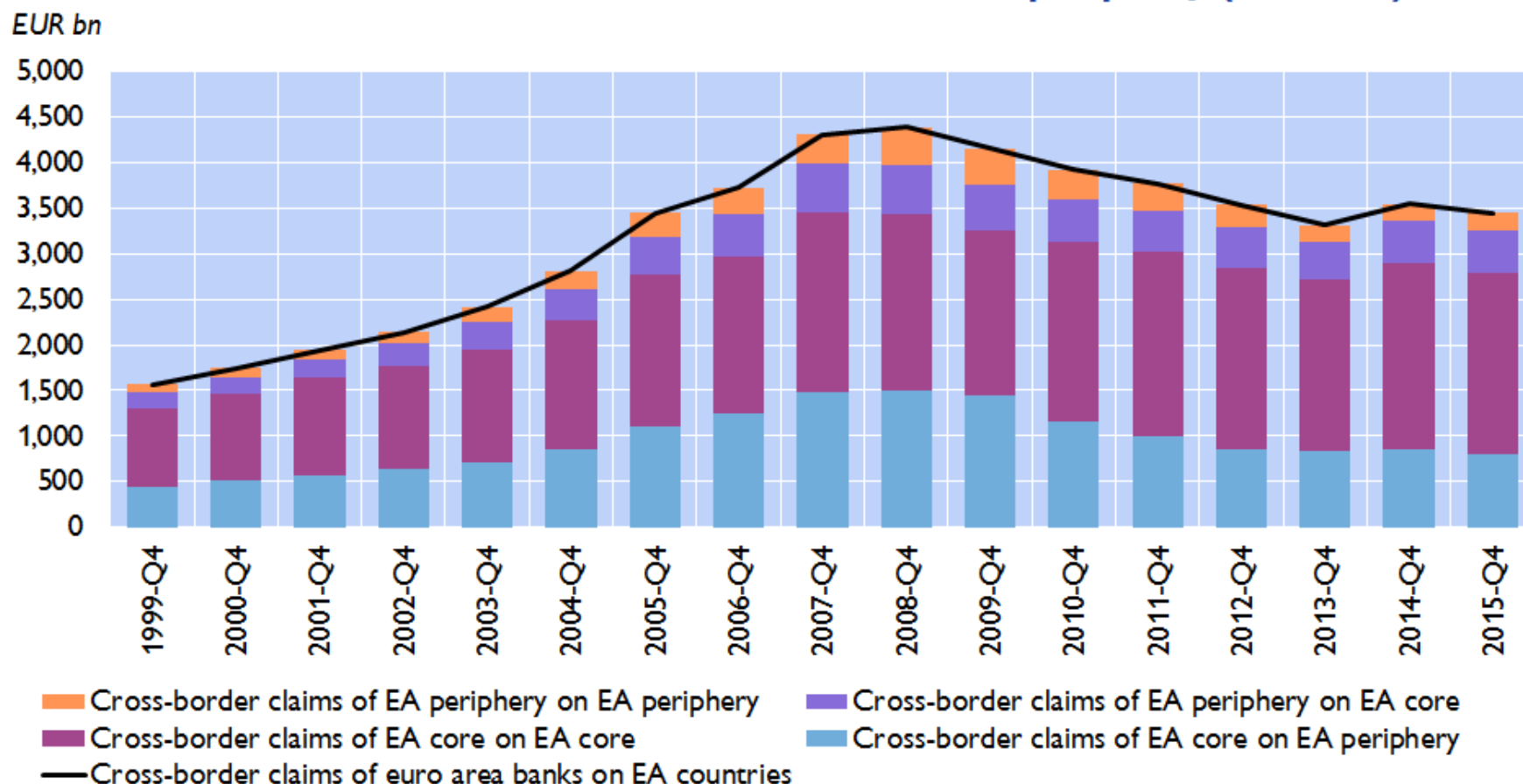


Source: U.S. Bureau of Economic Analysis.

Why were European Banks so Heavily Affected?

- Explosive growth of cross-border banking within the euro area

Cross-border claims of euro area banks on EA core and periphery (intra-EA)



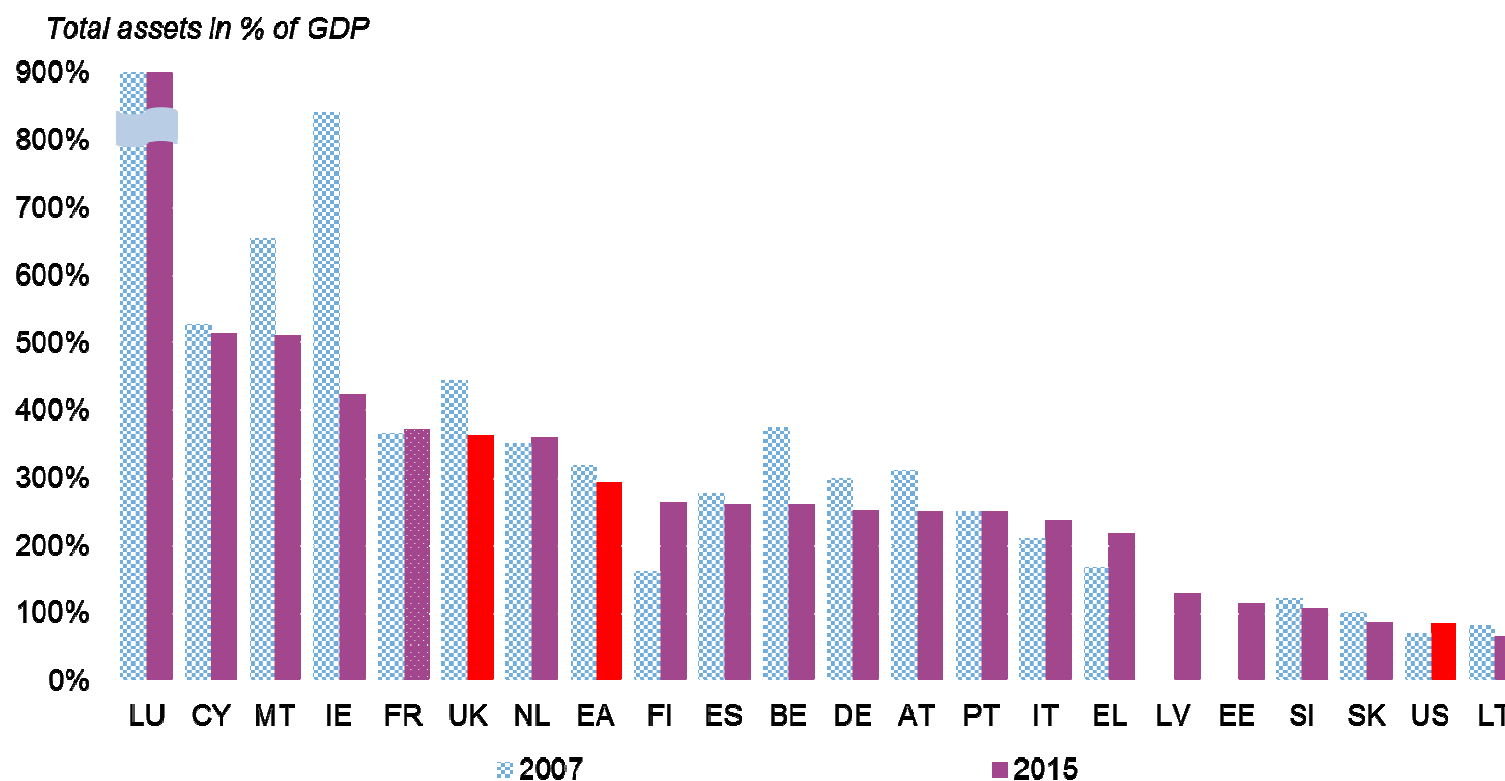
Note: Euro area periphery consists of Cyprus, Greece, Ireland, Italy, Portugal and Spain. Euro area core consists of the remaining EA countries, whereby Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia do not report data to the BIS.

Source: BIS locational banking data.

Design features of the euro area and the role of banks

- **Global banks – national supervisors**

Chart 3: Size of the banking sector in EA, UK and US



Source: ECB, Eurostat, FRED St. Louis.

LU: 2007: 31.800%; 2015: 1.548%.

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Design features of the euro area and the role of banks

- **Sovereigns and banks** in monetary union issue **debt** in ‘**foreign currency**’ (De Grauwe and Ji 2013)
 - **Governments cannot guarantee that liquidity will always be available to roll over government debt**
 - **Sovereign credit of the (weaker) member states is more exposed to the risk of liquidity runs, contagion and self-fulfilling default**
 - **Banks in the (weaker) member states are more exposed to the risk of bank runs – lack of common deposit insurance particularly harmful**

Design features of the euro area and the role of banks

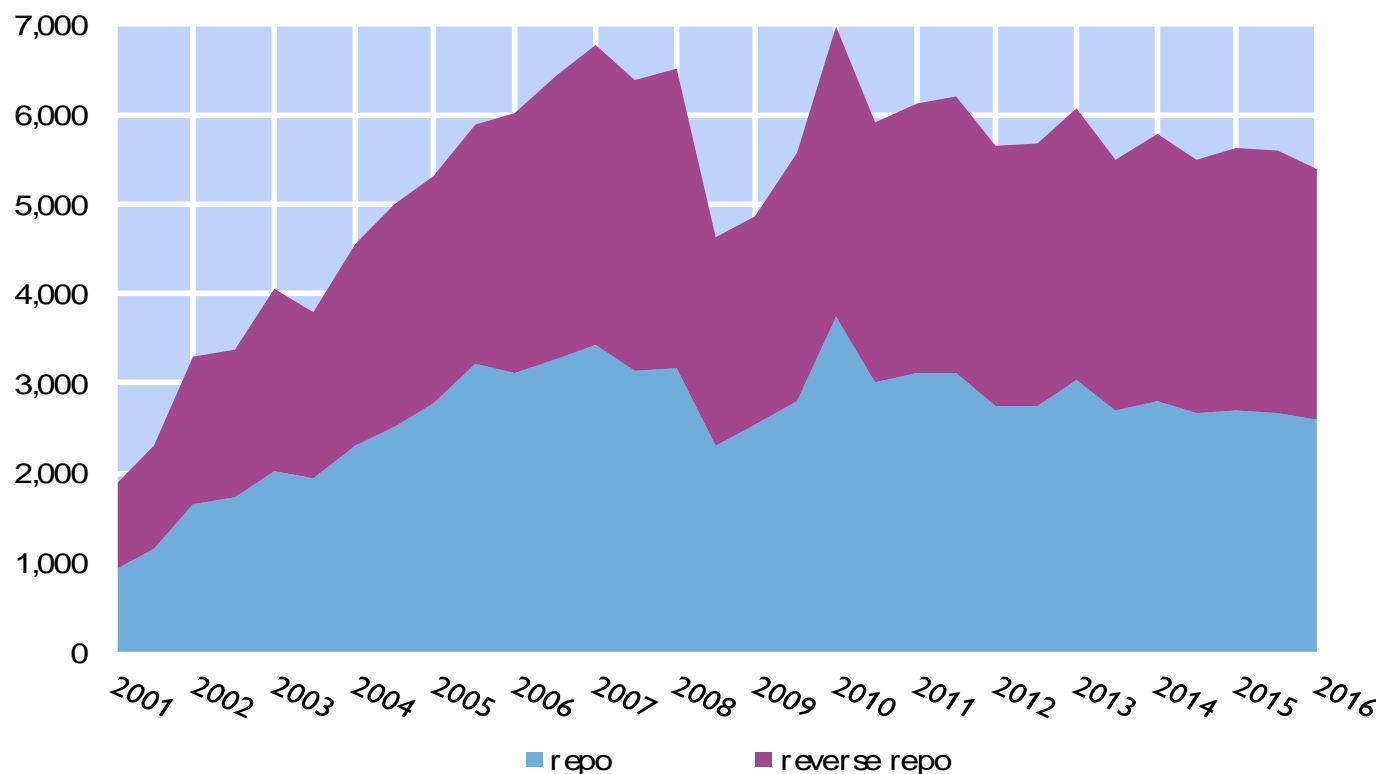
- **“Shadow-Fiscal”-Nexus is potentially destabilizing government debt markets**
 - Reliance on short-term repos that are to a large part collateralised **with government bonds** turned sovereign debt into a crucial tool for financing banks’ expansion strategies.
 - The fortune of sovereigns hinges, via the repo market, on shocks to short-term funding of global banks
 - In a currency union with many sovereigns not backed by their central banks, individual sovereigns are at the mercy of the multiple actors in the repo market

Design features of the euro area and the role of banks

- **“Shadow-Fiscal”-Nexus is potentially destabilizing government debt markets**

Total repo business

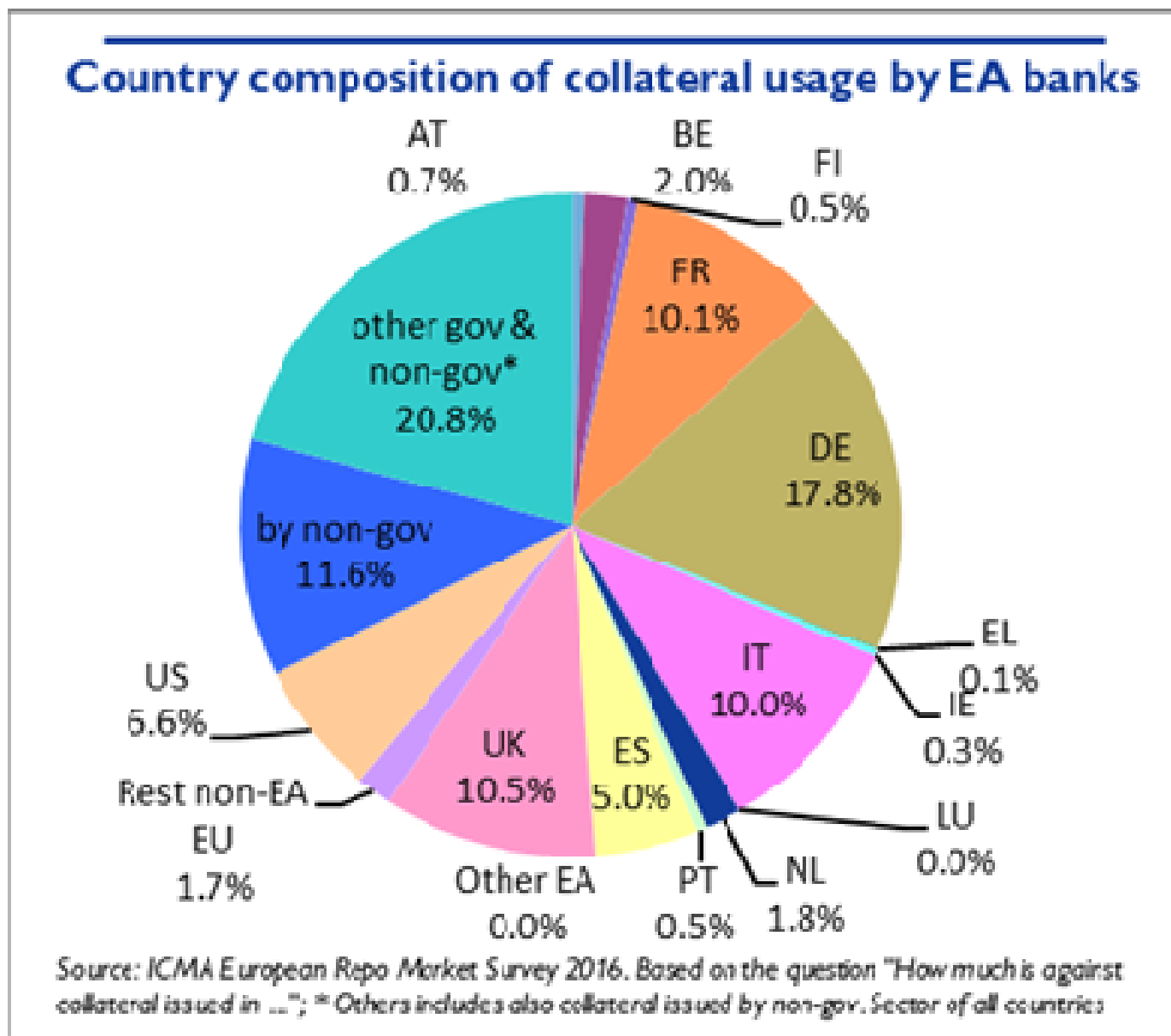
EURbn., value of outstanding (gross) transaction as of June 2016



Source: ICMA 2016.

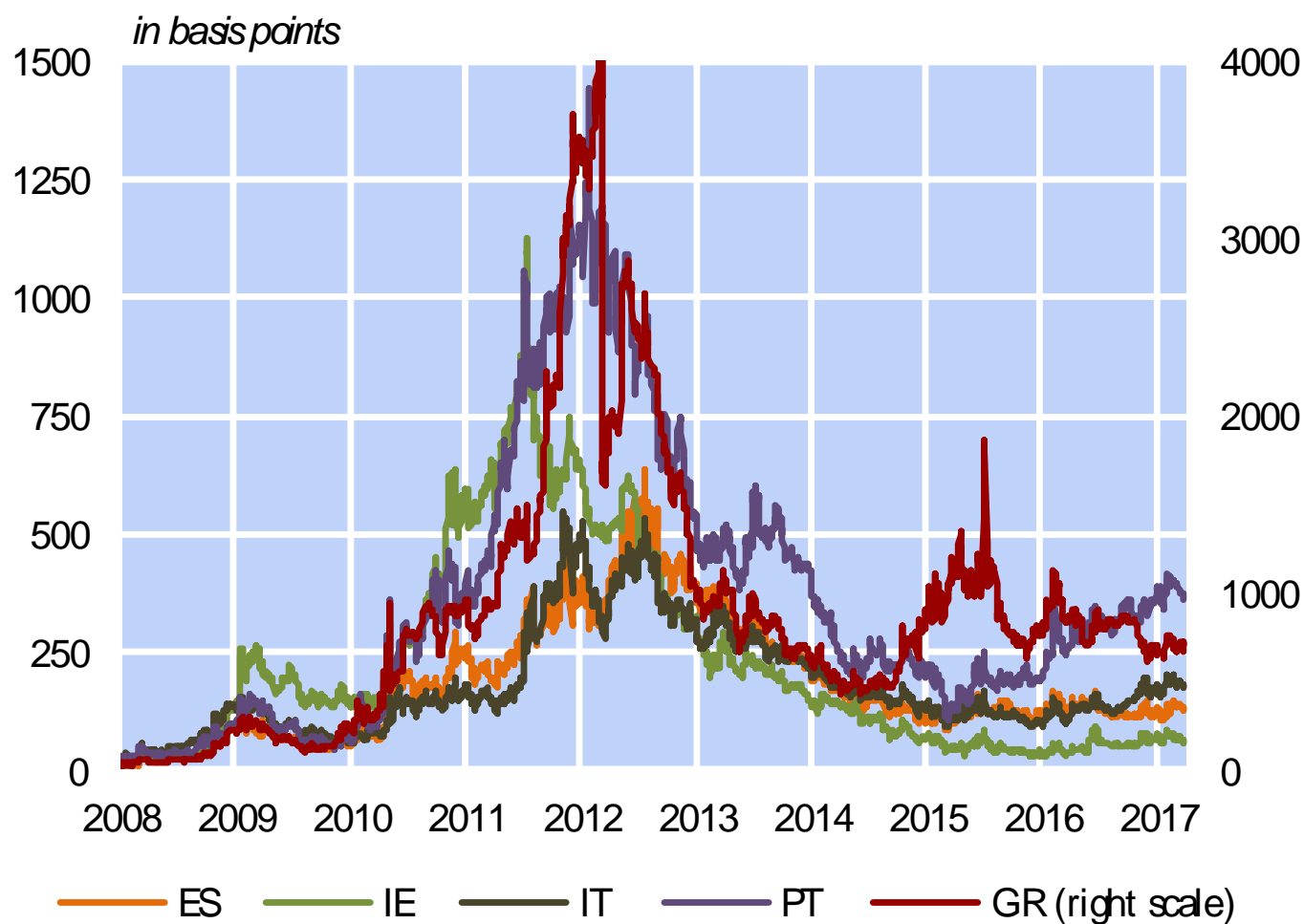
Note: Repo transactions by central banks excluded from survey; based on question "What are the total gross values of cash due to be repaid by you and repaid to you on repo transactions maturing after survey date?"

Design features of the euro area and the role of banks



Design features of the euro area and the role of banks

Spread of 10Y government bond yields vis-à-vis Germany



Source: Thomson Reuters.

Regulatory Reform – Overview

Implemented

Credit Rating Agencies
 Hedge Funds
 Securitisation
 Basel III
 Systemically important Financial Institutions
 Derivatives
 Remuneration of Managers
 Recovery and Resolution Framework
 New Financial and Supervisory Architecture
 Banking Union

- Single Supervisory Mechanism
- Single Resolution Mechanism and Single Resolution Fund

Work in Progress

Banking Union

- Single Deposit Guarantee Scheme

Bank Structure Reform
 Shadow Banks
 Capital Market Union
 Taxation of the Financial Sector

Structure

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Regulatory Reform - Assessment

Market Failure in the Financial System

Financial System as Source of Economic Shocks

'Leverage Cycle'

- The credit cycle is amplified by risk management and regulatory techniques, insofar as these techniques rely on market price valuation.

'Irrational Exuberance Bubbles'

- Asset price swings are related to exuberant expectations about economic prospects, herding behavior, and in particular myopia
- Certain structural features of financial markets further encourage short-termism (e.g. high frequency trading)

Waste, Opaqueness, Complexity

Poor intermediation function of the financial system

- Strong credit expansion relative to GDP growth mainly reflected residential mortgages and leverages purchases of already existing assets.
- Rapid rise of credit largely refinanced by short-term funding

'Too big to fail'

- Relevant criteria are the size, interconnectedness, and presence in key financial markets (concentration)

Excessive rents

- Reflecting lower refinancing costs due to too-big-to-fail
- Excessive rent seeking in financial markets may divert scarce skilled resources to the financial sector

Inefficient Distribution of Risk

Recent innovations have increased interconnectedness and correlation of risks in the banking system

- Credit Derivatives
- Securitized Products

Market Failure in the Financial System	Regulatory Initiatives	Assessment
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1. Financial System as Source of Economic Shocks

Leverage Cycle

Basel III, Macroprudential instruments (countercyclical capital buffers, loan to value ratios, loan to deposit ratios)

- **Focus on banking system: migration of risks to the shadow banking system**

Irrational Exuberance Cycle

Higher capital requirements for the bank book, Volcker-Rule, FTT

- **Modest Regulation**
- **Dominance of efficient market hypothesis**

2. Waste, Opaqueness and Complexity

'Too Big To Fail'

Higher capital requirements for systemically important banks, Bank resolution mechanisms, bail-in Instruments, bank structure reform

- **Focus on banking system**
- **Proposal for bank structure reform of the EC no political majority**

Excessive Rents

Remuneration, bank levies, FTT

- **Modest form of regulation (i.e. no absolute limits)**

Poor intermediation function of the banking system

Higher risk weights for mortgage loans, Loan-to-Value-Ratios

- **Principle: no public interference with the credit allocation decisions of the private sector.**

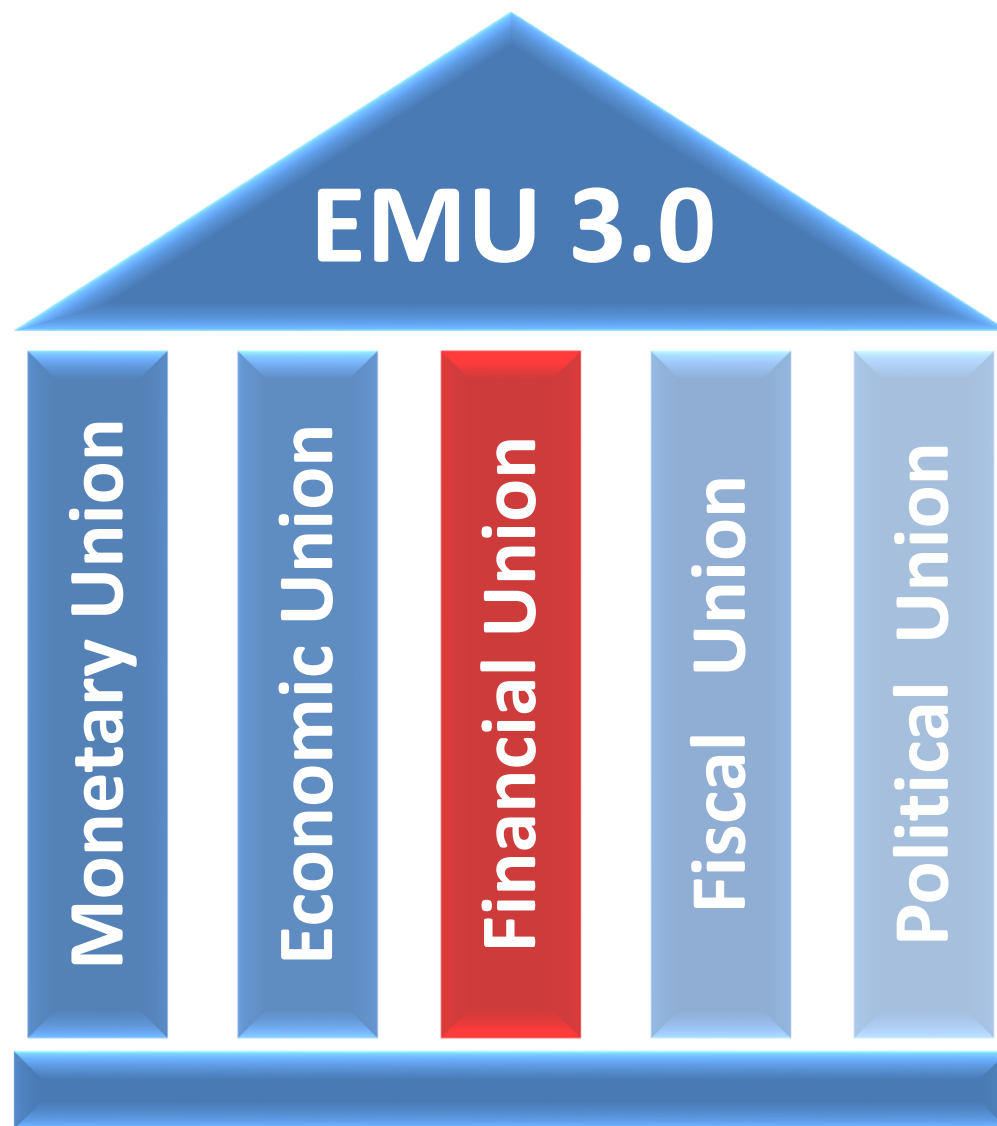
3. Inefficient Redistribution of Risk

Regulation of derivatives (Central Counterparty Platforms, Trade Repositories)

- **Principle of self-regulation still dominant (transparency)**

Banking Union in the Making

The 5 President's Report (2015)



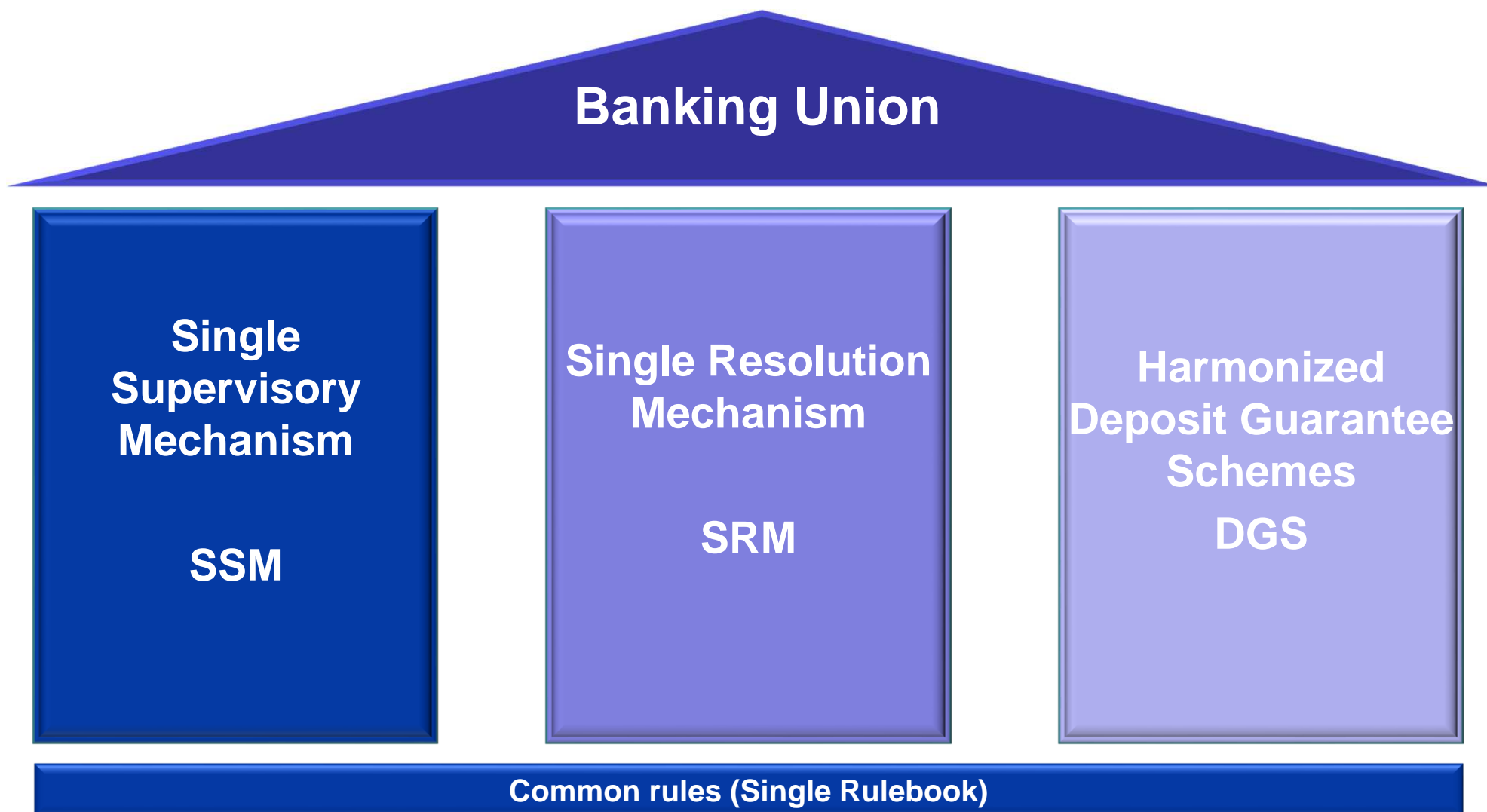
Governance and Regulatory Reform – Banking Union

Rationale of the Banking Union

- **Breaking the Sovereign-Bank Nexus – Reduction of fragmentation**
- **Minimization of Safe Heaven Flows**
- **Minimization of “Regulatory Capture”**
- **Avoid bank bailouts with taxpayer’s money**
- **Catalyst for deepening European Monetary Union**

Governance and Regulatory Reform – Banking Union

Three Pillars



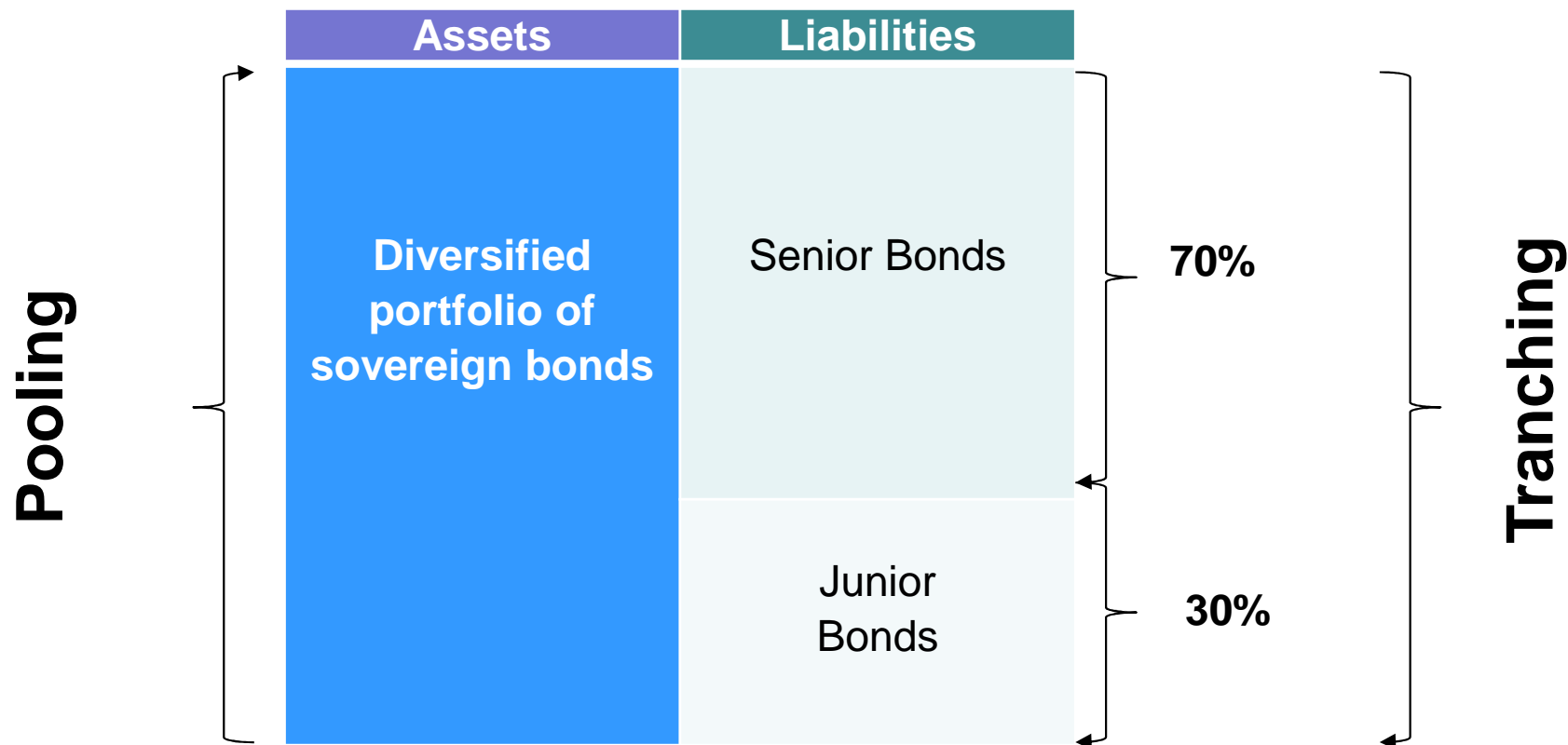
Governance and Regulatory Reform – Capital Markets Union

Capital Market Union (CMU) – Focus on private capital markets

- **Less dependence from banks**
 - **New class of infrastructure investment**
 - **Facilitate securitization**
 - **Venture capital: facilitate mutual funds**
- **Critique:** By strengthening shadow bank entities and shadow bank activities of large banks CMU might **increase financial instability** and might even jeopardize the goal of de-risking banks

Governance and Regulatory Reform – Capital Markets Union

Focus on public capital markets – European Safe Bonds



Governance and Regulatory Reform – Capital Markets Union

European Safe Bonds - Motivation

- **Mitigation of euro area fragmentation without mutualisation of risk**
- **Greater portfolio diversification**
- **Integration of public capital markets**
- **Strengthen stability of the banking sector**
- **Improvement of transmission mechanism of monetary policy**
- **Provision of a highly liquid European safe asset category**

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Overall Assessment

Much has been accomplished, but

- The G20 goal (April 2009) to „*extend regulation and oversight to all systemically important financial institutions, instruments and markets*” could not be achieved. Following stronger regulation by banks, **risks migrated to shadow banking entities**
- **Governance and regulatory reform lack some consistency:** Furthering capital market activities might jeopardize goals of a banking union, such as protecting tax payers’ money.

Overall Assessment

Much has been accomplished, but

- Regulatory reforms on resolution provided another powerful case for separation to limit the exposure of the equity base to heavy losses, i.e. in derivatives trading: **Too-Big-To-Fail banks may be too large, too complex and too interconnected to resolve over a weekend**
- The promise of a New Bretton Woods remains wishful thinking, but capital flow management instruments were included in the catalogue of macroprudential policy tools.
- **“Finance Serving Society”?**

Structure

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Challenges Ahead (I)

Completion of Banking Union

'Deposit insurance has been left in national hands with only a national back-up. But if there is a national crisis the government might not be able to provide a credible backstop for deposits (e.g., Ireland).'

Daniel Gros, Completing the Banking Union, Voxeu.org, 12 February 2016

European Safe Bonds

'Europe must formulate a strong and systemic response to the crisis, to send a clear message to global markets and European citizens of our political commitment to economic and monetary union, and the irreversibility of the euro. This can be achieved by launching or European sovereign bonds, issued by a European Debt Agency (EDA).'

Jean-Claude Juncker and Giulio Tremonti, Financial Times, December 2010

Challenges Ahead (II)

Regulation of Shadow Banking System (Entities and Activities)

„Concerns are that shadow banking entities could be part of future systemic events, also on account of their increased size and remaining opaqueness“

ECB, Financial Stability Review, Juni 2015

Separation of Retail from Investment Banks?

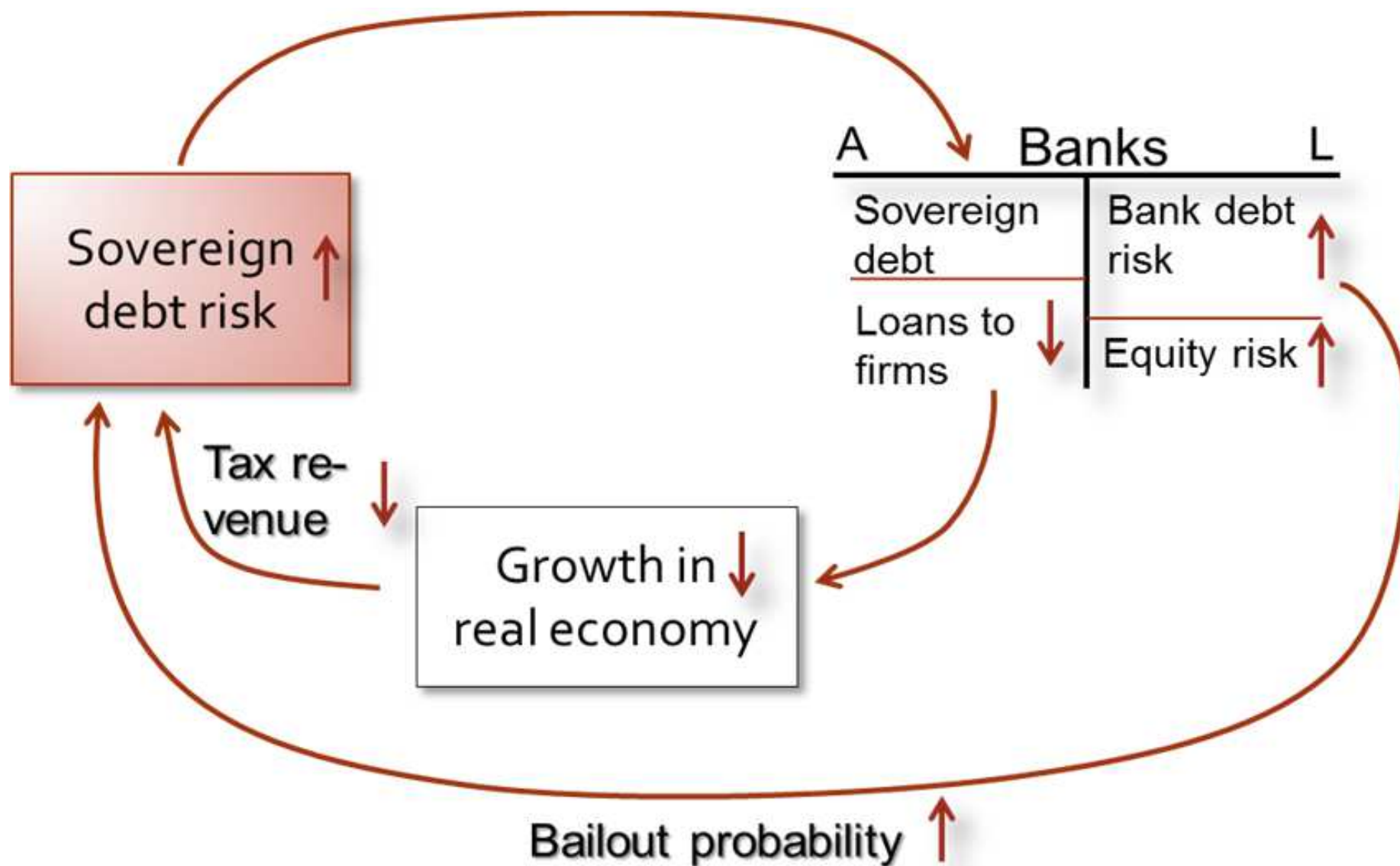
„I believe there are still doubts regarding whether the largest and most trading intensive banks in Europe can be rapidly resolved in the midst of a systemic crisis. If the structure of a bank has been simplified ex-ante, it is easier to impose resolution measures on it also in times of severe stress“

Erkki Liikanen, ECON hearing, European Parliament, 2. Dezember 2014

Additional Slides

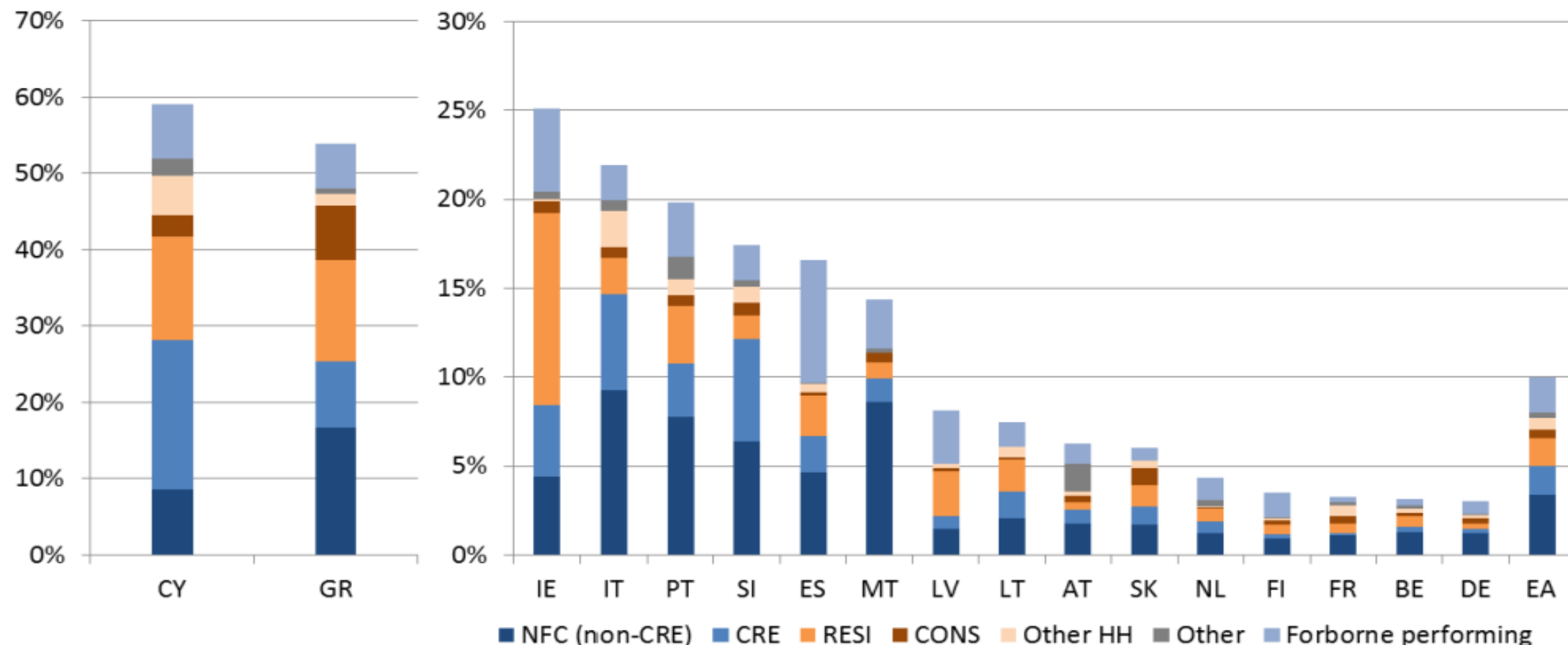
Design features of the euro area and the role of banks

Diabolic Loop between sovereign and banking risk



Design features of the euro area and the role of banks

NPL composition varies across countries



Source: ECB Supervisory Statistics.

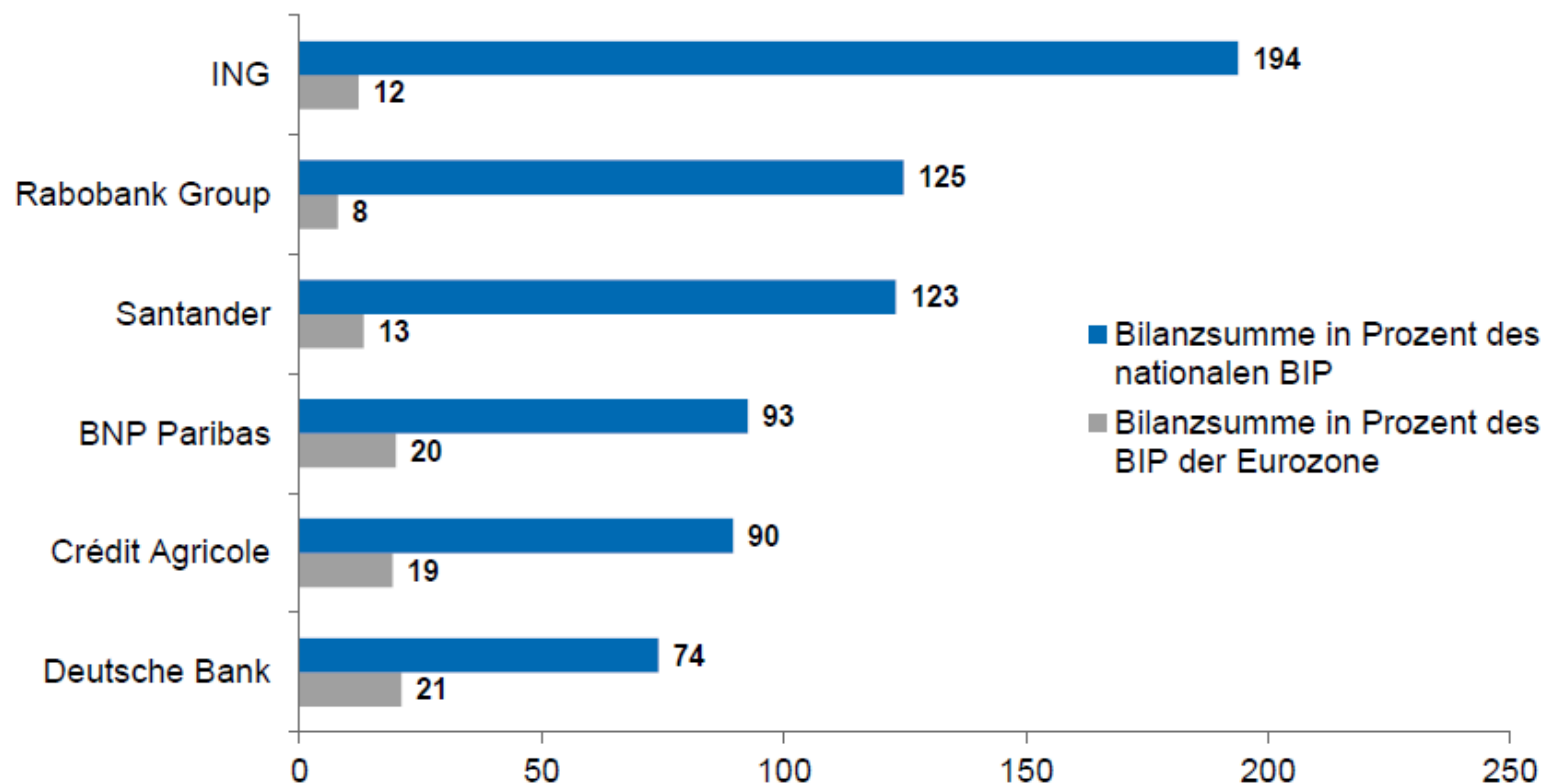
From: Martin, R., Lessons from NPL resolution in euro area countries. Presentation at the JVI, Vienna, 10-14 October 2016

Design features of the euro area and the role of banks

Banks too big to fail

Lösung von „Too Big to Fail“

Bilanzsumme in Prozent des Bruttoinlandsprodukts (BIP)



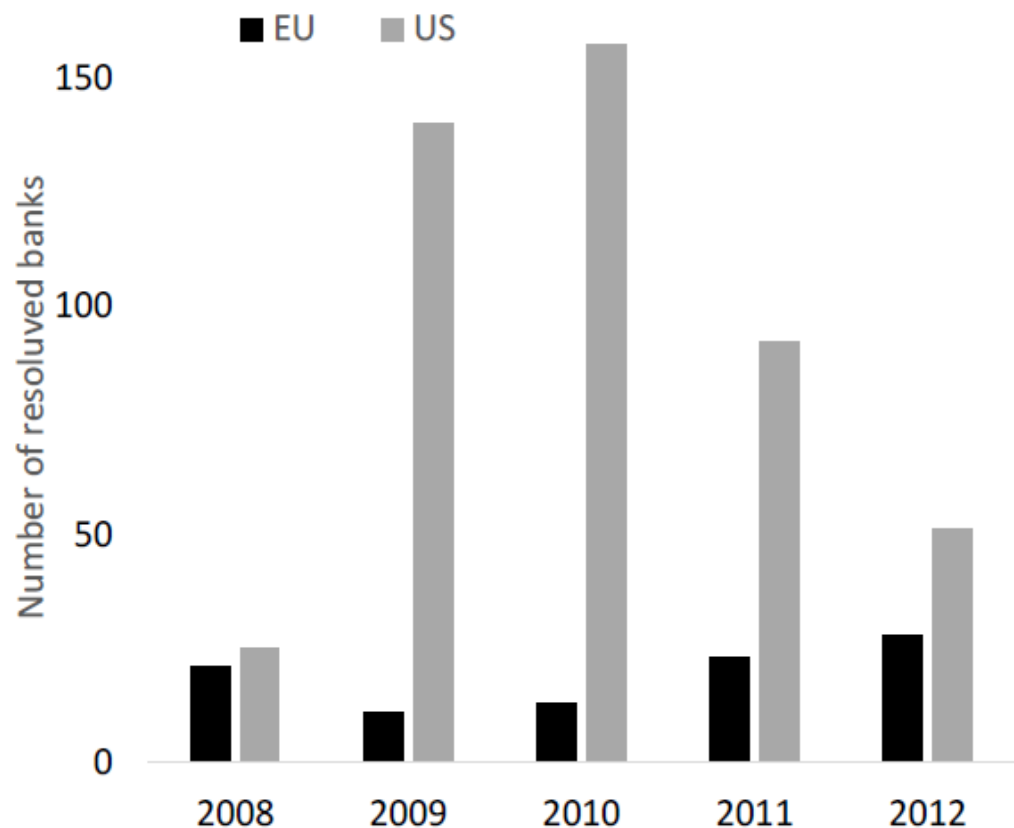
Quelle: Bloomberg, Eurostat, eigene Berechnungen

Dr. Markus Demary, Europäische Bankenunion: Stand der Umsetzung und Nachbesserungsbedarf, Berlin, 4. Juni 2014

Design features of the euro area and the role of banks

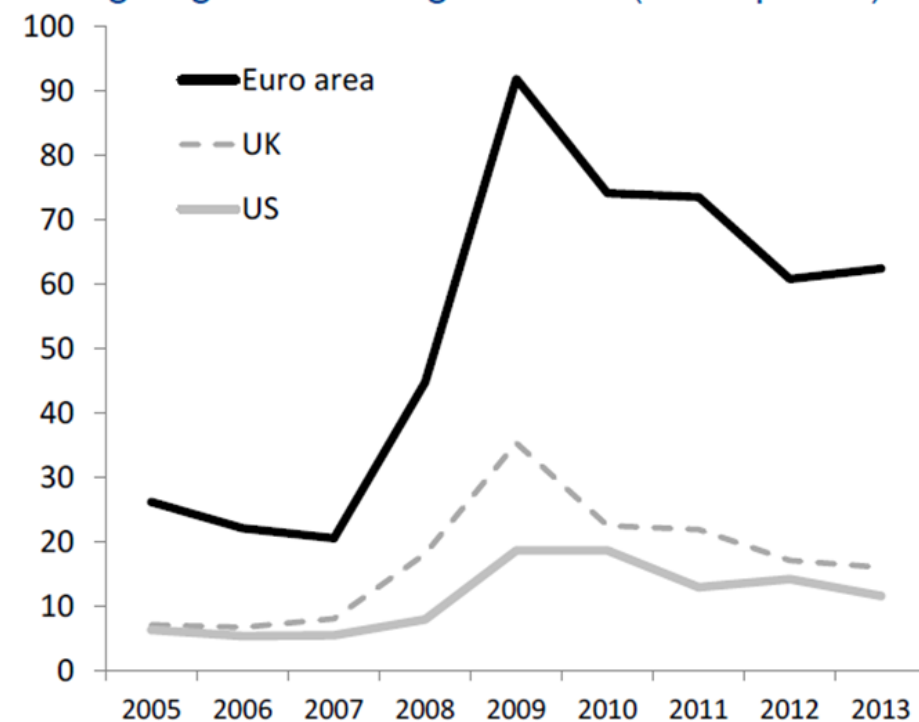
Banks too big to fail

Figure 37: Bank resolution in the US and EU



Source: FDIC and Open Economics. US data count the number of banks which failed and for which the FDIC was appointed receiver. EU data are from Open Economics, and count the total number of banks which failed (in a broad sense). EU data therefore include distressed mergers and part nationalisations; US data do not.

Figure 38: Average reduction in funding costs owing to government guarantee (basis points)



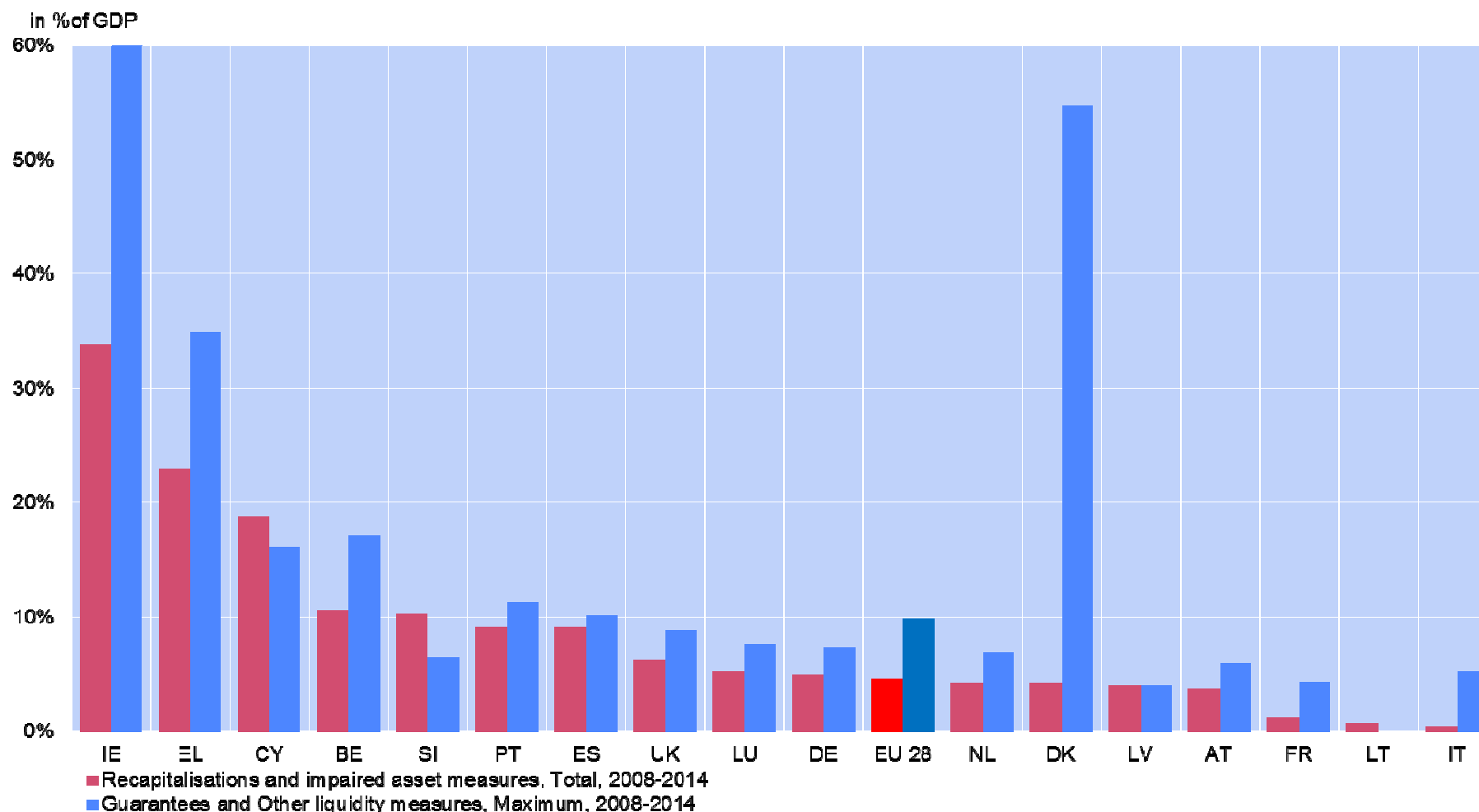
Source: Lambert and Ueda (2014). The data are taken from their Figure 3.10. The estimate of the reduction in funding costs owing to government guarantee is based on a ratings-based approach. The difference between issuer ratings and stand-alone (financial strength) ratings captures the rating uplift due to government support. This rating uplift is translated into a funding cost advantage based on historical relationships between ratings and bank funding costs (Soussa, 2000).

ESRB (2014), *Is Europe Overbanked? Report of the Advisory Scientific Committee*

Design features of the euro area and the role of banks

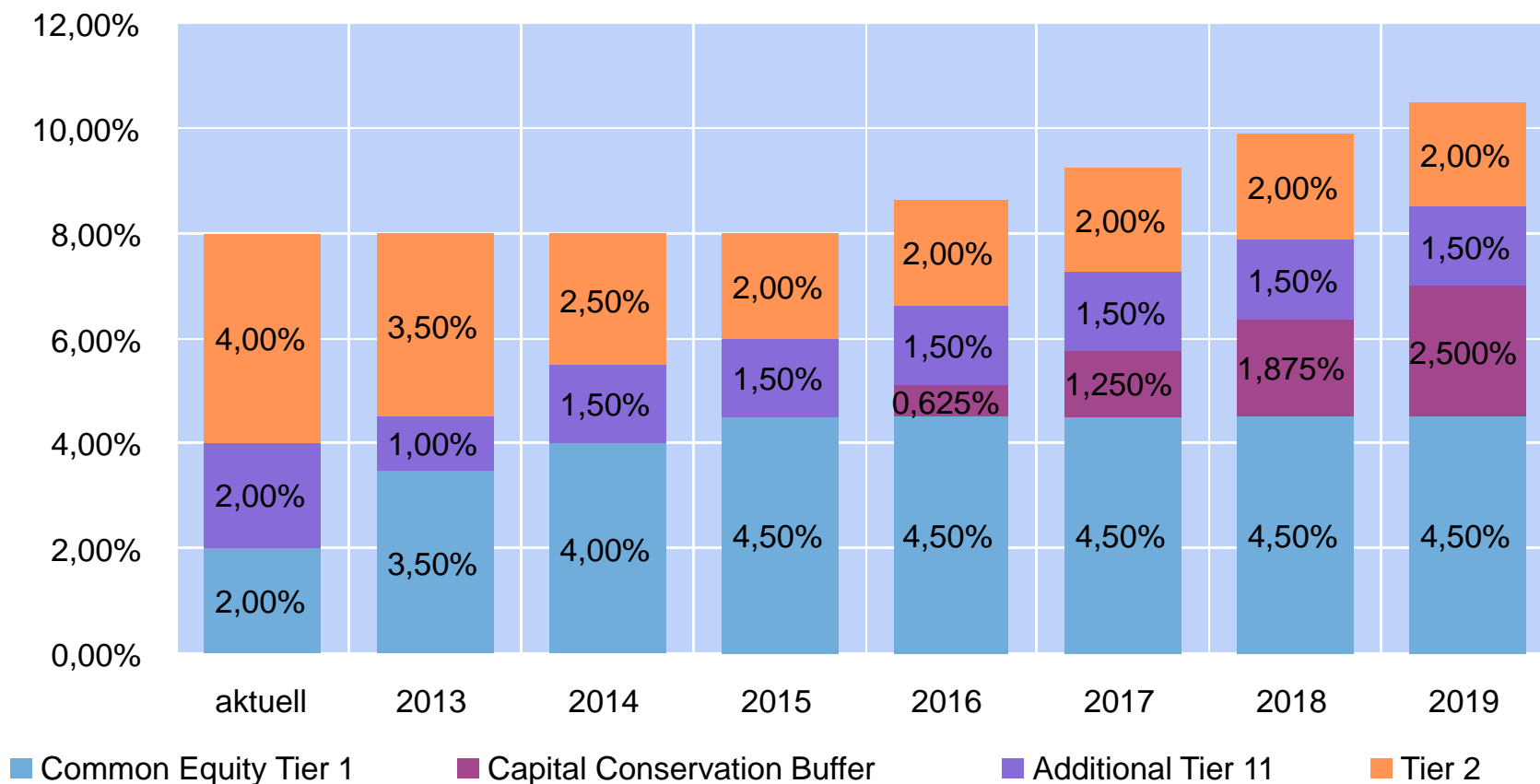
Bailouts borne by the taxpayer

Public support for the banking sector - selected economies, 2008-2014



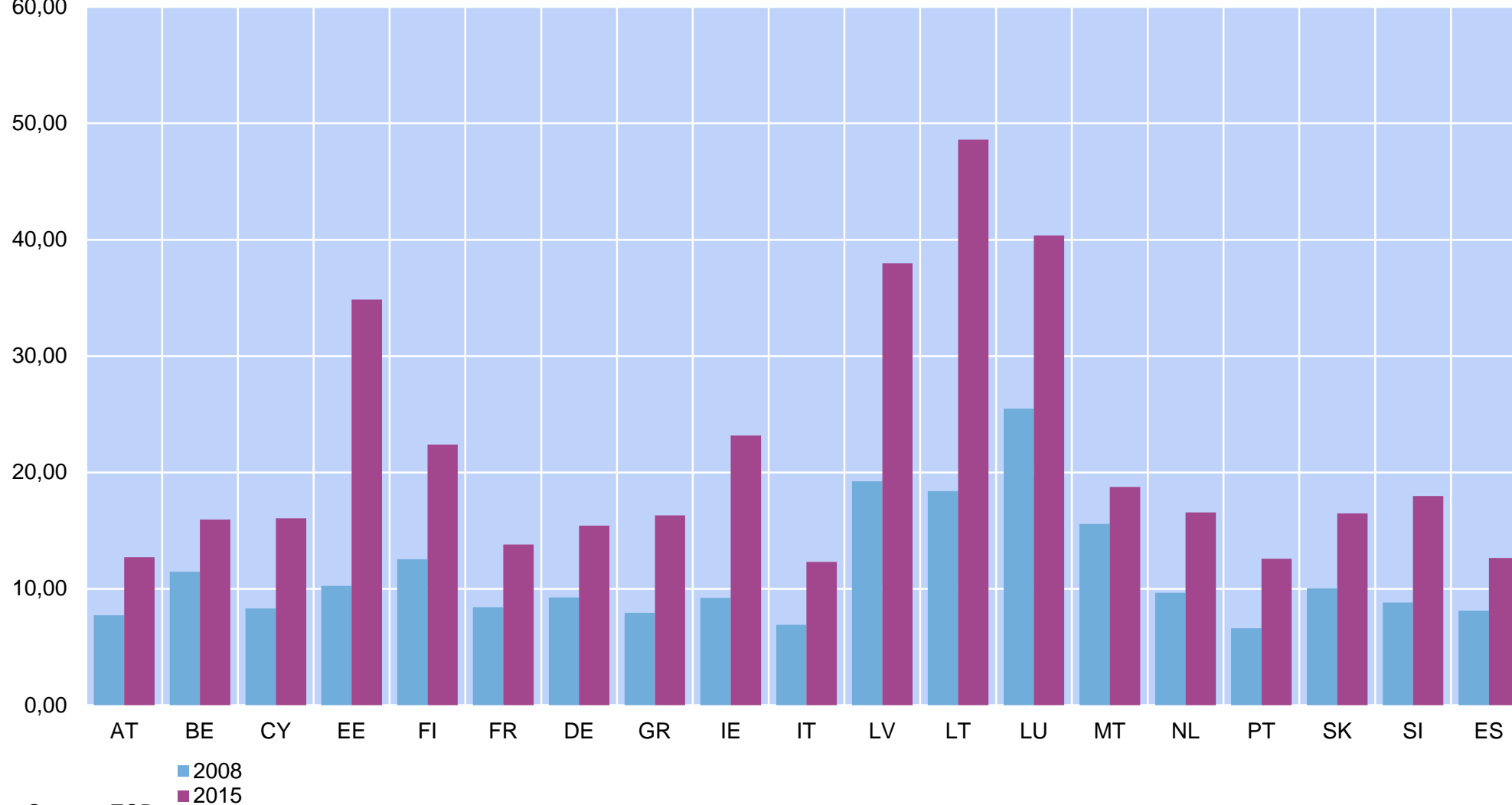
Quelle: European Commission, DG Competition.

Transitional provisions



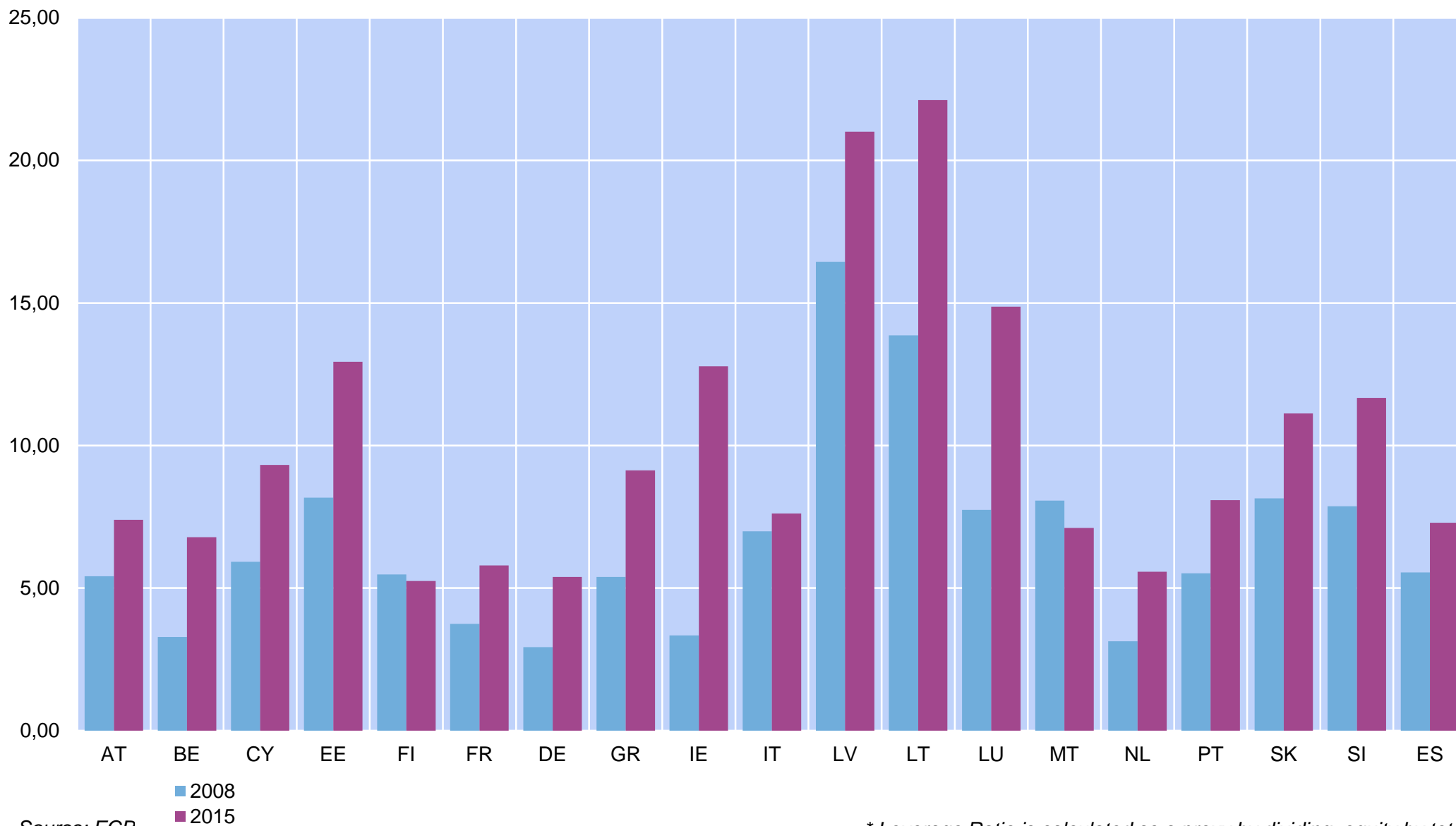
Development Tier 1 Ratio

in %



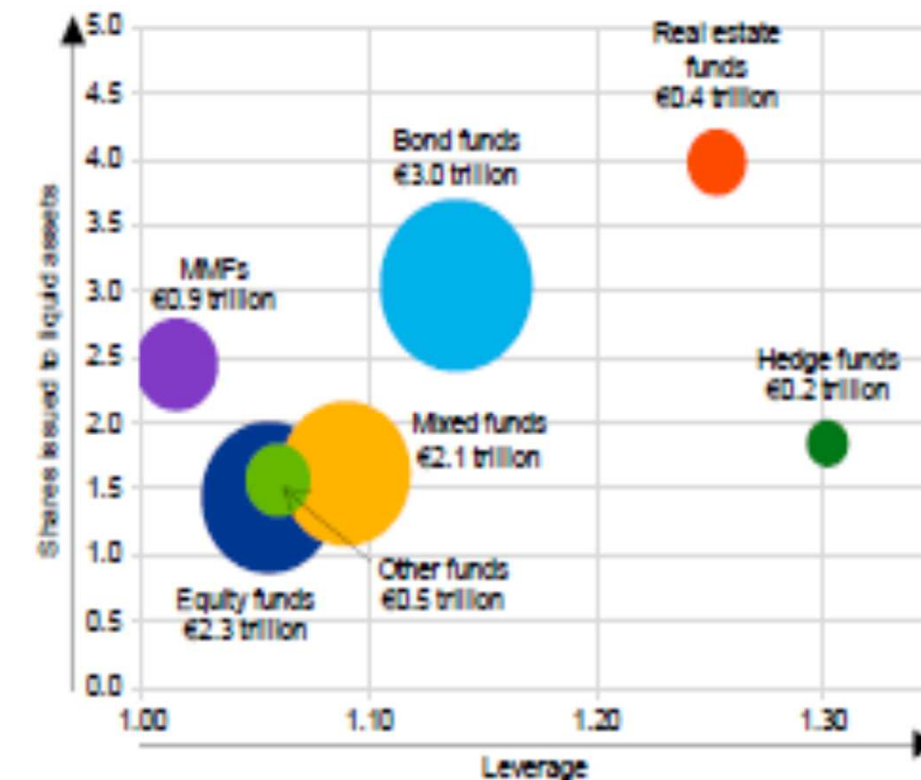
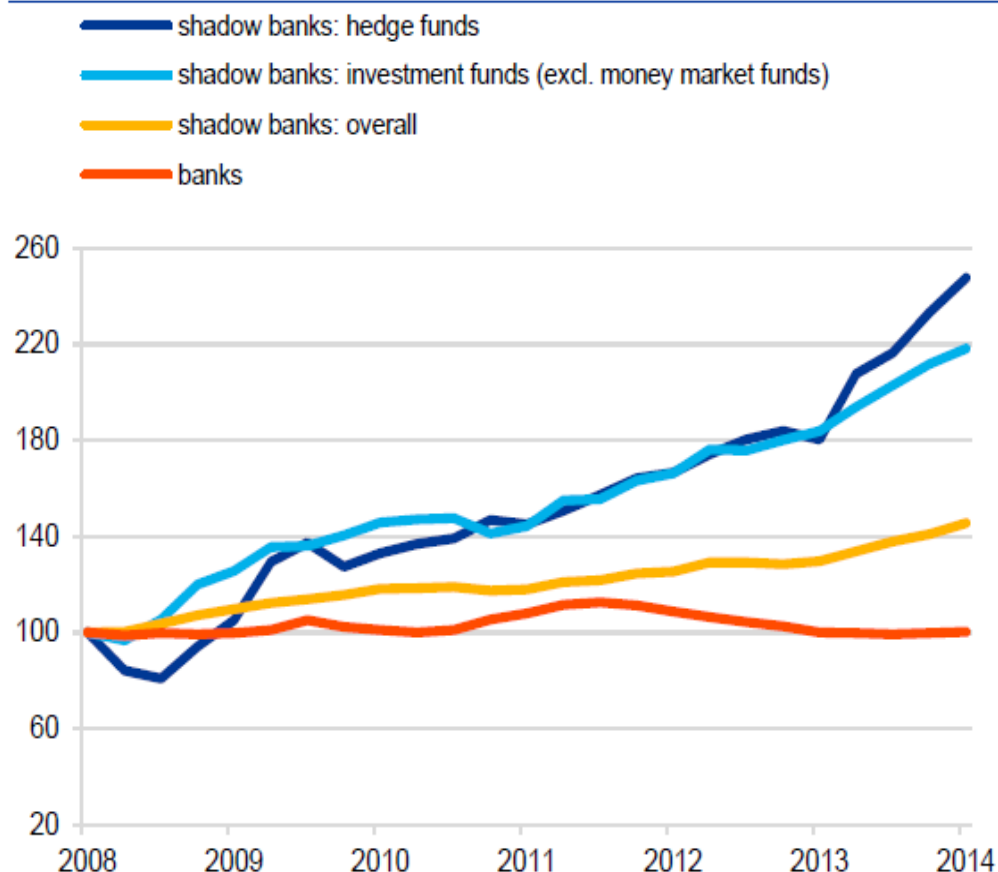
Development Leverage Ratio*

in %



Shadow Banks in the Euro Area

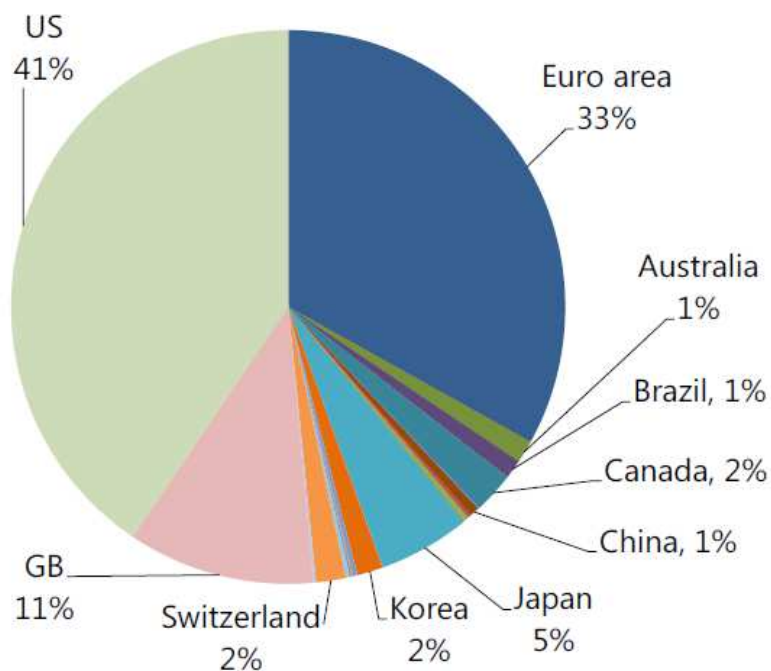
Index: 4. Quarter 2008 = 100



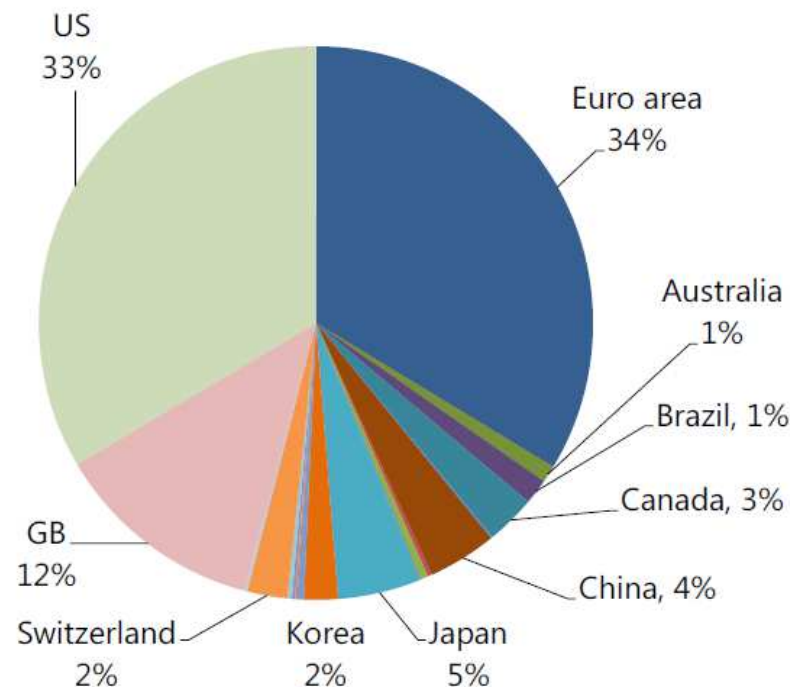
Quelle: ECB (2015), Financial Stability Review, June 2015

Non-Bank Financial Intermediaries (without insurance companies and pension funds)

At end-2007



At end-2013



Sources: National financial accounts data; other national sources.

Quelle: Financial Stability Board (2014), Global Shadow Banking Monitoring Report.

Regulierungsinitiativen in der Europäischen Union (I) – bereits

Regulierungsinitiativen	umgesetzt	Status Datum der Beschlussfassung	Kontext
1. Ratingagenturen	<ul style="list-style-type: none"> • Registrierung und Beaufsichtigung durch nationale <u>Aufsichtsbehörden</u> • Registrierung und Beaufsichtigung durch <u>ESMA</u>, Rating strukturierter Produkte • Haftung für Ratingagenturen, (Schadenersatzklagen möglich) Anreize für Finanzinstitute, eigene Risikoanalyse zu erstellen, Offenlegung der Methodologie, Harmonisierung der Ratingskala, die ESAs sollen möglichst nicht mehr auf Ratings verweisen, Regelungen zur Abschwächung von Interessenkonflikte, Rotationspflicht Beteiligungsgrenze (2%) gegen Interessenskonflikte Aber: keine Gründung einer Europäischen Ratingagentur, Krisenstaaten dürfen weiterhin geratet werden 	VO Nov. 2009 VO Mai 2011 VO-Vorschlag der EK vom Nov. 2011	G20
2. Alternative Investment Fondsmanager (AIFM) Richtlinie	Regulierung der Fondsmanager von Hedge- und Private Equity Fonds auch offene Immobilienfonds, Spezialfonds, Infrastrukturfonds, Geschlossene Fonds (KG-Beteiligungsmodelle) und Institutionelle Fonds , Registrierungs- und Meldepflichten.	R Mai 2011 Umsetzung in nationales Recht per Juli 2013	G20
3. Neue Aufsichtsarchitektur	ESRB (European Systemic Risk Board) ESFS (European System of Financial Supervisors) ESMA: European Securities and Markets Authority EBA: European Banking Authority EOPIA: European Occupational Pensions and Insurance Authority	VO Dez. 2010 VO Dez. 2010	EU Empfehlung de Larosiere
4. Verbriefung	<ul style="list-style-type: none"> • <u>CRD II: bei Verbriefung</u> mindestens 5% Selbstbehalt, höhere Eigenmittel bei Wiederverbriefung • <u>CRD III</u>: Höhere Eigenkapitalvorschriften für komplexe Verbriefungskonstruktionen 	R April 2009	G20
5. Renumeration	<ul style="list-style-type: none"> • <u>CRD III: Regelung der Renumeration</u> Orientierung der leistungsgebundenen Vergütungsbestandteile an längerfristigem Erfolg (3-5 Jahre); letzterer wird sowohl an quantitativen, als auch an qualitativen Kriterien gemessen, Beschränkung der Renumeration durch Regulatoren unter bestimmten Bedingungen 	R November 2010	G20

Regulierungsinitiativen in der Europäischen Union (II) – in

Regulierungsinitiativen	Ziel Vorbereitung	Status	Kontext
<p>6. Eigenkapitalvorschriften für Banken Änderungen der Kapitaladäquanzrichtlinie (Capital Requirement Directive, CRD)</p>	<ul style="list-style-type: none"> • <u>CRD IV (Basel III):</u> Probleme: Exzessives Bilanzsummenwachstum ohne entsprechendes Eigenkapital Prozyklizität in der Kreditvergabe Unzureichende Risikoabdeckung im Handelsbuch Zu stark auf kurzfristiger Refinanzierung aufgebautes Liquiditätsmanagement Maßnahmen: Quantitative Erhöhung der Eigenmittel Qualitative Erhöhung der Eigenmittel Höhere Eigenmittelanforderungen für das Handelsbuch Nationale „Countercyclical buffer“ - gegen exzessives Kreditwachstum Schrittweise Einführung der neuen Liquiditätsstandards und einer nicht-risikosensitiven Leverage Ratio • <u>Temporäre Erhöhung der Kapitalpuffer:</u> Erhöhung der Core Tier 1 Ratio auf 9 % per Juni 2012 1. Erschließung privater Quellen (einbehaltene Gewinne, Boni, Emission, ...) 2. Kapitalisierung durch Staaten 3. Deleveraging? 	<p>VO- und R-entwurf Juli 2011, soll per 1.1.2013 in Kraft treten</p> <p>EU-Rat am 26. Okt. 2011</p>	<p>Baseler Ausschuss (Sept. 2010), G20 (Nov. 2010)</p> <p>EU</p>
<p>7. Bankeninsolvenzrecht</p>	<p>Prävention: Sanierungspläne der Banken, Abwicklungspläne der Aufsichtsbehörden Frühintervention: Eingriffsmöglichkeiten von Behörden, wenn Institut regulatorische Eigenkapitalerfordernisse möglicherweise nicht erfüllen kann (z.B. Bestellung Sonderverwalter für eine Bank) Abwicklungsinstrumente und -befugnisse: z.B. Übertragung solider Vermögenswerte auf Brückenbank, alte Bank: reguläres Insolvenzverfahren Bail-In-Instrumente: Rekapitalisierung durch debt-equity swaps Abwicklungsfonds: 1% der gedeckten Einlagen in 10 Jahren (für geordnete Reorganisation, nicht für Kapitalisierung! (ev. Verschmelzung mit Einlagensicherungsfonds))</p>	<p>Konsultation ab Jän. 2011 (EK), RL-entwurf der EK vom 6. Juni 2012</p>	<p>G20, EU</p>

Regulierungsinitiativen in der Europäischen Union (III) – in

Regulierungsinitiativen	Vorbereitung	Status Datum der Beschlussfassung	Kontext
8. Systemrelevante Finanzinstitutionen (SIFIS)	SIFI-Aufschläge für 29 G-SIFIS (global systemically important financial institutions), bis Ende 2012 ‚Testament‘, ab 2016 Kapitalzuschlag um bis zu 2,5%-punkte (phasing in bis 2018).	November 2011	G20 Cannes
9. Wertpapierregulierung			
<ul style="list-style-type: none"> European Market Infrastructure Regulation (EMIR) 	<ul style="list-style-type: none"> Abwicklung von Transaktionen über zentrale Handelsplattformen (CCPs) Datensammelstellen (trade repositories) Vorschriften für über Hinterlegung von Sicherheiten bei bei OTC-Derivaten 	VO-entwurf Sept 2010 (EK)	G20
<ul style="list-style-type: none"> Richtlinie über Märkte für Finanzinstrumente (MiFID II) 	Regulierungsrahmen für sämtliche Wertpapierdienstleistungen (Transparenzvorschriften, Warenderivatemarkt, wie z.B. Positionslimits für Rohstoffhandel unter außergewöhnlichen Umständen, Sicherheiten (collateral) Hochfrequenzhandel, etc.)	R-entwurf und VO-Entwurf der EK Oktober 2011	G20, EU
<ul style="list-style-type: none"> Leerverkäufe (Short Selling) 	<p>EU-weite Harmonisierung der Regeln für Short Selling und Credit Default Swaps (insb. Transparenz), vorübergehende Beschränkung.</p> <p>Abschluss ungedeckter Swap-Transaktionen bei Staatspapieren (uncovered sovereign CDS transactions) wird begrenzt, Aufseher können Verbot aussetzen</p>	VO-entwurf Mai 2011 (EU-Rat) Okt. 2011 Einigung ER EP	EU
10. Besteuerung Finanzsektor	<ul style="list-style-type: none"> Bankenabgabe Finanztransaktionssteuer per 1. Jän. 2014 0,1% auf Spot-Transaktionen, 0,01% auf notional value von Derivaten Sitzlandprinzip (Residenzprinzip) Ausnahmen: z.B. Spot-Transaktionen beim Devisenhandel Spot-Transaktionen beim Handel mit Rohstoffen 	Konsultation Sommer 2011 R- Vorschlag der EK Okt. 2011	EU