OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

Reform of the Financial Sector for Crisis-free Growth

EUROPE: REWRITE THE RULES FOR SHARED PROSPERITY

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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

- **Banking Union**
- **Capital Market Union**

Overall Assessment

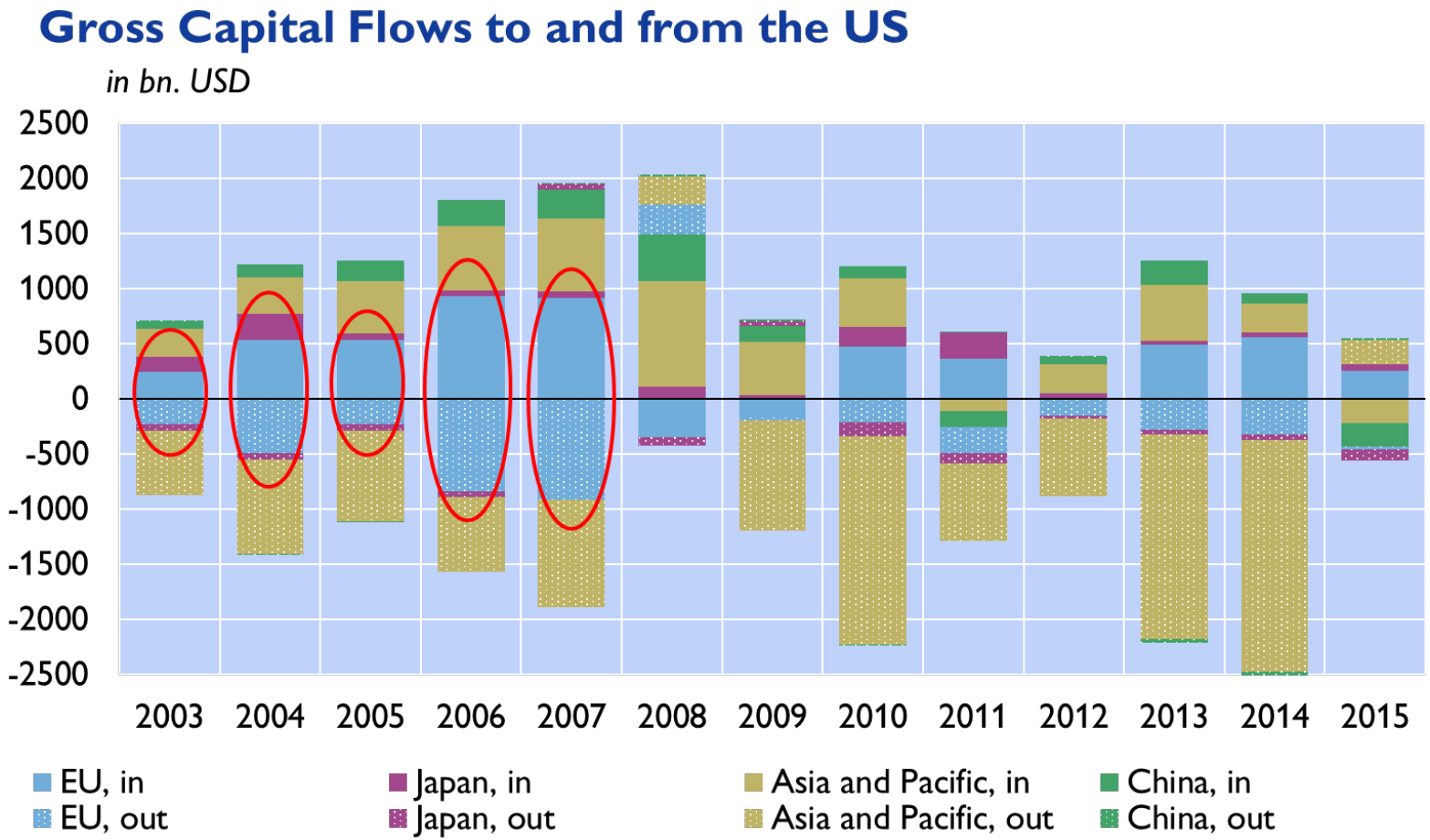
Challenges Ahead

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?

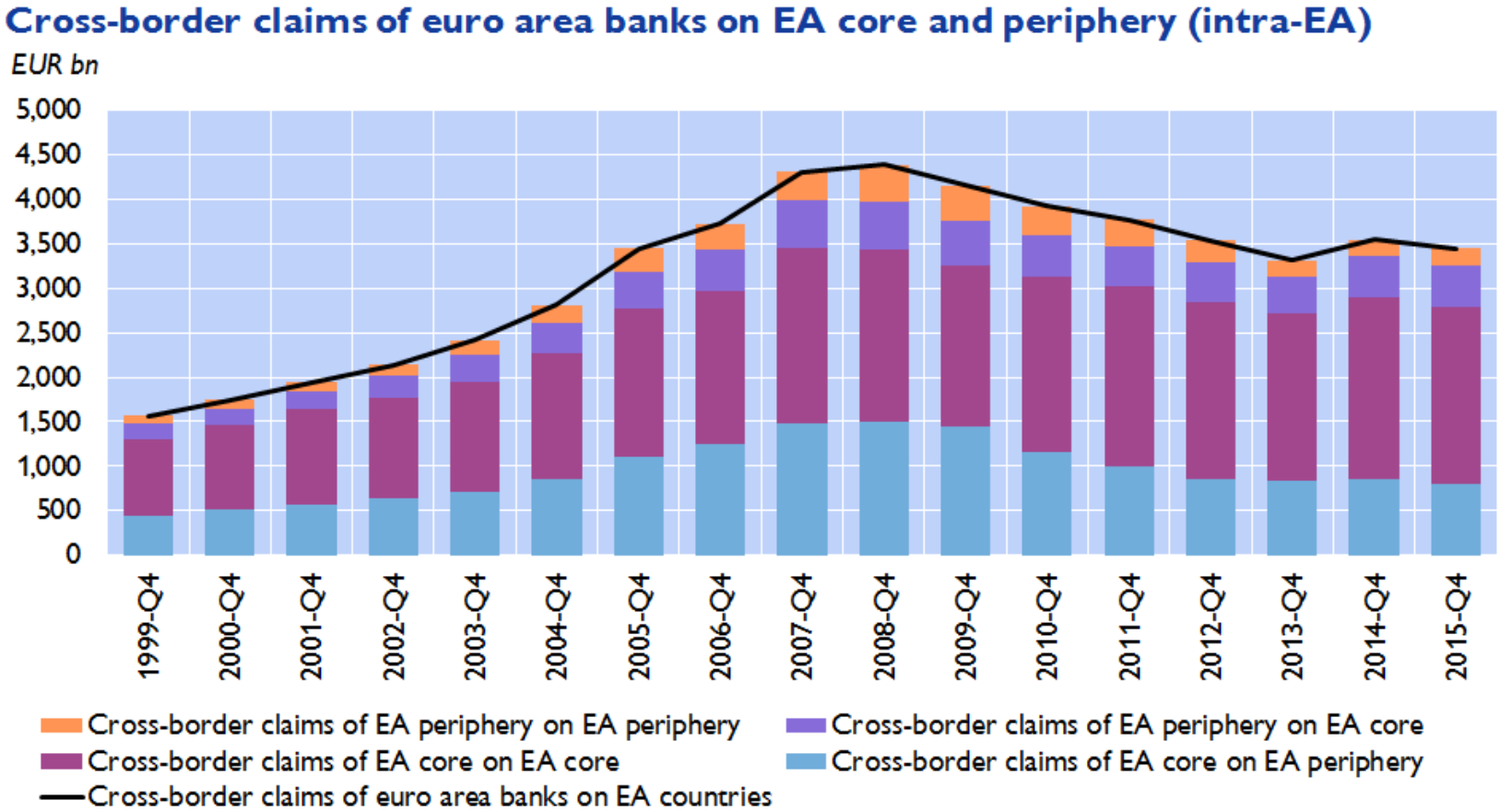
- **Global European banks increasingly engaged in round-tripping across the Atlantic**



Source: U.S. Bureau of Economic Analysis.

Why were European Banks so Heavily Affected?

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



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.

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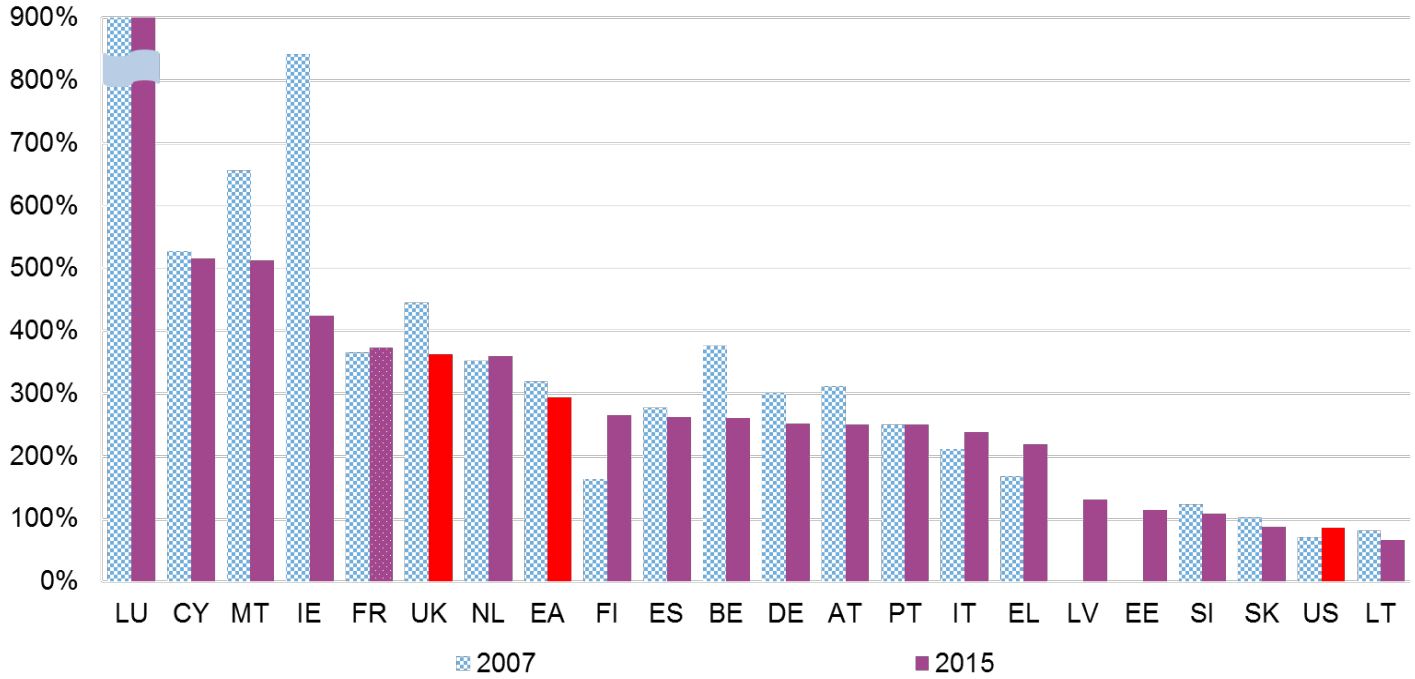
Design features of the euro area and the role of banks

- **Global banks – national supervisors**

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

Total assets in % of GDP



Source: ECB, Eurostat, FRED St. Louis.

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

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**

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Governance and Regulatory Reform – Overview

ONB

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

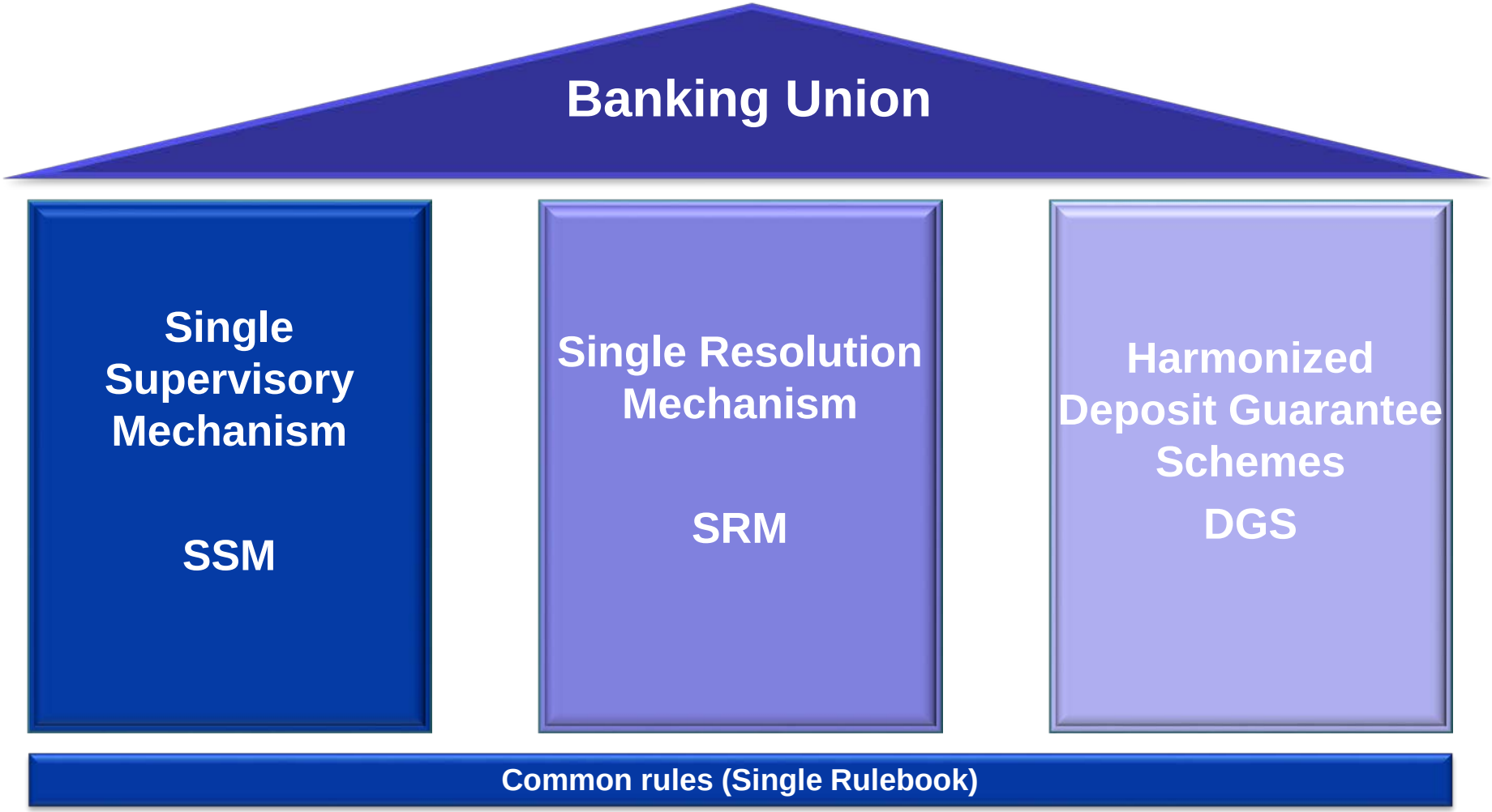
Governance and Regulatory Reform – Banking Union

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

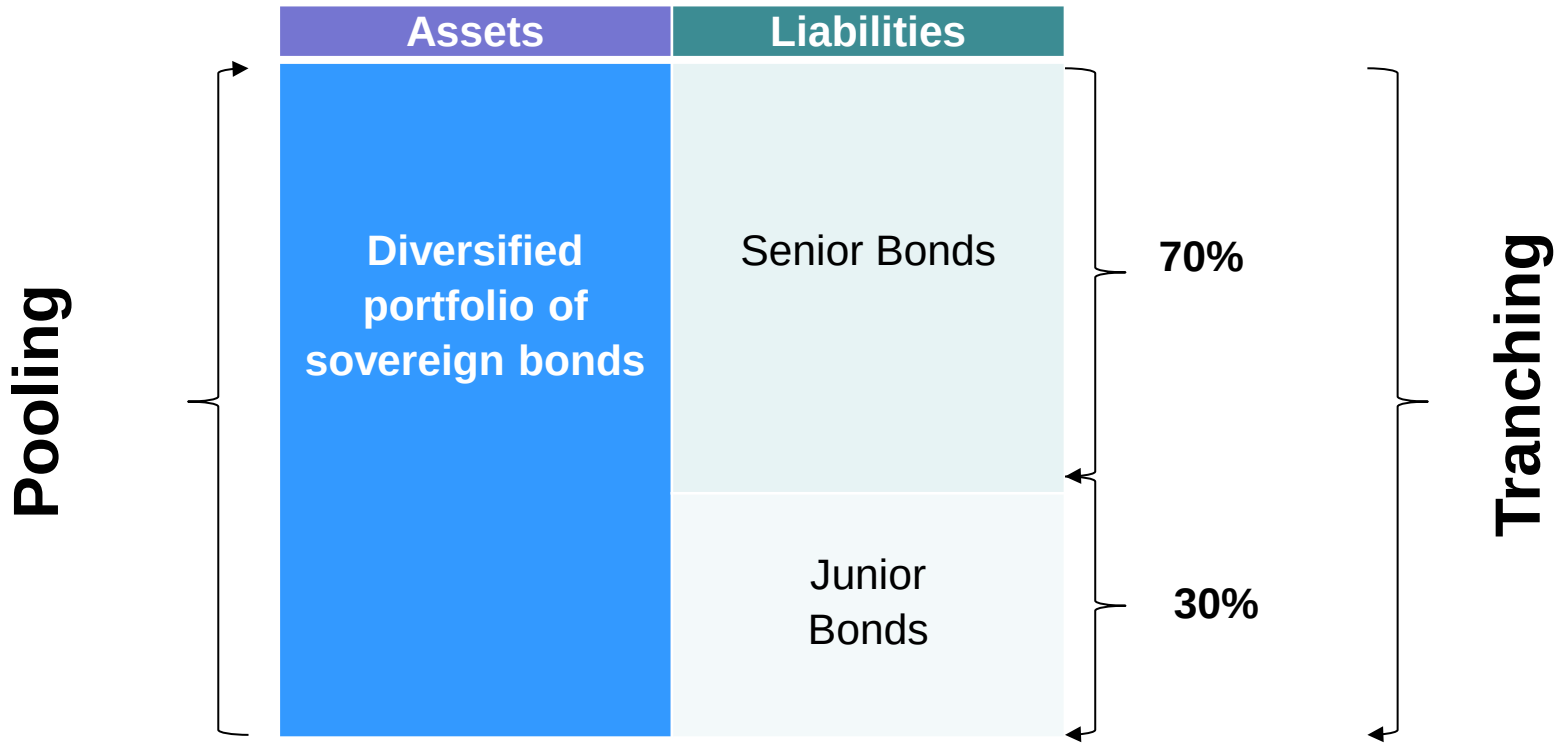
Capital Market Union (CMU) – Focus on private capital markets

- 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



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Overall Assessment

Challenges Ahead

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"**

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Overall Assessment

Challenges Ahead

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)

ONB

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?

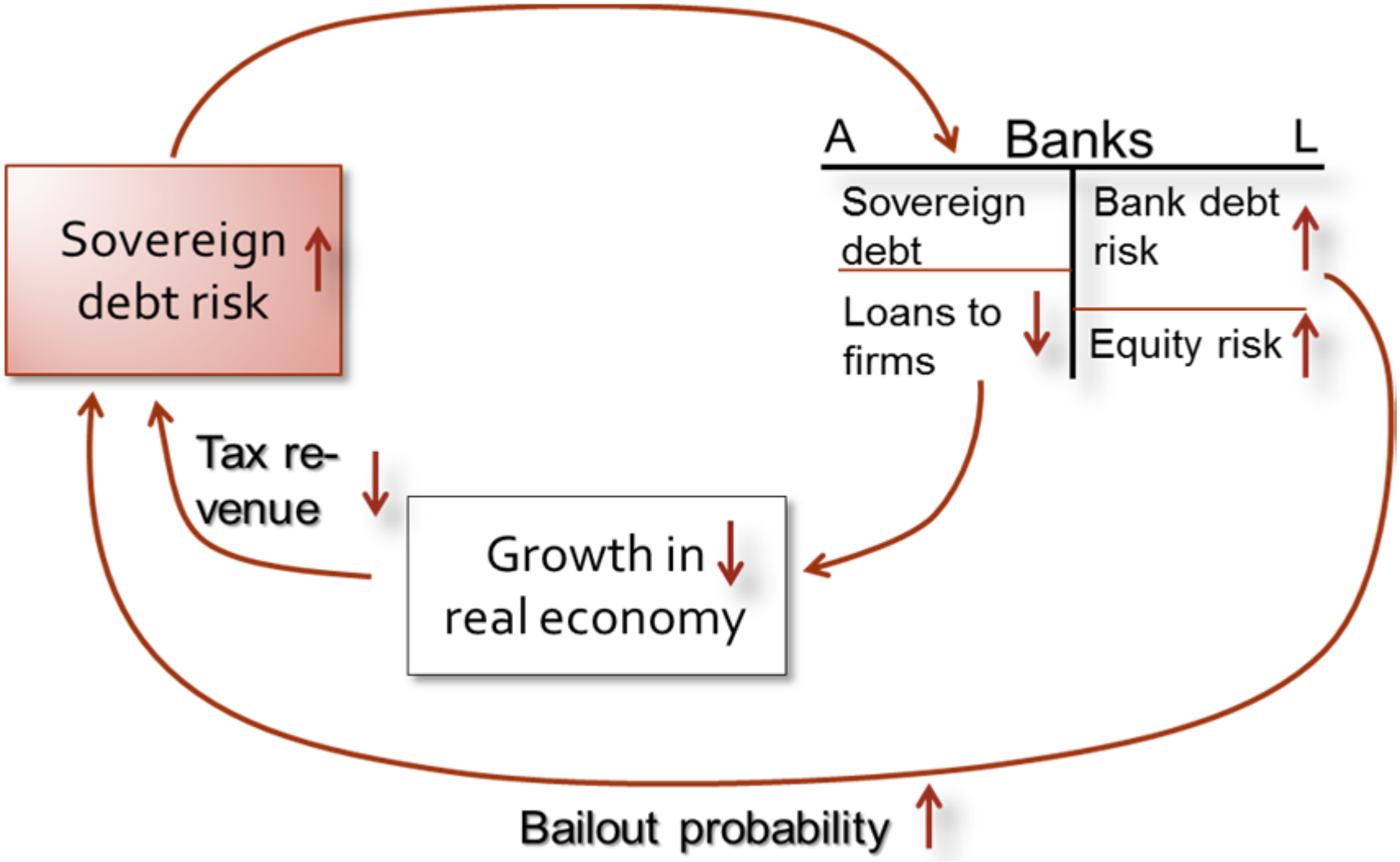
‚I believe there are still doubts regarding whether the largest and most trading intensive banks in Europe can be rapidly resolved in the midst of a systemic crisis. If the structure of a bank has been simplified ex-ante, it is easier to impose resolution measures on it also in times of severe stress'

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

Additional Slides

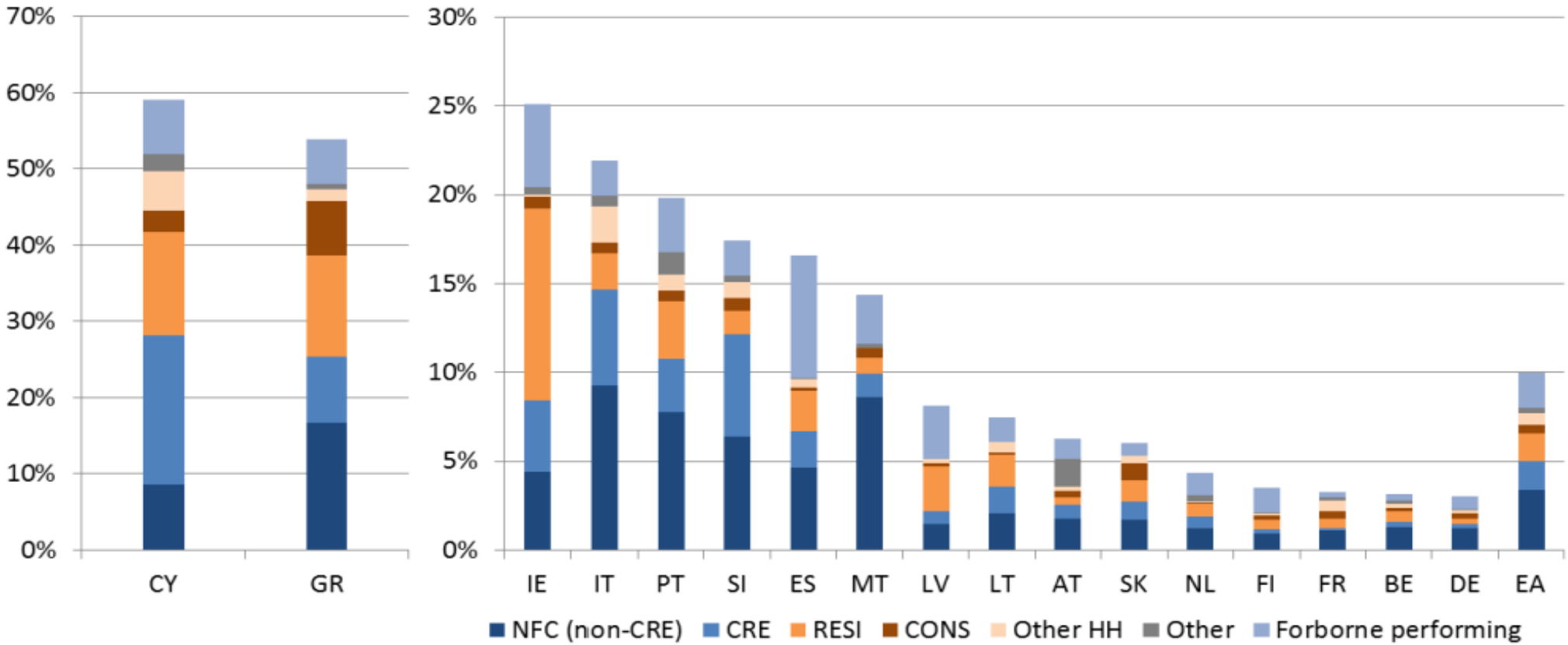
Design features of the euro area and the role of banks

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.

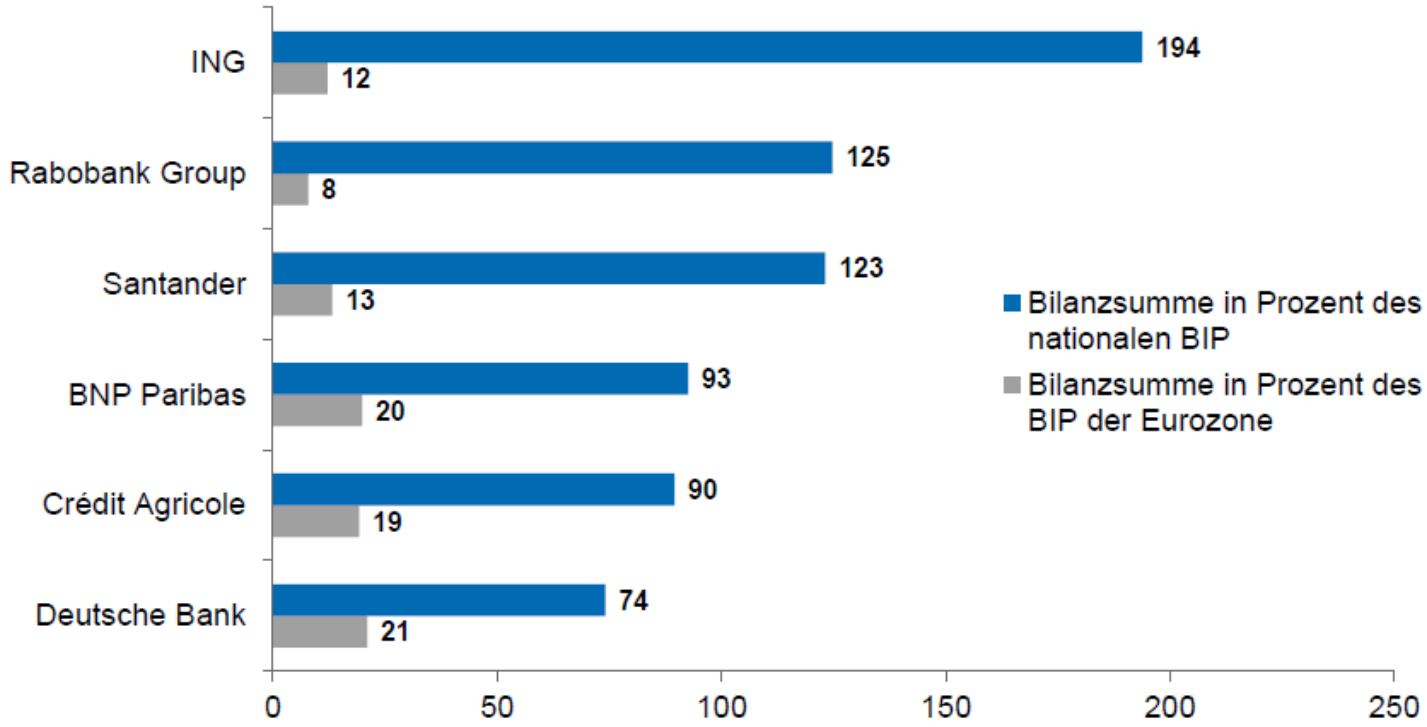
From: Martin, R., Lessons from NPL resolution in euro area countries. Presentation at the JVI, Vienna, 10-14 October 2016

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)



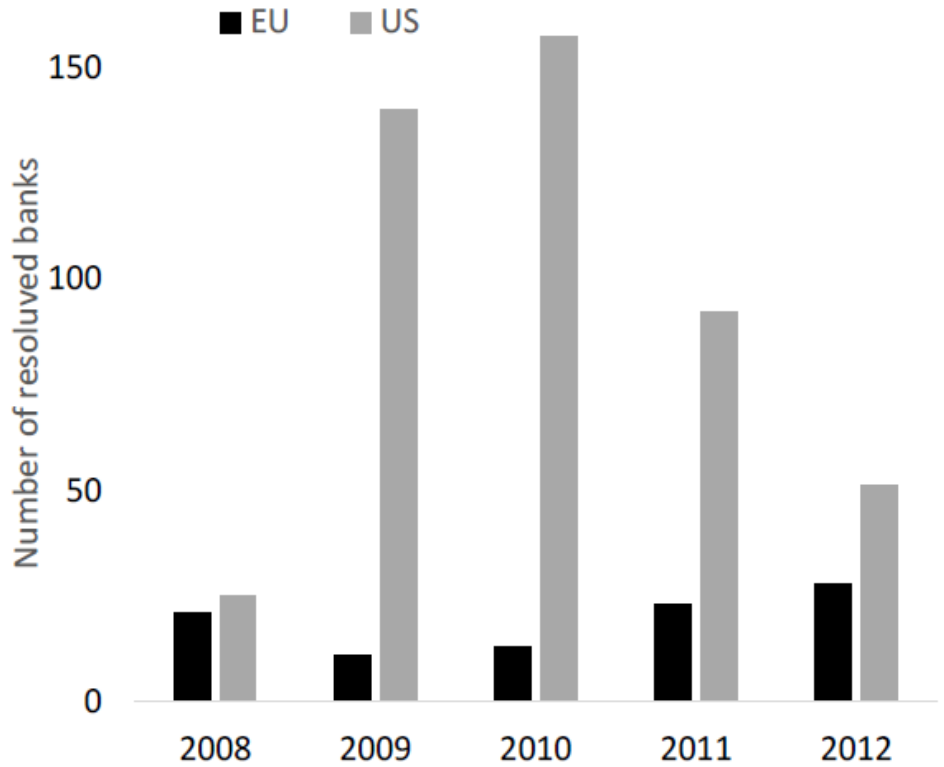
Quelle: Bloomberg, Eurostat, eigene Berechnungen

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

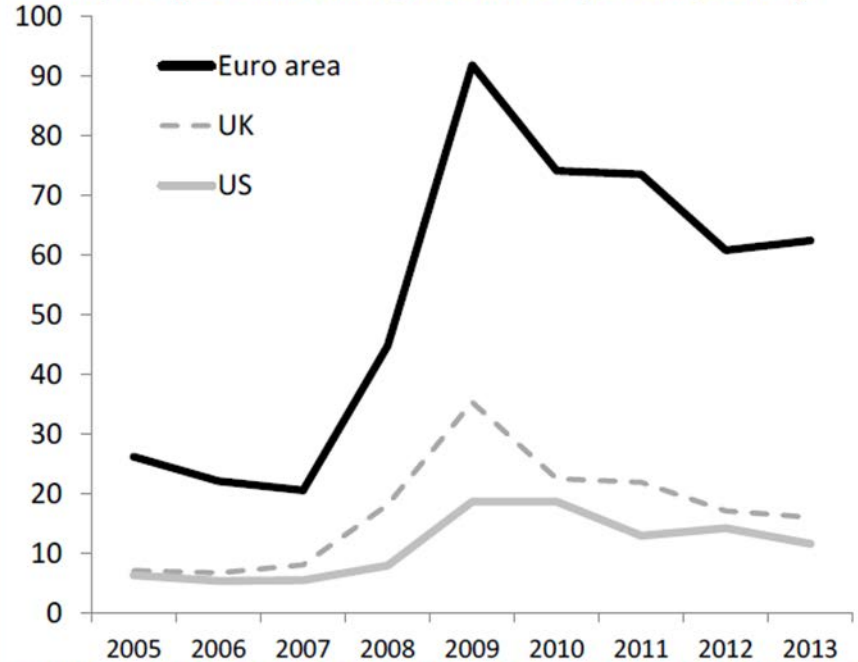
Banks too big to fail

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)



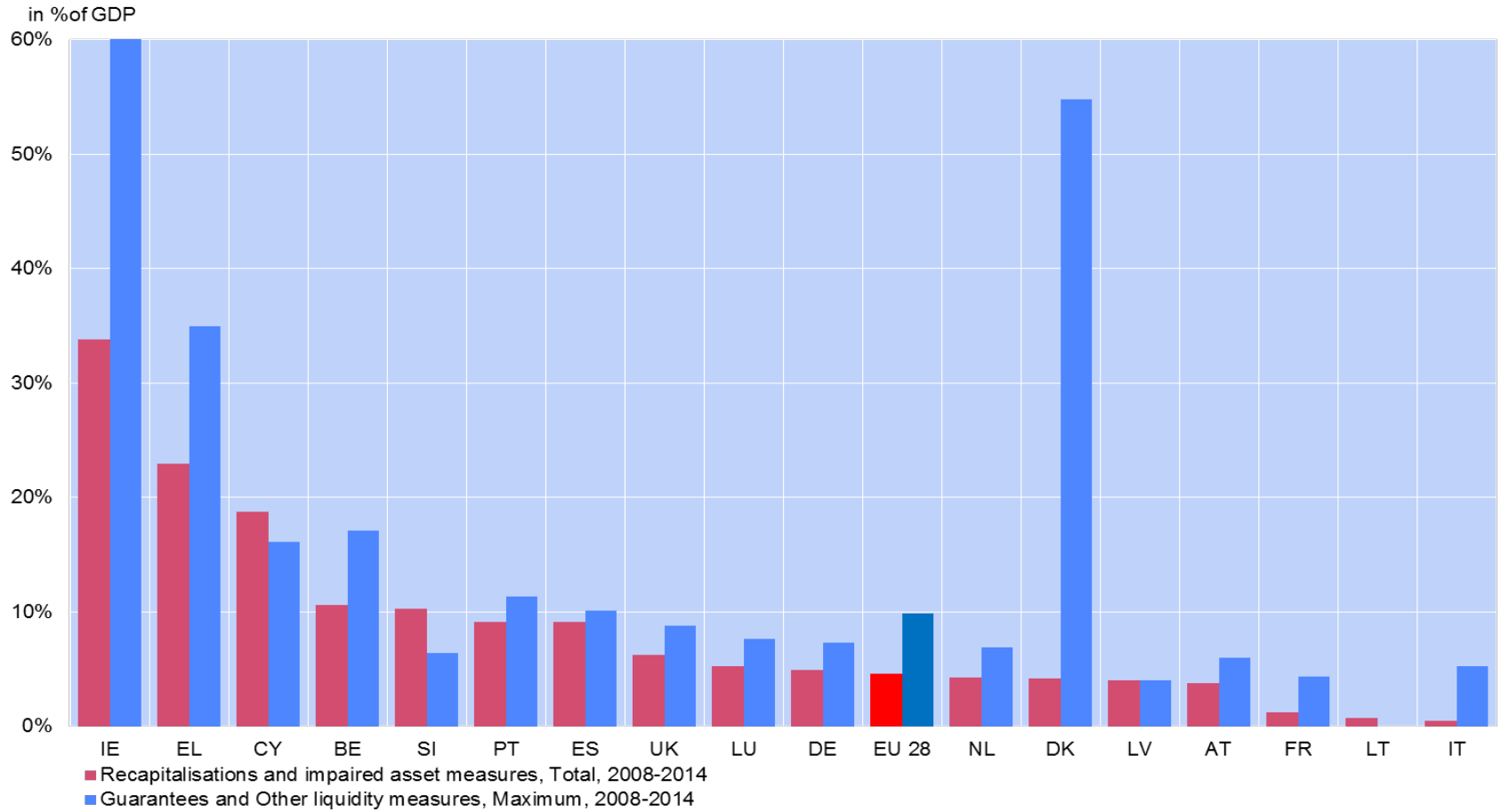
Source: Lambert and Ueda (2014). The data are taken from their Figure 3.10. The estimate of the reduction in funding costs owing to government guarantee is based on a ratings-based approach. The difference between issuer ratings and stand-alone (financial strength) ratings captures the rating uplift 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

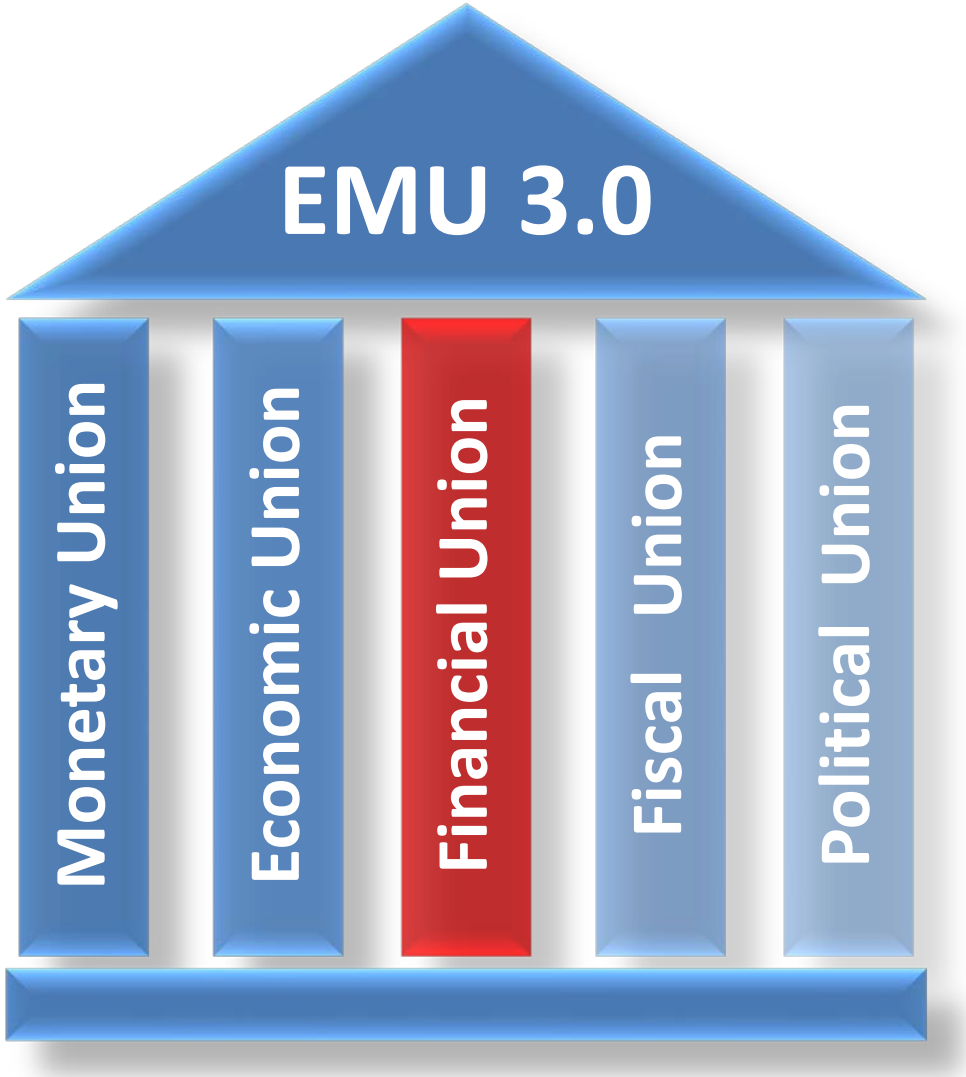
Public support for the banking sector - selected economies, 2008-2014



Quelle: European Commission, DG Competition.

Banking Union in the Making

The 5 President‘s Report (2015)



- **Economic Union – convergence, prosperity and social cohesion**
- **Financial Union – integrated finance for the economy**
- **Fiscal Union – integrated framework for sound fiscal policies**
- **Political Union – democratic accountability, legitimacy and institutional strengthening**

Banking Union in the Making
Financial Union (first part)

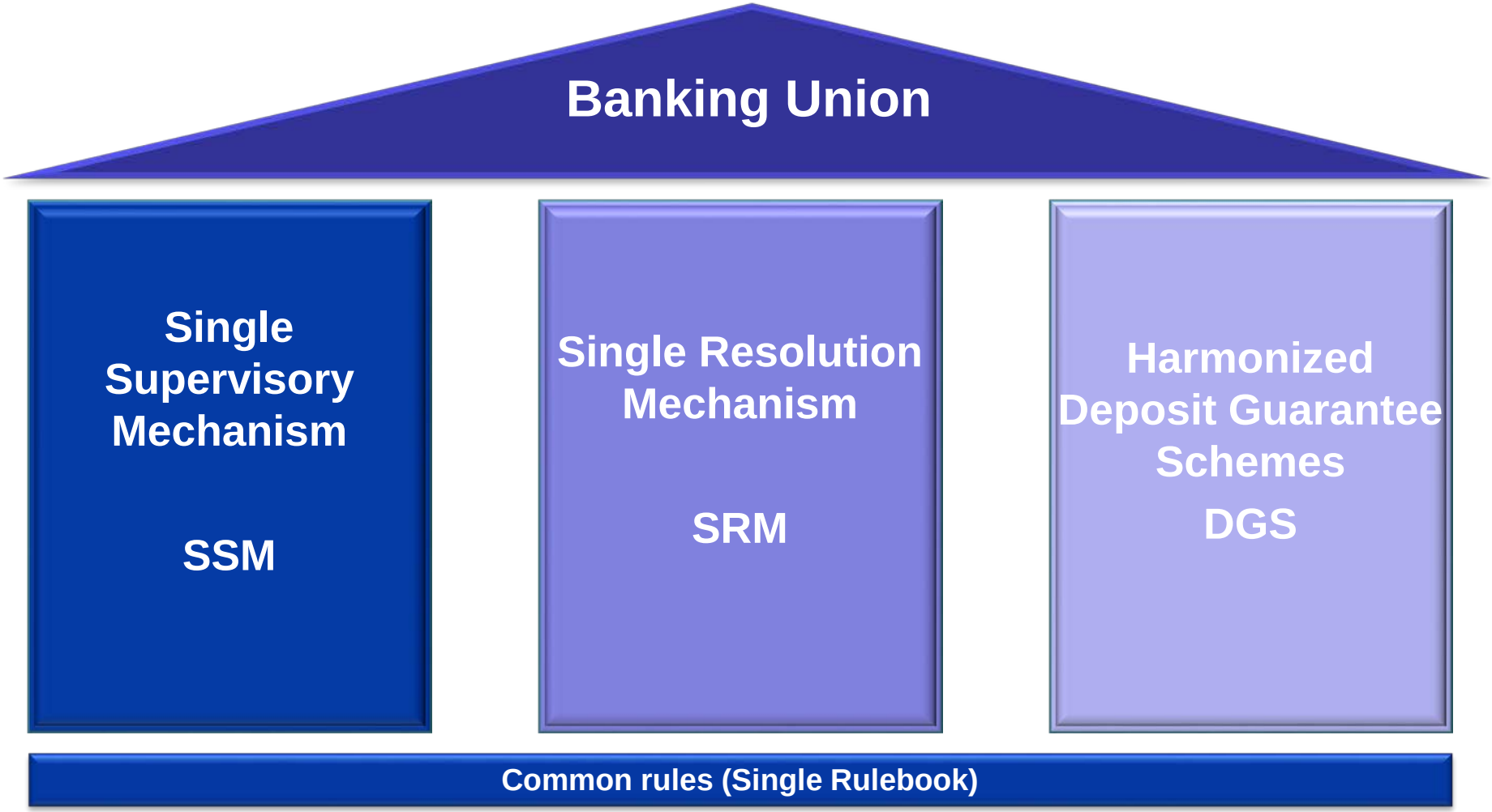
Banking Union – completion

- **EDIS –** European Deposit Insurance Scheme
- **Fiscal backstop**

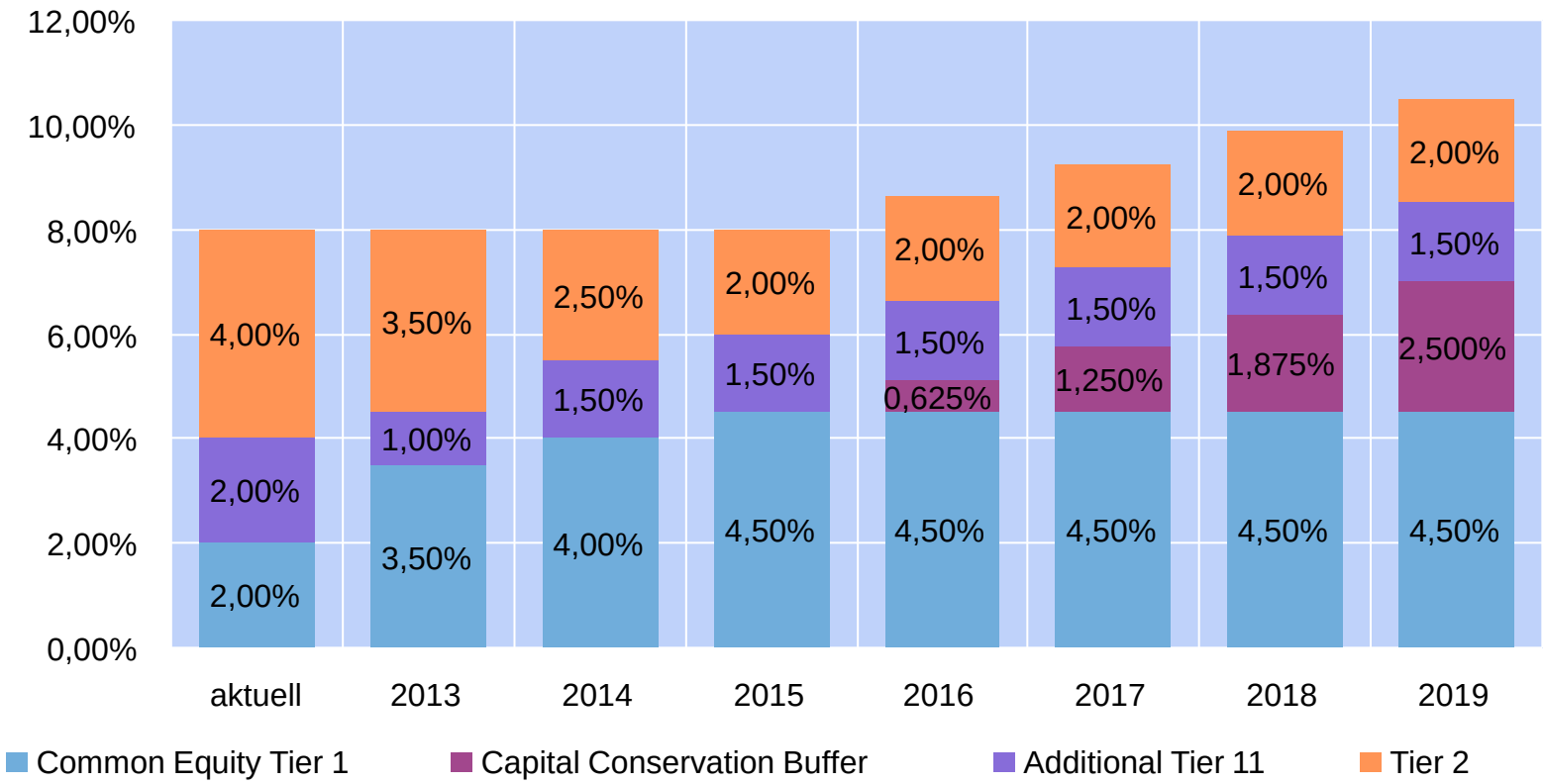
Capital Markets Union – start

- Less **dependence** from banks
- New class of **infrastructure investment**
- Facilitate **securitization**
- **Venture capital**: facilitate mutual funds
- Standardise **covered bonds**

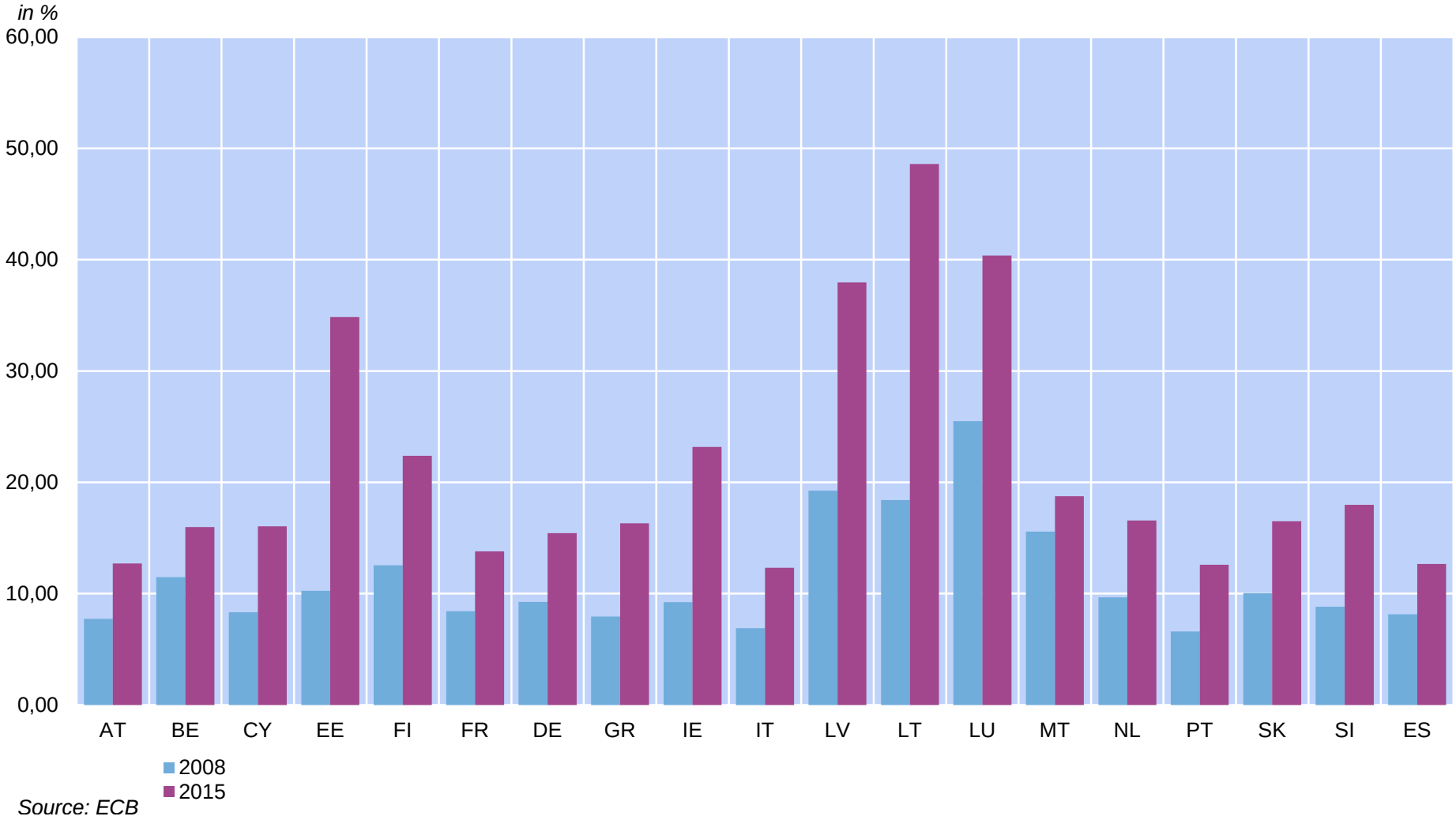
Banking Union in the Making
Three Pillars



Transitional provisions

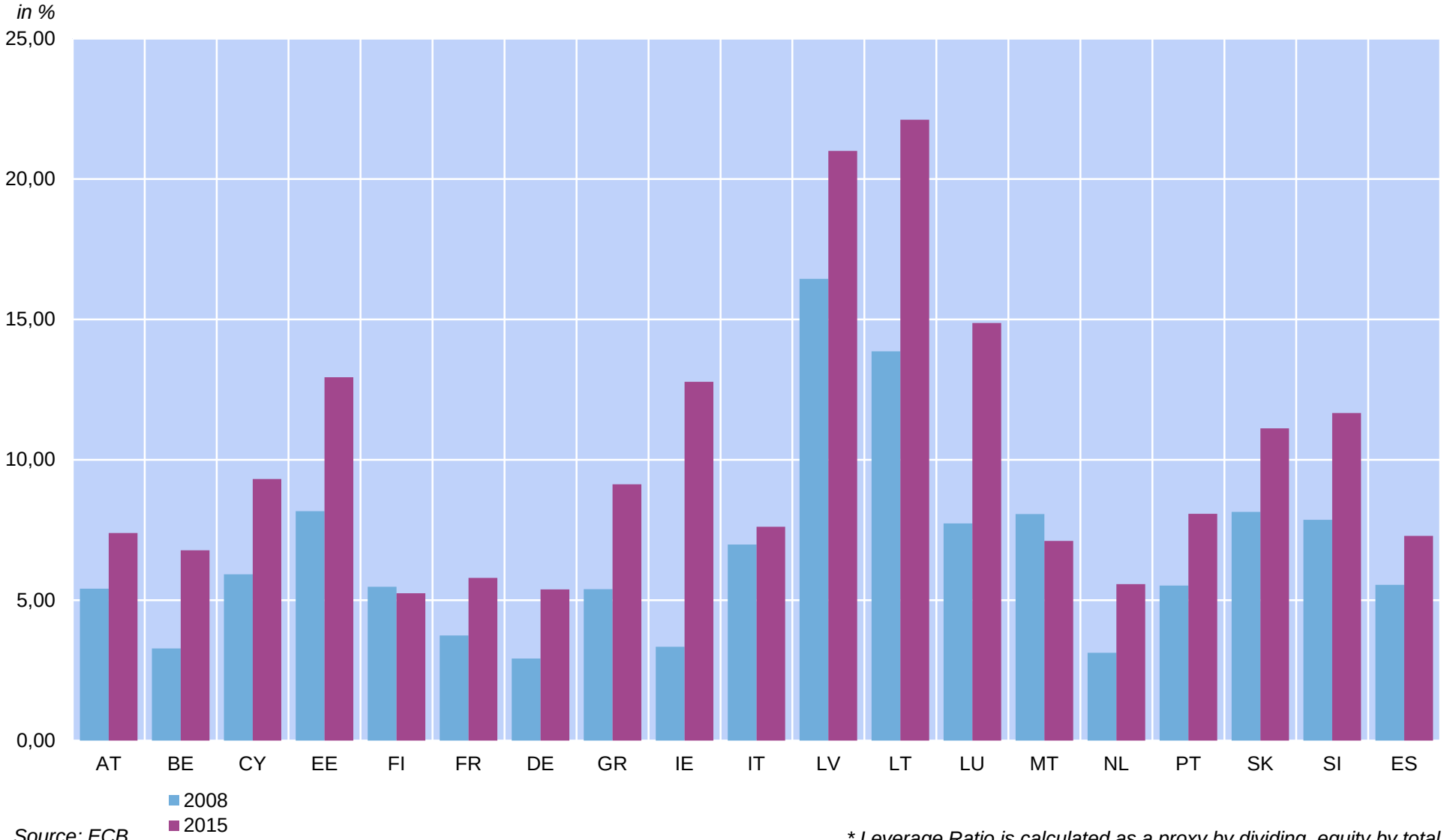


Development Tier 1 Ratio



Source: ECB

Development Leverage Ratio*

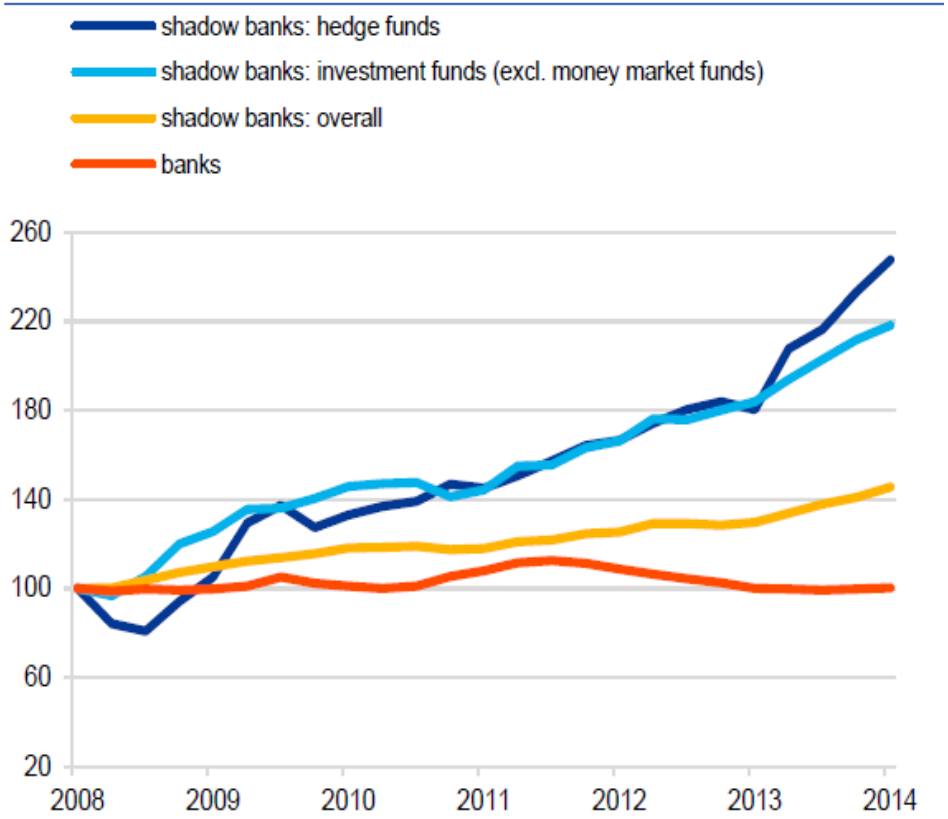


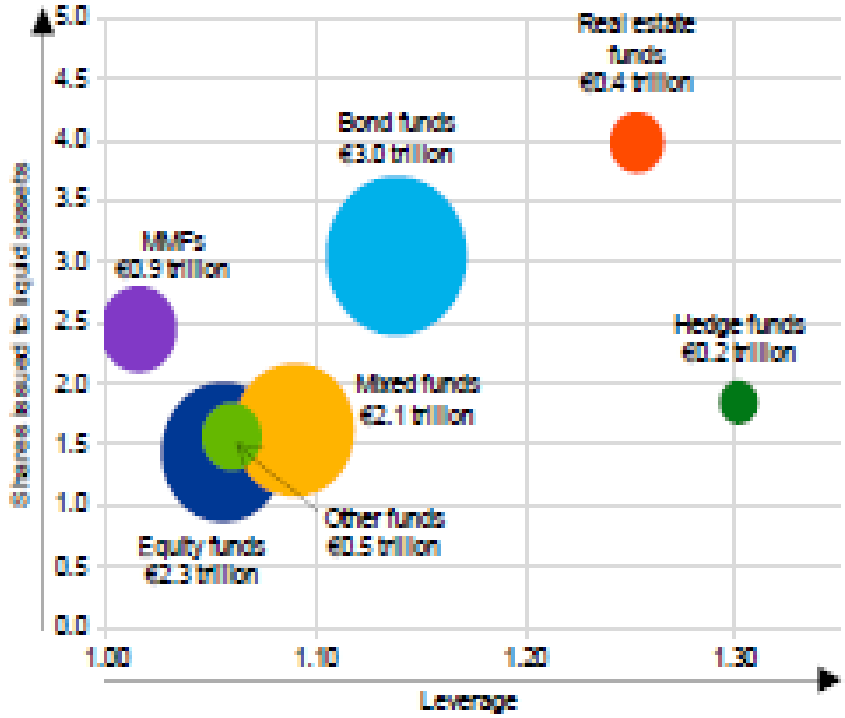
Source: ECB

** Leverage Ratio is calculated as a proxy by dividing equity by total*

Shadow Banks in the Euro Area

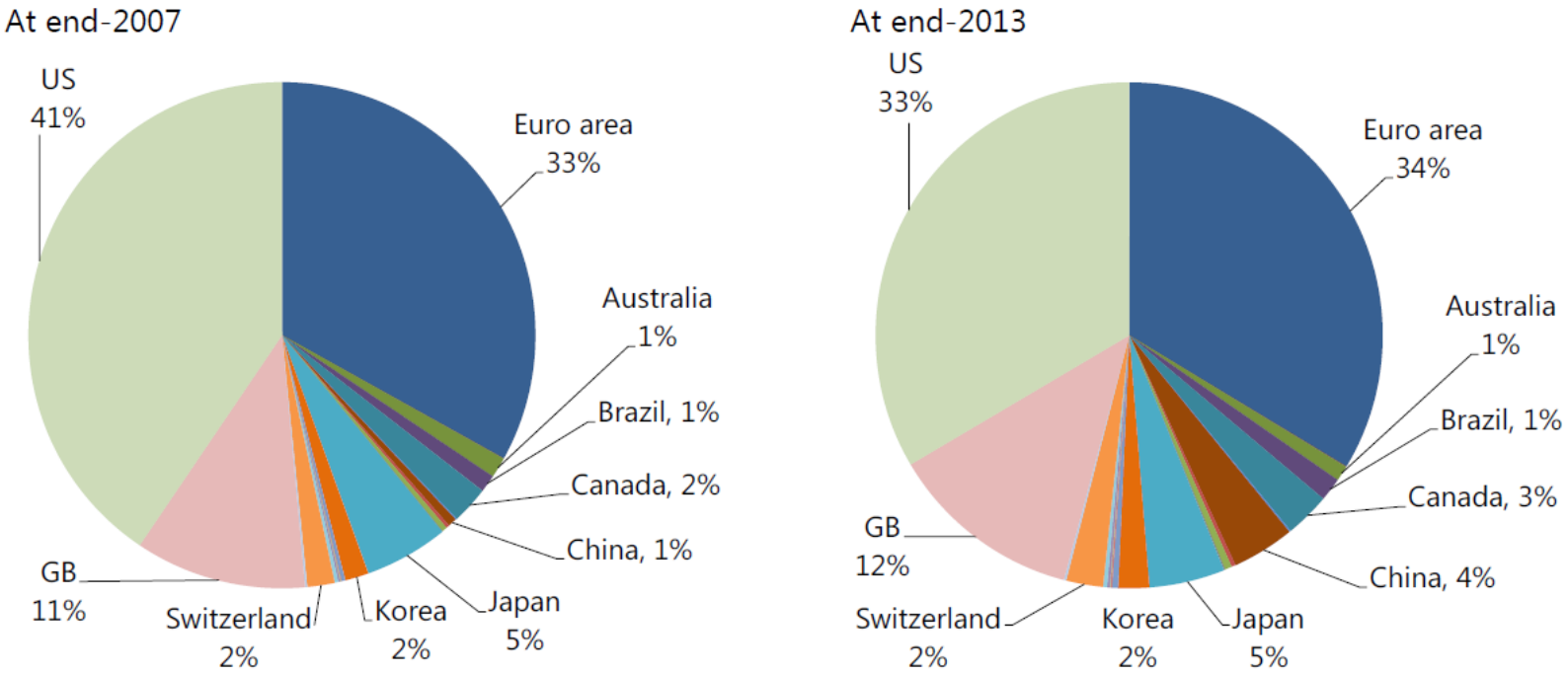
Index: 4. Quarter 2008 = 100





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

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



Sources: National financial accounts data; other national sources.

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

Economics of Banking Regulation in Europe

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