ΚΕΝΤΡΟ ΕΡΕΥΝΩΝ ΠΡΟΟΔΕΥΤΙΚΗΣ ΠΟΛΙΤΙΚΗΣ

30.10.2012

P.A. Thomopoulos

THE INTEGRATION OF THE EUROPEAN BANKING SECTOR AND REGULATORY REFORMS

The world financial system is still facing a crisis undermining growth, especially in the E.U. Almost all E.U. countries have been hit in varying degrees, even banks in the strongest economies (Germany, Holland, Denmark) had to be succored. The origin of the tremor differs from country to country. In some overreliance on wholesale funding (U.K.), in others investments in risky structured products (USA), too many loans to a bloated real estate market (Spain and Ireland), over investment in sovereign bonds (Greece) etc.

The lack of a mechanism for the identification, prevention and correction of what with hindsight we call investments in risky assets was a serious missing element in the EU banking regulatory and supervisory framework. Risky assets were not only structured products (derivatives) as was initially thought, but also government bonds and ordinary loans. Haircuts proved ex-post grossly insufficient as different classes of assets incur big losses in major crises.

De Larosiere's report identified the absence of a framework for a pan European financial oversight and the need to better assess the impact of the macro economy on the financial sector (including the built up of asset bubbles). For the banking sector the creation of the European Banking Authority – EBA- and in parallel the creation of the European Systemic Risk Board at the ECB were the first move towards a banking union. The two institutions will complement each other and critically analyze macro – micro developments impinging on Euro banks and the financial system in general.

However, the financial situation in the European Union continued to be fragile in some countries for the fifth year in succession, also because of the inability to solve the sovereign crisis, and the related lack of confidence not only in the financial system itself but also in the E.U. institutional framework. In addition, criticisms by the IMF concerning bank undercapitalization in Europe and the marked decrease in the flow of short term liquidity across Euro area frontiers posed new challenges. The ECB was called to meet these challenges first by filling the liquidity gap with extraordinary measures, but this proved insufficient to re-ignite the trans-Euro wholesale money markets as most banks still

prefer to deposit with the ECB their surplus liquidity instead of lending to each other, especially across the borders.

The June 2012 Summit decided to move forward with the creation of a banking union, which is an essential element for an integrated E.U. with the Single Market remaining an overarching objective. This, in combination with the new fiscal and economic severe rules, is expected to break the vicious interaction between bank risks and sovereign risks. This would help to reverse the fragmentation of the banking system in the E.U., which puts at risk not only the single market but also European unification. In addition, this would allow depositors to invest in the Euro area taking into account economic factors (e.g. rate of return) and not the risk of a breakup of the Euro i.e. it will help capital from surplus countries with low yield notes and deposits to move to countries that urgently need it.

This would also stop the capital flight which is also a matter of great concern for Greece and other countries as it undermines the recovery of the real economy. No recovery is possible when total Euro area credit to the private sector is contracting and domestic savings in a number of countries just suffice to cover amortization costs. The capital flight will hinder the recovery in Greece, but also in Spain and Portugal. The “banking union” should include a centralized supervision, common rules, a mechanism - the ESM - to finance directly (not through the budget) undercapitalized banks, a Resolution Authority and, if possible, a Common Deposit Insurance Scheme, which, however, will not see quickly the day. The banking union will release funds to the real economy, so that a sustained recovery supported by credit expansion can be set in motion thus reversing the recent credit contraction at the Euro area.

A centralized supervisory institution within the ECB, which has proven its competence and independence, will ensure that financial supervision is also independent. It should not be forgotten that in many countries, even in central and northen Europe the authorities tried to hide weak banks and only when the fire was in front of the door and illusions that they could stop it disappeared, they decided to intervene with at a very high cost to the tax payers.

National supervisory authority will of course continue to play a key role: after proceeding with off-sight and on-sight controls it will provide all necessary information and data to the ECB, so that the latter be able to make the right decisions. While retaining the responsibility for decisions, the ECB should delegate to national authorities the implementation of its decisions. The national authorities

should not, therefore, see themselves as outsiders, since they will also be in a position to influence the final decision and its implementation if they have done their work correctly.

This new institution will establish transparency and a level playing field especially for cross-border banks as conflicting views of the different national authorities will be smoothly resolved. This should restore confidence among market players and depositors. Living wills will also be a key element in the new banking scenery and the central supervisor will have to analyze them carefully especially for transnational big banks so the burden of a resolution, i.e. the cost of dismembering these banks is equitably shared by all countries concerned.

The ECB is also closely monitoring fiscal developments in the Euro area and since the correlation between fiscal deficits and bank risks is high, the ECB will be in a privileged position to better assess banks' credit and securities risks and, having learned the lessons from the recent past, to also prevent or mitigate the buildup of asset bubbles. Bubbles are extremely costly to unwind as they lead to significant loss of output and income over a protracted period. All the more that financial and real contagion, which is interrelated, crosses all frontiers as witnessed by the recent weakness in GDP growth even in strong economies, as in Germany.

Central banks and the ECB in particular also have very good information of the available collateral pool and its quality for refinancing purposes and are, also, in a position to assess the liquidity needs of the banking sector of the individual Euro area countries, which helps to prevent an abrupt credit squeeze. Liquidity shortage can be quickly transformed into a capital shortfall turning into a credit squeeze, which in turn affects the real economy leading to bigger fiscal deficits, especially in a cyclical downturn fiscal multipliers act in reverse. Here we have all the elements of a spiraling vicious cycle. ECB intervention by providing extraordinary liquidity at the early stage of the crisis in 2007-2008 has spared many countries from entering the vicious cycle and more will be spared in the future, since it will also become the centralized supervisor for the Euro area. And this, because the ECB having direct information on the soundness and capital adequacy of banks, therefore, assessing better potential risks, it will be even readier to provide the liquidity when the need is properly documented. However, we know that after the downgradings of sovereigns, banks and companies which will continue as long as the real economy in the Euro area remains weak, the pool of high quality collateral will further shrink, but not to the extent that it will stop ECB liquidity reaching banks.

A better functioning banking and financial union will also help to upgrade the transmission mechanism of the ECB monetary policy, an essential element for the unity of the Euro area. To-day there are big differences not only in market interest rates among the Euro area countries, but also in many credit terms, e.g. in countries with a higher risk banks shorten the maturity of loans, thus making an investment recovery even more difficult.

Of course, we should not have illusions that interest rates and lending terms will be the same in all Euro area countries, differences will persist but these will be greatly reduced. Accordingly, the integration of EU financial markets will become again a reality as was the case before the crisis, and European citizens will not be any more deprived of the benefits of the low cost of the financial services that they are entitled in the Euro area.

Establishing a single supervisor will produce greater transparency in national banking sectors and reduce regulatory arbitrage. And this because banks will not be able to exploit loopholes in the regulatory and supervisor framework in certain countries to avoid a strict application of the rules. This applies particularly to transnational banks which can easily move not only securities, derivatives but even loans from one subsidiary to another.

In parallel, a Resolution Authority to take care of banks in difficulty should also be established. However, we all hope that after the recent wave of recapitalization of most banks in Europe, there will be a significantly smaller number of banks resorting to state aid in the near future. A Banking Union Resolution Authority should also be responsible for big banks with subsidiaries and branches in other countries. However, there is a long way ahead. Harmonizing different bankruptcy laws will be a difficult and very lengthy process. But this should not be an excuse for not starting today, so that one day the Resolution Authority will see the light.

These regulatory reforms will be soon accompanied by a reshape of the banking sector. Today the prevalent philosophy in the E.U., which was inspired by the US, is to separate investment banking from the more traditional retail banking (collecting deposits, mainly short term, transforming them into longer term loans to the corporate sector, to mortgage and consumer loans). Investment banking proved to be more risky than traditional banking, as the recent crisis has proved. But to a great extent this implies returning back to basics, (i.e. traditional banks), and a good friend and experienced Greek banker recently reminded me that in this area Greek banks' performance was very very good. Indeed the plight of the Greek banks is the result of fiscal mismanagement. The

proposals now in preparation by the E.U. will also restrict proprietary investments, because it is considered that this puts at risk depositors' money and also may affect market making. The Likannen report proposes to ring fence investment banking. This should not prohibit banks to have assets other than loans e.g. bonds, shares and simple structured products. An upper limit of 20-25% of the total balance sheet for these assets is now envisaged as this is considered a good and relatively safe compromise, because (a) capital buffers are on the rise, (b) bigger attention is now paid to transparency, (c) the capital requirements for risky assets have been raised, and (d) that most structured products will increasingly be traded through central counterparties, which should ensure the execution of trades. However, supervision should also enforce these efficiently.

European universal Banks, which have proved to be resilient during the current crisis, have serious reservations for some of these proposals as they will reduce profit margins, which will be transformed into higher fees and interest rates charged to corporations and households. I believe that all financial actors across the table will put forward their proposals and the Commission will present a document which will be balanced and will foster the efficiency of European Banks so as to be even more competitive in the international arena, while minimizing the risks for the tax payer. The move towards the US financial system, where banks play a smaller role and financial intermediation uses other vehicles (funds, market instruments, etc.) presupposes that under the auspices of ESMA there will be a rapid growth in corresponding institutions and instruments (e.g. venture capital, investment funds) in the E.U. Otherwise, the E.U. financial sector will be lopsided and will affect negatively growth, which is already weak. I have to point out that some proposals have a lot of negative spillover effects for certain sectors of the real economy. For Greece in particular, which needs urgently to improve its infrastructure, the new Basel rules penalizing long term bank loans is a matter of concern. Inevitably new institutions and financing mechanisms should emerge even in Greece to fill the gap that banks will leave in the long-term loan sector, but the earlier this is done, the better. For this reason, the authorities, especially in Greece should try to resolve this problem as quickly as possible; otherwise some of the large infrastructure projects in the pipeline will be relegated to the Greek calends, with a corresponding loss of valuable E.U. financial aid.