Completing the Banking Union and Implications for CMU

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Banking Union Semantics

• An ongoing process started mid-2012
• A current set of institutions and policies
  – SSM + SRM = “Half-built banking union”
• Breaking the bank-sovereign vicious circle
  – HBBU + targeted policies to address bank-sov. linkages
  – “No-doom-loop banking union”
• A level playing field for banking business
  – NDLBU + lots of further harmonization
  – “Single-market banking union”, parallels CMU
• A geographical area
“Completing Banking Union”

• A minimal package of interdependent steps to break the “doom loop”:

1. Sovereign Concentration Charges (SCCs)
   – Removing current high home bias in euro-area banks’ euro-area sovereign exposures

2. European Deposit Insurance (EDIS)
   – European Commission proposal of November 2015
   – Possible refined design options

3. Phase-out of geographical ring-fencing
   – End of penalization of cross-border expansion
Bank-Sovereign Linkages

Sovereign

- Sovereign exposures
- Erosion of guarantees

Domestic banks

- Direct Linkages
  - Guarantees (implicit + explicit), including deposit insurance

Domestic Economy

- Indirect Linkages
  - Austerity
  - Lower tax revenue
  - Lower credit quality
  - Credit scarcity / misallocation
Breaking the Vicious Circle

Sovereign Concentration Charges

Sovereign exposures
Erosion of guarantees
Guarantees (implicit + explicit), including deposit insurance

EDIS

Sovereign
Domestic banks

Direct Linkages
Indirect Linkages

Sovereign Concentration Charges

Austerity
Lower tax revenue

Lower credit quality
Credit scarcity / misallocation

Cross-border bank integration

Domestic Economy
Sov. Concentration Charges

(Paper published by European Parliament, November 2017)

• Pillar-1 instrument

• Add to RWAs in capital ratio denominator
  – Only concentration, no credit risk assessment = acyclical

• SCC coefficient increases with concentration
  – Pain threshold in the 100-200% range

• Preparation long phase-in, grandfathering

<table>
<thead>
<tr>
<th>Bucket</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign exposure ratio</td>
<td>&lt;33%</td>
<td>33%-50%</td>
<td>50%-100%</td>
<td>100%-200%</td>
<td>200%-300%</td>
<td>300%-500%</td>
<td>&gt; 500%</td>
</tr>
<tr>
<td>Sovereign concentration charge</td>
<td>-</td>
<td>15%</td>
<td>30%</td>
<td>50%</td>
<td>100%</td>
<td>200%</td>
<td>500%</td>
</tr>
</tbody>
</table>

Sov. exposure ratio = sovereign exposure to a given member state / Tier-1 capital
### SCCs: Expected Impact

<table>
<thead>
<tr>
<th>Exposure ratio (%)</th>
<th>Marginal SCC</th>
<th>Average SCC</th>
<th>Capital impact (bp) (Tier-1 ratio = 10%)</th>
<th>Capital impact (bp) (Tier-1 ratio = 15%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>15%</td>
<td>5%</td>
<td>-3</td>
<td>-6</td>
</tr>
<tr>
<td>100%</td>
<td>30%</td>
<td>18%</td>
<td>-17</td>
<td>-38</td>
</tr>
<tr>
<td>150%</td>
<td>50%</td>
<td>28%</td>
<td>-41</td>
<td>-90</td>
</tr>
<tr>
<td>200%</td>
<td>50%</td>
<td>34%</td>
<td>-63</td>
<td>-138</td>
</tr>
<tr>
<td>250%</td>
<td>100%</td>
<td>47%</td>
<td>-105</td>
<td>-225</td>
</tr>
<tr>
<td>300%</td>
<td>100%</td>
<td>56%</td>
<td>-144</td>
<td>-301</td>
</tr>
<tr>
<td>350%</td>
<td>200%</td>
<td>76%</td>
<td>-211</td>
<td>-430</td>
</tr>
</tbody>
</table>

- Diversification within euro area, not reduction of aggregate euro-area exposures
  - No international competitive distortion (if diversification)
  - Exact portfolio rebalancing patterns hard to predict
  - Not disruptive if well prepared (≠ credit risk weights)
### SCCs: Potential Reallocation

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of banks in sample</th>
<th>Coverage of country's SIs (by assets)</th>
<th>Total domestic exposures of domestic banks in sample</th>
<th>Domestic exposures of domestic banks above 33% of Tier 1</th>
<th>Domestic exposures of domestic banks above 100% of Tier 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>6</td>
<td>93%</td>
<td>349,773</td>
<td>249,763</td>
<td>119,467</td>
</tr>
<tr>
<td>Germany</td>
<td>15</td>
<td>92%</td>
<td>301,538</td>
<td>242,432</td>
<td>155,080</td>
</tr>
<tr>
<td>Italy</td>
<td>6</td>
<td>78%</td>
<td>179,626</td>
<td>145,040</td>
<td>74,820</td>
</tr>
<tr>
<td>Spain</td>
<td>3</td>
<td>67%</td>
<td>135,978</td>
<td>92,143</td>
<td>23,634</td>
</tr>
<tr>
<td>Belgium</td>
<td>4</td>
<td>65%</td>
<td>51,844</td>
<td>43,675</td>
<td>27,091</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4</td>
<td>95%</td>
<td>48,498</td>
<td>14,744</td>
<td>0</td>
</tr>
<tr>
<td>Portugal</td>
<td>4</td>
<td>85%</td>
<td>25,105</td>
<td>19,772</td>
<td>11,502</td>
</tr>
<tr>
<td>Austria</td>
<td>6</td>
<td>95%</td>
<td>22,511</td>
<td>13,243</td>
<td>2,596</td>
</tr>
<tr>
<td>Greece</td>
<td>4</td>
<td>100%</td>
<td>19,676</td>
<td>9,463</td>
<td>1,175</td>
</tr>
<tr>
<td>Ireland</td>
<td>3</td>
<td>89%</td>
<td>15,498</td>
<td>9,061</td>
<td>686</td>
</tr>
<tr>
<td>Cyprus</td>
<td>2</td>
<td>58%</td>
<td>2,779</td>
<td>291</td>
<td>0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2</td>
<td>80%</td>
<td>2,650</td>
<td>2,045</td>
<td>816</td>
</tr>
<tr>
<td>Finland</td>
<td>1</td>
<td>25%</td>
<td>1,755</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Malta</td>
<td>2</td>
<td>65%</td>
<td>1,335</td>
<td>1,142</td>
<td>772</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1</td>
<td>23%</td>
<td>731</td>
<td>242</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>63</strong></td>
<td><strong>83%</strong></td>
<td><strong>1,159,298</strong></td>
<td><strong>843,055</strong></td>
<td><strong>417,638</strong></td>
</tr>
</tbody>
</table>
Refined EDIS Design

• Fully integrated institutional framework (SRB)
  – Mandatory national schemes phased out

• Compartments
  – National compartments sized by total covered deposits
  – Possibility of network-specific compartments (e.g. Sparkassen), with conditions to prevent abuse
  – Voluntary top-ups can remain unchanged

• National insurance fee add-ons
  – Based on quality of credit policies

• Waterfall structure is backstopped by ESM

• Comprehensive assessment of LSIs
Cross-Border Integration

• Phasing out of national ring-fencing of capital and liquidity

• Rewards for geographical risk diversification
  – Capital calculations (asset correlation parameter in IRB)
  – Stress test scenarios
  – Intra-euro-area linkages in G-SIB determination
  – Formula for deposit insurance fees?

• Too-Big-To-Fail safeguards
  – TLAC, higher leverage ratio (cf. Basel III finalization)
Other “No-Doom-Loop” Items

• All residual guarantees at European level
  – Enable ESM prec. recapitalization + guarantees

• Strengthening of SRM
  – Fuller SRB authority over resolution scheme execution
  – Harmonization of bank insolvency law
  – ESM backstop (ongoing) + liquidity in resolution

• Additional steps against needless bail-outs
  – Normalization of state aid control
  – Tightening of precautionary recap. process

• Elimination of structural distortions
# Structural Distortions

<table>
<thead>
<tr>
<th>&quot;Large Euro-SIs&quot;</th>
<th>% of aggregate assets</th>
<th>&quot;Anglo-SIs&quot;</th>
<th>% of aggregate assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td># banks</td>
<td>GSIBs</td>
<td>All</td>
</tr>
<tr>
<td>Dispersed</td>
<td>15</td>
<td>6</td>
<td>44%</td>
</tr>
<tr>
<td>Minority influence</td>
<td>18</td>
<td>-</td>
<td>13%</td>
</tr>
<tr>
<td>Private control</td>
<td>11</td>
<td>-</td>
<td>3%</td>
</tr>
<tr>
<td>Cooperative</td>
<td>13</td>
<td>2</td>
<td>24%</td>
</tr>
<tr>
<td>Public sector</td>
<td>19</td>
<td>-</td>
<td>10%</td>
</tr>
<tr>
<td>Nationalized</td>
<td>8</td>
<td>-</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>84</strong></td>
<td><strong>8</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

*Euro-SIs are significant institutions (SIs) headquartered in the euro area with more than €30bn in total assets.*

*Anglo-SIs are equivalent institutions (groups > €30bn total assets) headquartered in Australia, Canada, UK & US.*

*GSIBs = Global Significantly Important Banks (FSB ranking of November 2016). Assets are measured as of end-2015.*

*Source: Nicolas Véron, "The Governance and Ownership of Significant Euro Area Banks", Bruegel & PIIE, May 2017*
Implications for CMU

- Capital Markets Union is just another name of single market for financial services
- Banks will remain central to the euro area / EU / EEA financial system
- Completing the banking union is the real centerpiece of CMU
- Banking union also proof-of-concept for other Europe-wide financial supervision
  - Conduct of business (ESMA) and AML
Thank You For Your Attention

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