Banking and Financial Markets between Integration and Segmentation after the Crisis

Insights from the SUERF/UniCredit & Universities Foundation Workshop held in Vienna on 12 December 2013

by Ernest Gnan, SUERF Secretary General

The winners and organizers of the 1st SUERF/UniCredit & Universities Foundation Research Prize: (l-r) Lena Tonzer, Franco Bruni, Jean-Edouard Colliard, Manuel Buchholz, Giannantonio De Roni, Annalisa Aleati

On Thursday 12 December 2013, a half-day workshop was held at UniCredit Bank Austria AG's premises in Vienna, at which the winners of the inaugural SUERF/UniCredit & Universities Foundation Research Prize presented their prize-winning papers, with the two winning papers having been chosen by a scientific committee from 30 eligible submissions made to the Call for Papers on the umbrella topic of *"Banking and Financial Markets between Integration and Segmentation after the Crisis"*. The presentations of the papers and ensuing discussion offered interesting insights into various issues addressed by the papers and relevant to the topic of the seminar.

Jean-Edouard Colliard, ECB, presented his paper "*Monitoring the supervisors: optimal regulatory architecture in a banking union*". Both centralised and localised supervision have pros and cons of their own. The former takes into account cross border externalities, as well as the risk of supervisory forbearance at a local level, while in the latter, local supervisors have better knowledge of the local specificities, given the inherent opacity of banks. The centralised supervision of banks will alter banks' business model of banks over time - leading to further integration of the financial system, which in turn again will increase externalities, thereby further strengthening the case for centralised supervision.

Multiple equilibria are possible - the banking system may become very fragmented or very integrated, depending on the dynamics under way. European Banking Union and more specifically the Single Supervisory Mechanism have triggered an important process. The optimal supervisory solution in a two-tier supervisory system such as the SSM is dependent on the objectives of central and local supervision, as well as inspection and monitoring costs.

His analysis had yielded 4 types of banks – with SIFIs being split into those that are opaque, and those that are transparent – and small banks being split into those that are systemic as a herd, and those that remain non-systemic. The case for centralised versus decentralised supervision goes from very strong to very weak along this order.

With regard to the reaction of the markets and business models, an exogenous increase in inspection leads to more foreign lending to banks (reflecting more trust from international investors). Funding costs become cheaper as a result of increased international funding, in turn leading to a greater conflict of interests for the local supervisor, thus strengthening the case for a central supervisor as a strategic complementarity.

Which of the multiple equilibria will apply is influenced by the starting point of the process – there is the possibility of being trapped in equilibrium. At the same time, supervision regimes need to be forward looking. Banks that do not currently require being centrally supervised may need to be so in the future. Flexibility is thus required.

The distinction between centrally and locally supervised banks may induce a diverging development of business models among these two groups of banks. While the international orientation, due to investor trust and

favourable international funding opportunities, of centrally supervised banks may be further enhanced, regionally supervised banks may be confined to their local business. This may also raise issues of a level playing field for competition.

The paper also offers an application to banking groups: Local banks borrow from larger domestic parent banks, which in turn borrow from international creditors – thereby necessitating a full network analysis of banking. In the case of small countries with very large banks, the domestic supervisor may be very risk-averse, even though the risk of the banking group in question at the global level is small. In this scenario, local supervisors may turn out to be more stringent than a central supervisor. Without common resolution, the distribution of losses between foreign and domestic creditors remains uncertain; the case for central supervision becomes much stronger where there is common resolution.

By centralising supervision, the nature of lobbying and the risk of regulatory capture changes. With local supervisors, a major motivation may be to protect market share against foreign market entrants, whilst the lobbying agenda is different at the European level. Great care must be taken, therefore, when designing the governance of the SSM to avoid new forms of regulatory capture.

Under the SSM currently being set up, joint supervisory teams, consisting of ECB and national supervisors, will be formed to supervise systemically important institutions, with the aim of ensuring local knowledge while avoiding risks of local supervisory forbearance. In practice, a careful selection of ECB supervisors in these joint teams will be important and needs to take into account incentives due to career considerations in the event of a future return of employees to their countries of origin.

The second paper, by **Manuel Buchholz** (IWH Halle and University of Tübingen) and **Lena Tonzer** (European University Institute), focussed on "*Sovereign Credit Risk Co-movements in the Eurozone: Simple Interdependence or Contagion?*"

Interdependence due to various channels (e.g. trade and financial linkages) is often distinguished from contagion (co-movements not justified by economic fundamentals, for irrational reasons such as herd behaviour etc.). Econometrically, contagion is often identified as being the non-explained part of regressions on economic fundamentals. By contrast, the authors in this paper define contagion as occurring where there is a significant increase in cross-country co-movements.

In particular, the authors distinguish between three types of contagion channels, namely:

- Global shocks, where there are similarities in fundamentals (so-called "wake-up call" contagion)
- Changes in the strength of direct links: e.g. portfolio reallocations
- Non-fundamental-based contagion, e.g. herding behaviour etc.

They measure contagion by means of dynamic conditional correlations for daily CDS spreads, which are then aggregated on a weekly basis, from which episodes where a significant increase in weekly co-movement are detected in order to construct a contagion indicator.

Their approach is able to identify all those episodes of tension in Euro Area financial markets usually associated with important events. Countries with similar economic fundamentals are found to exhibit higher co-movement, confirming what the authors call "wake-up call contagion". Fundamentals can change their effects in non-linear, state-dependent ways: Financial linkages can reduce sovereign credit risk co-movement in normal times because they make funding more "elastic", but change their role in crisis periods to amplify spill-overs, which can be seen as evidence of "fundamental-based contagion". Observed co-movement in higher crisis-induced stock market price co-movement is taken as evidence of "non-fundamentals based contagion".

The authors conclude that evidence of "Eurozone effects" calls for solutions taken at the level of the Euro Area. Policy can also work effectively by affecting expectations, thereby influencing the likelihood of various multiple equilibria, and thus ultimately also of economic fundamentals (such as the ECB's announcement of the OMT and its promise to do "whatever it takes" to preserve the euro).

The event concluded with some topical remarks by Franco Bruni (Chairman of the Scientific Committee, UniCredit & Universities Foundation and former SUERF President), who also presented the winners with their awards. It is envisaged that following a successful inaugural SUERF/UniCredit & Universities Foundation Prize, the prize will again be awarded in 2014.

The papers and presentations given at the workshop are available for download from the SUERF website at **www.suerf.org/vienna-uuf2013.**