MONITORING BANKS AND STATES: GOVERNANCE AND REFORMS IN EUROPE

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I. INTRODUCTION

(1) *Euro-crisis is an institutional crisis.*

Cannot abstract from incentives and interests of nation-states.

(2) *Our knowledge is rather patchy*. This talk emphasizes an incentive view of Eurozone institutions:

- some based on existing research
- most based more on "gut feeling"

(3) *Outline*:

II. European institutional reforms

III. Banking union

IV. Banking reforms

V. Concluding remarks on monetary policy

BRIEF REMINDERS ON WHAT WENT WRONG

Clichéd remarks, yet heart of subsequent analysis.

a) *Dual debt and competitiveness crisis*
   - large debts & spreads ▸ government
     - financial crisis
     - failure to implement reforms (labor market, pensions, investments in tradable sector, competition policy, tax collection/state profligacy, ...)
   - Fiscal adjustment ▸ fiscaladjust

- loss of competitiveness and trade imbalances ▸ labor
  - no possibility of nominal devaluation,
  - a bit of fiscal devaluation,
  - and much internal devaluation in a subset of Southern European countries (sufficient? sustainable?) ▸ restoring

b) *Coupling of banking and sovereign crises*

- A "reverse accountability" insight.
- That private debt is public debt was ignored by Maastricht treaty. ▸ coupling

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c) *Weak European institutions*

Political bias toward laissez-faire understandable:

- lack of pivotality: why get into a country's bad books?
- political agendas
- anticipation of quid-pro-quo.

Outcome: no-man's land in which neither the market nor the official sector was monitoring.

d) *Financial sanctions vs. reduction in sovereignty*

e) *Europe's handling of the crisis was not stellar*

Shifting the blame; conducting lenient stress tests; making confusing announcements on PSI; buying time ("whack a mole" style).

(1) *Solidarity within the Eurozone*

- Insurance/moral hazard tradeoff
  - policies leading to lack of competitiveness
  - policies leading to public debt concerns.

- Ambiguous allocation of risk
  - perception of (implicit) joint-and-several liability turns into PSI
  - sovereign risk-free regulatory tag
  - no-man's land: neither market nor official sector was monitoring
  - US historical example US historical ex

(2) *Which solidarity?*

Spontaneous/ex post?

- ex-post bailouts

Contractual/ex ante?

- Eurobonds/Eurobills ▸ eurobonds proposals
- other mechanisms involving joint liability (banking union ...)
- reserve fund

Solidarity area puzzle

Bailouts and refinancing capability are intertwined

J. Tirole "*Country Solidarity, Private Sector Involvement, and the Contagion of Sovereign Crises*" (2012):

- Collateral damages imposed on other countries through default are de facto country's collateral

  [spillovers: economic linkages (trade, banking exposures, fear of runs) and geopolitical considerations (empathy or nuisance power; European construction)].

- Joint & several liability ("JL"; e.g., Eurobonds) would boost countries' refinancing ability at cost of
  - cross-subsidies if asymmetric situation
  - contagion.

- *No JL in asymmetric situation*: JL increases total surplus, but no feasible compensating transfer

  [not in the self-interest of healthy countries to accept JL and assume the concomitant cross-subsidy, even though they realize that they will be hurt by a default and thus will ex post show some solidarity in order to prevent spillovers.]

- Like for an insurance contract, JL more agreeable if behind veil of ignorance:

  JL emerges provided that country shocks are sufficiently independent and spillovers costs sufficiently large relative to default costs.

- Both cases: debt brakes desirable. In the absence of credible discipline, incentive to minimize spillovers/solidarity.

Toward a full-fledged federalism?

- Fiscal integration, or even Eurobonds, require being behind veil of ignorance. We are not. Direction of transfers too predictable

  [Worry about exit might be too narrow: Gerxit. The case of Catalonia.]

- Institutions? Implications of a majority rule?

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(2) *Changing institutions to restore sustainability of Eurozone*

- Countries must accept (permanent) *loss of sovereignty* if they want to preserve European construction:
  - European-level financial regulation
  - independent fiscal councils
  - further interference when in trouble.
- No federal budget, but *incentivizing transfers*
  - labor market remains big issue in Southern Europe

    [is subsidiarity principle applicable? Affects competitivity and debt; also makes austerity harder to bear.]
- Transfers based on cyclical, but not structural differentials?

Monitoring sustainability

- Fiscal compact (March 2012)
  - maximum primary deficit of 0.50 % (cycle adjusted);
  - automatic sanctions (reverse majority voting);
  - ECJ enforcement;
  - unanimity rule abandoned (12 out of 17 needed).

- Complexity and manipulations of public accounts Measuring publ indebt
  - sanctions hard to implement $\Longrightarrow$ also need ex-ante control
  - need supranational oversight of budgets.

Independent fiscal councils: Ideally

- nomination validated by EU, report to EU/ECJ as well

  [like ECB: no regional diversity requirement; recognized standing and professional experience. Contrast French HCFP] French council
- forecast of growth rate for budget
- broader remit (Swedish fiscal council)
  - assessment of consequences of government policies
  - assessment of sustainability, surveillance of competitiveness
- need European independent fiscal council, plus democratic process.

The appropriation issue

- Bi-partisan in Sweden, Germany, Chile, ... In Southern Europe too, but opposite.
- Independent Councils, like golden rules (1840s in US), optimally would be voluntary/appropriated. We no longer can afford this luxury.

III. BANKING UNION

Current state:

- Home rule for regulation
- Bailouts are nationally financed

  [Compare US: Washington Mutual was not bailed out by state of Washington!]
- Recent European institutions: EBA (microprudential) and ESRB (macroprudential): too few control rights.

Logic for banking union

- Too little expertise in any of the 27 regulatory authorities
- Externalities when a cross-border financial institution fails

  [Counterparties, ring fencing, export of credit crunch, deposit insurance (subsidiaries)]
- Externalities when bank failure increases government debt

Problems with home regulation

- turn a blind eye on problems at home (e.g., real estate bubble)
- defend “national champion” abroad

Spain: a lesson for Europe?

[IMF Financial Stability Assessment June 2012] ▸ IMF on Spain

Bird's-eye view:

- Excellent supervisory authority (Banca de Espãna); quickly identified real estate boom and concomitant hazards.
- Hardly any corrective effort.
- Too much politics
  - Ministry of Economy (sanction and resolution capacity)
  - Regional governments (Cajas)

European Commission (September 12, 2012)

- Strong supervisor located at ECB ▸ Likely overall struct.

  [Centralization: Germany's condition for €500 bn of ESM to be usable for direct bank rescues. In 2013 for banks receiving ESM money. January 1, 2014 for the others]

  - oversees 6, 000 banks
    - important: Cajas, Landesbanken
    - some (including Germany) wanted 25 large banks that are TBTF/TBTSC (Too Big To Save)

    [National supervisors still in charge of day-to-day supervision.]

  - orders inspections, carries out stress tests
  - can withdraw banking license

- *Early intervention/resolution*

Supervisor must not be a new EcoFin!

Prompt corrective action and resolution rather than inaction.

- *Decision-making*
  - governing council: non-transparency, sufficient independence of board w.r.t. politics (including independent budget).

- *Flow of information* from national supervisors to European supervisor is key
  - national supervisor employee/reports to ECB.

Other question marks

- Resolution: Europe has no Treasury. Future of ESM funding?
- *Deposit Guarantee Scheme*
  - requires European-level regulation
  - legacy losses

    [Example: Spain. My view: create bad bank, country remains liable, forced into program.]

IV . BANKING REFORMS

Some progress

- Capital requirements
- Countercyclical buffer
- Centralized exchanges (does not go far enough, though)

Question marks: many, among them:

- Liquidity regulation? Rationale and LCR
- Retail-investment bank separation?
- Future of internal models?
- Asset income runs? Asset income runs
- Decoupling banks-sovereign?
- Legal harmonization of resolution?

STRUCTURAL REFORMS

SEPARATING RETAIL AND INVESTMENT BANKS

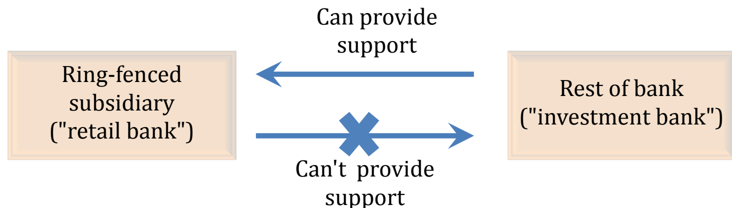
Philosophy: insulate basic banking services from investment banking risks. In a sense, reflects the view that regulators will always lose in the cat and mouse game (may be right).

(1) *Volcker* :

- Rules out “proprietary trading”, ownership of private equity and hedge funds, or activities involving a conflict of interest.
- Underwriting, market-making, hedging, proprietary trading of US government securities OK.

Meaning of “proprietary trading” (market-makers’ inventory risk is in essence prop trading; underwriting = sale of a put option)?

(2) *Vickers* : "Structured universal banking". Deposit-taking institutions are ring-fenced:



- Operational independence
- No trading book, activities abroad, market making: only loans to households, firms and other ring-fenced banks; HQ liquid securities
- Can hedge ("Treasury function")

- Freedom of action (different from Volcker)

Variant: Liikanen (allows securities underwriting in deposit bank).

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Fungibility issue and remaining risks

(a) *Large risks on banking book*. Examples

- Real estate risk (household, commercial): Ireland, Spain, US, ...
- European banks' capital guarantees (large macro risk)

(b) *Hedging function*

Reduces or increases risk-taking opportunities?

JP Morgan's London Whale (CDSs part of "hedging")

Recent experience: failure of pure investment banks, of (primarily) retail banks.

- Higher capital requirements for retail bank: not much confidence that ring-fencing will make bank safer?
- Credibility of absence of bailout of the investment bank?

  [should not repeat US episode, where big ones – including AIG holding and except Lehman – were rescued. Reputation risk may make bailout more likely]

MIGRATION ISSUE

- Shadow banking. Transformation without public-sector enhancements (CB liquidity, FDIC insurance): Hedge funds, MMMFs, new players, disintermediation will fill the void

  [hedge funds' loans to mid-caps; substantial market-making activities by non-retail banks in US prior to 2008; SPVs; etc.]

- General rule: Can't have access to taxpayer money, yet be unregulated.

  Yet bailouts of shadow banks because
  - cross-exposures (AIG)
  - fire sales
  - loans to politically sensitive or fragile agents.

- To be certain: SIFI rules.

  However:

  - Shadow banking fragile (no Basel III liquidity requirements; access to CB liquidity?)
  - How do we know who is systemically important?

    [LTCM? AIG?]
  - Supervisors already are understaffed to oversee retail institutions; besides, activities migrate toward less regulated segment.

Own view

Insulate prudentially regulated entities (retail banks, insurance companies, pension funds) from counterparty risk: stop the SBC for unregulated entities!

- Vickers: one step in this direction: limited exposure to own investment bank; but must be true of external, unregulated players as well.
- need to go faster in migration toward use of centralized exchanges (with prudential regulation of exchanges).

HIDDEN STRUCTURAL SEPARATION: ASSET INCOME RUNS

Regulators are not the only actors who have difficulty in assessing balance/off balance sheets in their entirety.

- Idea : earmark specific assets to specific lenders (easy resolution; no brainer).
- Has always existed:
  - collateral in repos. Legal clarification boosted use of repos
  - covered bonds.
- Recently, run for collateralization (in rough times, debt maturity shortens and more collateral demands). Banks pledge more and more assets.
  - Vickers: a form of regulatory asset income run (facilitates resolution).

V. CONCLUDING COMMENTS ON MONETARY POLICY

Protracted period of low interest rates ?

Rationale

- Rescues financial institutions with large maturity mismatch
  [Farhi-Tirole *AER* 2012: strategic complementarities: if others engage in maturity mismatch, CB will be forced to lower interest rates and engaging in maturity mismatch raises ROE.]
- Similarly, boosts industry's net interest margin.

Costs

- Boosts asset prices
- Distorts savings decision
- Saws the seeds for the next crisis: incentive to borrow short, lowering of short-term rates conducive to expanding balance sheets.
- Reaching for yield.

Monetization of sovereign debts?

- debt restructuring (Spain, ...) seems likely, especially if insufficient commitment to reforms
- alternative would be debt monetization; important setback
- makes it even more urgent to re-establish trust through reforms (credible signals of LT discipline).