

Banking Union framework and the stability of the European Banking sector

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Abstract. *In the past few years, the ECB faced many challenges in conducting the monetary policy in Eurozone. The sovereign debt crisis revealed the economic growth divergence between center and periphery in the European model. The creation of the Eurozone increased the correlation link between the banking sector and the public debt. The European authorities' role is to break down the doom loop between public debt and banks. During the sovereign debt crisis ECB exceeded its monetary policy objective of price stability through diverse operations assimilated by the markets as debt monetization. The Banking Union framework should approach three sensitive points related to fiscal sustainability, an integrated financial system and an EMU shock absorption mechanism.*

Keywords: Banking Union, debt monetization, price stability, public debt, financial shock.

JEL Classification: E44, E58.

Introduction

The sovereign debt crisis emphasized the lack of coordination between monetary and fiscal policies in the Eurozone. In order to restore credibility in the financial system ECB exceeded its limits and approached unconventional monetary policies. The tight link between public debt and the banking sector fueled the negative reaction from the financial markets. The crisis eroded the confidence in the Eurozone framework and proved that the deficit of political legitimacy in many sectors is a potential threat for EU. The creation of the Banking Union and the new financial framework in EU is destined to change the perception of the financial markets. The huge influence of the banking sector in the financing of the non-financial firms in EU created vulnerabilities for the national economies. Due to the uncertainties and the lack of stability in the financial system, the development of the private sector and implicitly, the economic growth of national economies in Eurozone were affected.

Analysis

The task of the ECB is dominated by three major constraints: national fiscal policies, exogenous or endogenous financial shocks and regional divergences. The main task of the ECB is written in article 127 (1) of the Treaty of the Functioning of the European Union: “*The primary objective of the European System of Central Banks (...) shall be to maintain price stability*”. In fulfilling this task of preserving price stability, it has full independence from EU institutions, bodies or agencies and from national governments of states members as exposed by Talani (2009).

ECB behavior during the crisis exceeded its primary objective and through its operations contributed in absorbing the shocks suffered by the banking sector through their public bonds exposure. Its monetary policy ventured into unknown territory and was often criticized by economists. In order to secure this policy ECB referred to Article 127 (1) “*without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union*”.

The monetary policies were dominated by unconventional features:

- Quantitative Easing Programmes - targeted credit easing through asset purchases, the Eurosystem bought covered bonds of over 100 billion euros during 2009-2012.
- Longer Term Refinancing Operations (LTROs) with maturities up to three years, from which the banking sector from Eurozone borrowed almost 1 trillion euros.
- Emergency Liquidity Assistance (ELA) - an emergency liquidity line, provided by national central banks to solvent banks that in exceptional moments do not have high quality collateral to access normal Eurosystem operations. It was commonly used during Greek, Cyprus and Ireland crises in order to stabilize their national banking sector and it was latter criticized by outsiders because of the lack of transparency in these operations.

- Collateral policy - several times during the sovereign debt crisis ECB changed its collateral framework changing the assets eligibility in order to ease possible shortcomings derived from collateral shortage.

During this period ECB designed two government purchasing Programmes, the Securities Market Programme (May 2010 - September 2012) and Outright Monetary Transactions (after September 2012). Their common goal was to sterilize the monetary liquidity and restore the transmission channels of monetary policy. The OMT is unlimited in principle, the limitations deriving strictly from the outstanding stock of eligible bonds with maturities between one and three years. *ELA provided banks a carry trade opportunity and created additional profits for the financial institutions, while realizing a back-door financing of public debt* (Veron, 2013).

Through this mechanism, banks borrowed cheaply from ECB in order to purchase government bonds with higher interest rates. Even if the OMT purchases were carried on the secondary markets a lot of economists saw this as a debt monetization procedure. A lot of investors purchased bonds on the primary market, acting as an intermediate for ECB secondary market purchases. The abrupt interruption of these operations could endanger the health of the European banking sector, while the uninterrupted continuation of this mechanism could diminish the ECB credibility.

In normal times central banks rarely adopt these sort of unconventional policies due to the theoretical issue of moral hazard (Darvas and Merler, 2013). The direct correlation between the sovereign debt problem and the liquidity of the European banking sector created the premises for this monetary policy approach. The composition of Tier1 Capital in the most important financial institutions in Eurozone was and is still dominated by public bonds. The European statistics reveal that Center and Northern European states increased their exposure on southern countries after 1999, and mainly after the convergence of the inflation rates in Euro Area as emphasized by Eichengreen (2010). The removal of exchange rate risk led to cross-border positions between financial investors in the core countries and borrowers in the periphery.

The creation of the Banking Union should diminish the link between the banking sector and sovereign debt. Without the fulfillment of this goal the stability of the financial system in Europe is in doubt and a negative reaction of the financial markets could anytime trigger another shock. This interdependence led to a fragmentation of the single market and raised doubts over the evolution of the European model. Faced with global competition, the European banking system needs a new framework based on strong pillars to ensure financial stability in the Eurozone.

The vicious circle between sovereign debt of the Member States and the European banking system stability must be restored on new principles able to ensure progress towards an integrated single market. The regulatory framework of the Eurozone Member States must guarantee against the following risks: asymmetric economic

shocks, the divergence pattern of economic growth between center and periphery, a stable banking sector able to surpass recessions or global shocks. The interdependence between Member States and the new directions of international banking regulations could cause systemic risks in the European model in the absence of a functional coordination mechanism. In this context, the lack of a stable regulatory framework can cause fragmentation of the single market and reverse the evolution towards a less integrated banking sector in Europe.

The new lawmaking process of the European financial system comprises the following three steps:

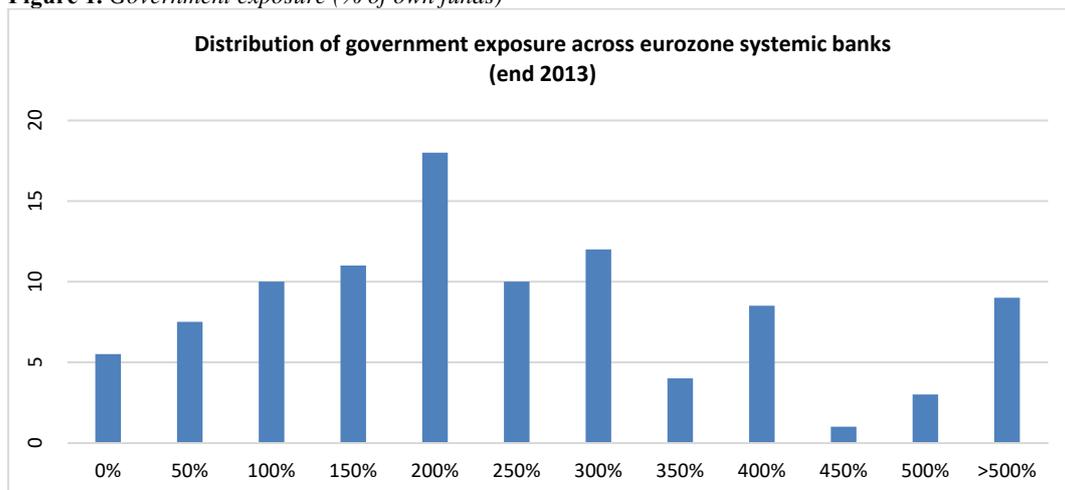
- ensuring financial stability and interdependence while breaching the link between European banks and sovereign debt;
- expanding the regulatory framework of the financial system through the implementation of structural policies at national level;
- establishing a single mechanism able to surpass endogenous and exogenous shocks in the euro area.

The creation of the Banking Union should tackle at least two particular issues according to Daniel Gros (2016):

- *Banks hold too much debt of their own sovereign. A sovereign default would bankrupt the banks in the country, a case illustrated by Greece.*
- *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 (Ireland).*

Banking regulation should be redesigned in order to apply a common rule for sovereign bonds compared to other debtors. The general purpose of this rule is evident, the insolvency of one debtor should not endanger the entire capital of a bank.

Figure 1. Government exposure (% of own funds)



Source: De Groen, 2015.

The histogram shows the total exposure to governments as a share of the total own funds across different own funds bins. According to de Groen (2015) “18% of the banks had exposures to governments between 150% and 200% of their own funds”. The data and distribution was set on 109 Eurozone banking institutions and subsidiaries on non-EU banks that were stress-tested by EBA. The entire group of large financial institutions selected held at the start of 2014 almost 2.5 trillion Euros sovereign debt. The calculations reveal that this figures represent twice the total sum of their own funds.

Definitely, a large exposure rule should be applied to government debt in the Euro Area, breaking the vicious link between sovereign debt and banking sector. The national deposit insurance funds cannot cope with large financial institutions balance sheets. The Ireland crisis clearly emphasized this problem, so the Banking Union should approach the subject of resolution funding from an entire system level. European authorities should advance this problem from a common perspective raising the issue from national to the European level. As Daniel Gros and Schoenmaker (2014) emphasized “*nation states are usually able to deal with small shocks themselves, but they need support when the shock is so large that access to the capital market is impaired*”.

As I described (Hrebenciuc, 2010) “*The eternal issue of the states with large structural budgetary issues that cannot be automatically regulated and in which the automated stabilizers have a significant role continued to exercise a high amount of pressure. It seems that the situation is also suffering due to an endless string of factors, with negative influence over the entire development*”.

The economic development of the European model depends largely on the role and functioning of the financial system in a globalized world. Effective national economic policies and economic convergence toward the center of the model cannot be achieved without the existence of financial stability in the banking sector. One of the main problems regarding ECB authority at the EU level was the lack of supervision over the banks during the crisis. The monetary policy was at times less powerful, due to the fact that banks were under the supervision of national authorities, while the ECB had no clue over the health of their balance sheets. The 2007 example of the collapse of Northern Rock showed how the lack of coordination between different authorities emphasized the limits of a lender of last resort not involved in supervision.

The vicious circle made up of sovereign debt and the stability of the financial institution has created a regulatory vacuum in the Eurozone. In this context, decision makers have mapped the configuration of a new legislative framework to ensure credibility in the system. As revealed by Veron (2013) after November 2014 ECB formally started to over-see the Eurozone banking system, following the decision to create a single supervision entity at Euro Area level in 2012.

The new configuration includes a set of measures focused on three main areas:

- Banking Union - the Single Supervisory Mechanism, National deposit guarantee schemes, the Single Resolution Mechanism, direct recapitalization through the European Stability Mechanism.
- Fiscal Union - 'Six Pack' Treaty on stability, coordination and governance 'package two'.
- Economic Union Frame - ex-ante coordination of reforms of economic policy (TSCG, art11), understandings contractual inserted in the European semester aimed at absorbing asymmetric shocks.

The Banking Union framework should provide a higher banking integration inside the Eurozone. This will translate in a convergence of interest rate in the banking sector in Euro Area. Studies reveal that the convergence is less powerful in retail banking due to the high degree of heterogeneity in demand for retail credit products. Because of the preference for debt versus equity financing in different states, ECB should not expect the convergence of bank loans interest rates. At this moment, the overall picture that emerges is one of limited bank integration in Europe and incomplete bank integration within states in Europe.

ECB (2009) studies revealed a higher integration in euro money markets after the creation of Eurozone. The elimination of exchange rate cost facilitated the comparability between rates of returns of banks in the Euro Area countries. The perception that banking sector is integrated if there is a common ROA (Return on Assets) to which all banks converge seems to function for US, but not in Europe.

The US banking sector is reasonably well integrated, while the European banking sector is far from reaching this point near soon. R. Gropp and A. Kashyap (2010) revealed that: *“non-listed banks have still prominent market shares in both US and Europe, while the percentage of European bank assets residing in listed banks is 53 percent and 47 percent in US. In the United States, listed and unlisted bank profits converge to the same target level, while in Europe only the listed banks appear to be governed by a common ROA”*.

The economic and financial integration has led several countries (ex. Ireland) to specialize in the production of financial services. This phenomenon led to a growing shadow banking system that erupted in the public debt crisis and required large public capital infusions for its survival. In 2008 at the height of the financial crisis the Euro Area member states devoted almost 1.5 trillion euros in order to recapitalize their banking systems (Wallace, 2016). The instability of the financial sector in Europe would cause great imbalances, according to the figures published in 2014 by Association of Financial Markets in Europe, banks provided almost 70% of debt financing for non-financial firms. The health of the banking sector greatly influences the real economy of the Euro Area. The low economic growth of the core countries after 2010 partly aroused from the capital problems in the financial system.

Conclusion

The recent crisis has emphasized that Eurozone government debt is not immune to default. The new legislative framework should relieve public debt restructuring with private sector burden sharing. Given the fact that many large financial institutions in Europe contain government bonds in their Tier1 capital, the large exposure rule would be a first step in breaking the tight link between public debt and banking sector. This problem could be resolved through ECB operations of asset purchases along with the introduction of large exposure requirement. The entire problem should be supervised at European level in order to mitigate the possible negative shocks. Any future crisis is hard to manage because of Euro Area different practices with regard to deposit insurance and bankruptcy procedures.

The designing of a new financial framework for Eurozone is directly influenced by the political legitimacy deficit. The behavior of some member states unable to ensure their national fiscal sustainability and proceed to real structural reforms negatively affects the whole process designed at EU level. EU policies should direct the banking sector to a US style system, in which state level public debt is small, there is no federal financial bail-out and the central bank does not purchase public bonds. US banks do not hold a large amount of state debt and an eventual crisis in the state government funding does not affect the financial stability of the banking system.

The new financial framework in Europe should distance ECB from any sort of conflict of interest or back door debt monetization. The public debt crisis revealed major differences in the transmission of monetary policy across the members of the Euro Area. The scope of the Banking Union creation is to acquire a balance between the banking sector stability and sovereign debt problems in EU.

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