MONITORING BANKS AND STATES: GOVERNANCE AND REFORMS IN EUROPE

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

Cannot abstract from incentives and interests of nation-states.

(2) *Outline*:

I. Banking union

II. Banking reforms

III. Concluding remarks on monetary policy

I. BANKING UNION

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

CHALLENGES FOR THE BANKING UNION

- *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
  - ideally, national supervisor employee/reports to ECB
  - joint team may indeed help.

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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.]

II . BANKING REFORMS

Some progress

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

Question marks: many, among them:

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

SEPARATING RETAIL AND INVESTMENT BANKS

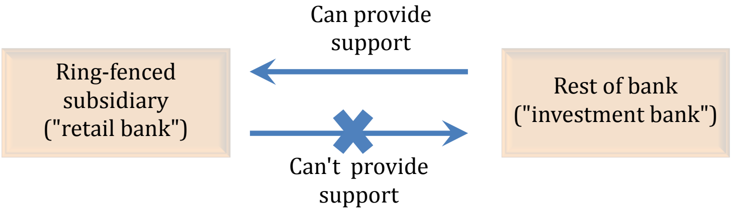
Philosophy: insulate basic banking services from investment banking risks. In a sense, reflects the view that regulators will always lose in the cat and mouse game (may be right).

(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).

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).

III. 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 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).

Thank you very much!