Current and Future Financial sector issues and Challenges
The View from Europe

25th Annual World Bank / IMF / Federal Reserve
"Seminar for Senior Bank Supervisors from Emerging Economies"

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Washington, October 2012,
1. Euro area Sovereign debt crisis: main features

2. Policy answers to stabilize the acute phase of the crisis

3. Long term reforms to restore confidence in the euro area

4. Current debate on the European banking model
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The Sovereign debt crisis, third phase of the financial crisis

Financial crisis (2007)

Sovereign debt crisis (2011)

Economic crisis (2009)
The rise in public debt in the wake of the financial crisis

Strong use of fiscal policy

Fiscal balance
(in GDP %)


Euro area (15 members) United kingdom United States Japan
Fiscal balance (% of GDP) – 2012 estimates

- Spain: -8.5%
- Portugal: -4.2%
- Greece: -9.2%
- Ireland: -3.8%
- Italy: -4.1%
- Euro Area: -8.4%
- UK: -9.5%
- Japan: -9.7%
- USA: -9.7%
The rise in public debt in the wake of the financial crisis

Public Debt (% of GDP) – 2012 estimates

- Spain: 87.9%
- Portugal: 124.3%
- Greece: 168.0%
- Ireland: 121.6%
- Italy: 122.7%
- Euro Area: 98.8%
- UK: 104.2%
- Japan: 214.3%
- USA: 108.6%

October 2012, 16th
The euro area at the epicenter of the sovereign debt crisis

10 years Interest rates- Benchmark (%)
Why the Euro area at the center of the Sovereign debt crisis?

- Markets realized that national situations were sharply contrasted within the Euro area (Greece - 2009)
- The refinancing needs of European countries were especially large in 2012
- The governance of the Euro area was put into question
- The long term sustainability of the current institutional setting
Low compliance with the Stability and Growth Pact even in “normal” times

Fiscal balance
(% of domestic GDP)

Source: CE
Spillover from sovereign risk to the banking sector

CDS average premium: Sovereign vs. banks (in basis points)
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Strong structural efforts to tackle fiscal deficits

- Greece: a EUR bn. 11.7 for 2013-14 + new structural reforms to keep the program on track; further aid disbursements awaited for next November, after Troika’s report;
- Portugal: achievements in line with expectations (deficit < 3% in 2014)
- Ireland: Initial program of EUR bn. 15 over 2011-14 to reduce the total public deficit under 3% before 2015.
- Italy: 2011 consolidation plan amounting to 3% of GDP for 2012 + 2013 (target: structural deficit = 0 in 2013)
- Spain: 2011 and 2012 consolidation plans
Non conventional monetary policy measures

- Measures aiming the banking sector, which finance $\frac{3}{4}$ of the euro area economy:
  - Fixed rate full allotment
  - Up to 3-year maturity
  - Extension of collateral requirement

- Direct market purchases to insure a correct transmission of monetary policy:
  - SMP: Government securities
  - CBPP: Covered bonds
Banks’ capital consolidation plans:

- European Banking Authority capital exercise (end 2011): more than EUR 200 bn. capital increase for major European banks
  - A mandatory 9% CET1 ratio to be reached as of June 2012, 30th
    - based on CRD III requirements (Basel 2.5)
    - Including a capital buffer to account for potential losses stemming from exposures on European sovereigns (based on Sept. 2011 market values).
  - The 27 banks that had to submit a capital plan (due to a shortfall) have strengthened their capital position by EUR bn. 116 in aggregate.
  - The overall increase in capital positions could be achieved mainly through capital measures, such as retained earnings and new equity
  - Limited bank deleveraging
- **Spanish bank recapitalisation and restructuring**
  - **Top down exercise (June 2012):**
    - a stress test on the 14 main banking groups (domestic portfolio) based on macro scenarii designed under the auspices of the ECB and the IMF
    - global shortfall of capital in the range of EUR bn. 51-62 in the stress scenario
  - **July 2012, EU decision to provide financial assistance to Spain to recapitalize its banks up to EUR bn100**
  - **Bottom-up exercise (September 2012):**
    - Review of banks’ domestic loan portfolio by the 4 international auditing firms
    - Based on these data, new stress test carried out on the same 14 banks => EUR bn. 59.3 capital shortfall for 7 banks (4 of them already nationalized)
  - This shortfall to be completed up to a third by banks themselves and for the remaining two thirds through European assistance
  - Troubled assets to be transferred to a “bad bank”
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A credible « firewall » for crisis management

  - 192 billion for Greece, Ireland and Portugal
  - 109 billion additional for Greece
  - up to 100 billion for the Spanish banking system
  - Cyprus

- European Stability Mechanism (ESM – October 2012): EUR bn. 500
  - Conditionality / Seniority
  - Interest rates close to EFE funding costs
  - Prevents spillovers and ensures financial stability
Progress after the Euro Area Summit (June 2012)

- Strengthening the efficiency of the Euro area firewall:
  - May purchase public debt in the primary and secondary debt markets « in a flexible and efficient manner »
  - ESM clause of seniority no longer automatic (cf. Spain)
  - The ESM will be empowered to directly recapitalize banks in the euro area once an effective single supervisory mechanism for euro area banks is established

- 12 September: German Constitutional Court rejects calls to block the ESM Treaty

- October: launch of the ESM
A “fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area”

- A prerequisite: strict conditionality attached to an appropriate EFSF/ESM programme.
- Involvement of the IMF will be sought (design of conditionality + monitoring of the programme)
- Also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access
- Transactions focused on the shorter part of the yield curve (sovereign bonds with a 1 to 3 years of residual maturity).
- No *ex ante* quantitative limits
- The Eurosystem will accept the same (*pari passu*) treatment as private or other creditors
- The liquidity created through OMT will be fully sterilized.
EU supervisory architecture (Jan. 2011 – Now)
Why a Banking Union?

- Breaking the vicious circle between banks and sovereigns
- Improving the conduits of monetary policy
- Protecting deposits and avoid bank runs in periods of stress
- Ensuring direct recapitalization of banks through the European Stability Mechanism (ESM)

3 pillars:

- A single supervisory mechanism (SSM)
- A single resolution mechanism (SRM)
- A single deposit insurance scheme (SDIS)

Calendar:

- Proposals on the SSM in September; decision by year end
- Proposals on the SRM and SDIS to be released in 2013
What geographical Scope?

- Euro-zone countries (17)
  
  “In view of the close links and interactions between Member States participating in the current currency, the banking union should apply at least to all Euro area Member States”

- Opt-in clause for countries outside the Euro-zone (10)
  - Close cooperation with non-euro Member States is provided for in the Regulation area…
  - ….with a view to eventually open the participation to the SSM to all Member States.
• **What institutional Scope?**

  • All Euro-zone credit institutions, with a phasing-in approach:
    - **January 2013, 1st:** the ECB will be able to supervise any bank, in particular banks which have received or requested public financial assistance.
    - **July 2013, 1st:** the most significant credit institutions of European systemic importance shall be subject to ECB supervision.
    - **January 2014, 1st:** ultimate deadline for all euro area credit institutions to fall under ECB supervision.

  • **What about other financial institutions?**
    - Art. 127.6 excludes insurance firms from the ECB’s supervisory scope.
    - National authorities will continue to supervise directly all institutions which are not credit institutions under EU law (e.g. investment firms, financing companies).
What role for the ECB?

Responsible for key tasks as outlined in the draft Regulation:

• Granting and withdrawing license of all credit institutions
• Assessing acquisition and disposal of holdings in banks
• Ensuring compliance with all prudential requirements and setting, where necessary, higher prudential requirements
• Carrying out supervisory stress tests and consolidated supervision
• Imposing capital buffers and exercise other macro-prudential powers
• Applying requirements regarding governance and internal processes
• Carrying out, in coordination with resolution authorities, early intervention tasks
• Coordinating common position of national supervisors within the Euro Banking Agency.
What role for national authorities?

- National authorities would prepare and implement the ECB acts under its oversight (e.g. ongoing day-to-day assessment of a bank’s situation and related on-site verifications):
  - National authorities possess crucial local expertise, daily monitoring experience, and qualified resources.
  - Operational and practical arrangements between the ECB and the national authorities are needed.

- National authorities would remain responsible for tasks not conferred to the ECB, including for example:
  - Fight against anti-money laundering and terrorism
  - Consumer protection
  - Supervision of third country branches and investment firms
What role for the EBA?

• Maintenance of EBA tasks and prerogatives:
  – Regulatory and coordination role fully maintained
  – Specific procedure for cases of settlement of disagreement and emergency actions: ECB submitted to comply/explain procedure, and effective means of intervention granted to EBA

• In order for the decision making process to remain balanced, new rules are needed:
  – Qualified majority votes are maintained for the adoption of guidelines, recommendations and draft technical standards: Euro Area Members do not have a qualified majority
  – Regarding breach of law and settlement of disagreement through a binding mediation: simple majority needs to be adapted
Quick implementation of Basel 3 (CRR/CRD 4):
  • Increase capital level and quality
  • Strengthen risk coverage (market operations, securitization, …)
  • Complement risk coverage (with standardized liquidity ratios)

Harmonized EU insurance regulation: Solvency II

Regulation of Systemic Financial Institutions:
  • Enhanced loss absorption capacity (G-SIFIs)
  • Restructuration mechanism and enhanced supervision
  • A framework for D-SIFIs

Financial markets:
  • Clearing by regulated central counterparts (CCPs)
  • Better supervision of ‘shadow banking’, in particular hedge funds
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What are we talking about?
Universal banks are institutions that combine the lending and payment services of commercial banks with a wider range of financial services.

In the EU, the 1989 European directive made universal banking the norm:
- introduction of a single banking license with a wide range of activities, valid throughout the European Union.
- Universal banks are widespread across the EU: Barclays, HSBC, RBS, Lloyds in the UK, Société Générale, BNPP, Crédit Agricole in France, Deutsche Bank, Commerzbank in Germany, BBVA, Santander in Spain, etc.
The financial crisis and market expectations have put pressure on banks to comply with the new regulations sooner than initially planned (no transition period).

- Many banks committed to comply with Basel III (including systemic surcharge) as early as 2013 (instead of 2019)
- Fears of several unintended and adverse consequences.

LCR focusing the greatest concerns:

- EUR tn. 1.76 shortfall as of June 2011 for international banks
- Possible trigger of a “deposit war” among banks
- Undesired consequences for some business lines (USD financing: trade and project finance)
- Sovereign debt holding vs. funding to the economy
The Volcker rule
- Restricts deposit-taking banks from engaging in certain types of market-oriented activity (proprietary trading).
- Prohibits any banking entity (with exemptions) from engaging as principal in short-term trading in securities, derivatives and commodity futures.
- Different from the regime prevailing between 1933 and 1999 in the US.

The Vickers report is based on a ring-fencing principle
- Within a banking group, deposit taking and loans to individuals and SMEs can only be provided by a ring-fenced entity.
- Ring-fenced entity prohibited from carrying out most market operations.
- Legal independence and strong operational and funding autonomy.
- Ring-fenced entity submitted to higher solo prudential requirements.
- In case of emergency, the ring-fenced entity can be isolated from the group in a few days.
The context:
- No banking model performed better during the financial crisis
- Excessive risk-taking at the heart of the main difficulties

Mandatory separation of trading activities
- Trading portfolios + AFS > [15-25%] of total assets or EUR bn. 100
- And specific trading assets > % of total assets (to be determined)

Assets to be transferred to the “trading entity”
- Proprietary trading + market making
- Loans / commitments to hedge funds (including prime brokerage) and SIV/SPV
- Private equity investments
No mandatory organizational scheme

• No need for a bank holding company
• Possible relations between the trading entity and the “deposit bank” at market conditions and subject to large exposures regulation
• CRR/CRDIV on a solo basis for the two entities
• An extra capital buffer for the trading entity

Additional proposals

• A wider scope of activities might be transferred to facilitate the implementation of the Recovery Resolution Plan
• Bail-in instruments
• Capital requirements on trading assets and real estate-related loans
• Strengthening banks’ governance and control

European Commission first draft expected in 2013
Conclusion

- European banks hit by Sovereign Debt crisis

- Growing consensus on the direction to overcome the crisis by:
  - strengthening fiscal governance and crisis management framework
  - establishing a banking union (single EA supervisory system, resolution mechanism and deposit guarantee scheme)