

Can the EU respond adequately to the next crisis with its current instruments?

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Workshop on advancing new tools for the EU budget to foster crisis management and economic convergence

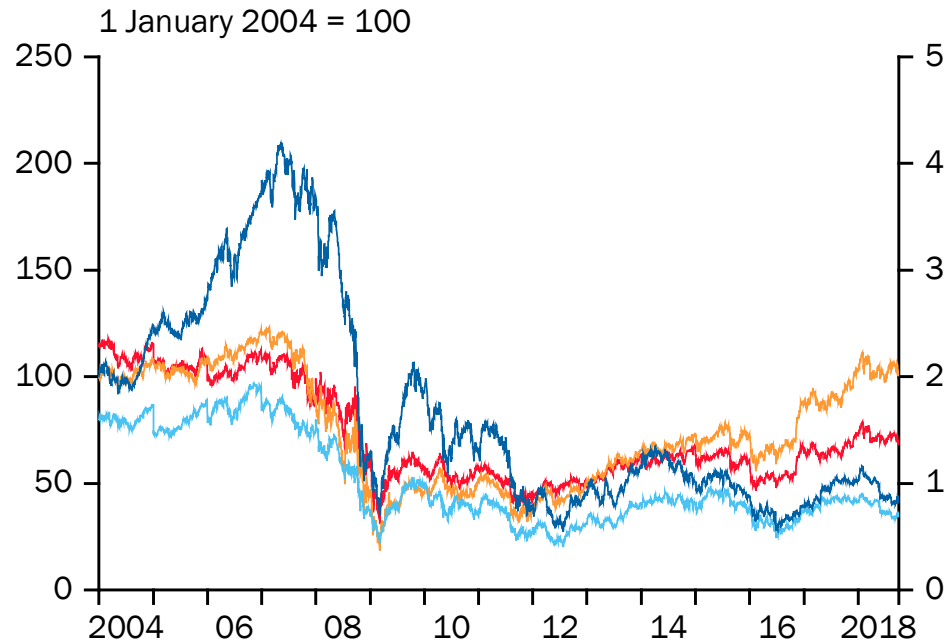
5 February 2019, OECD, Paris



I. Financial sector in the euro area still fragile

European banking sector remains weak

Bank share prices and price-to-book ratios



Stock price indices:

— Euro area — United States

Price-to-book ratio (right-hand scale):

— DE,FR,IT,ES — United States

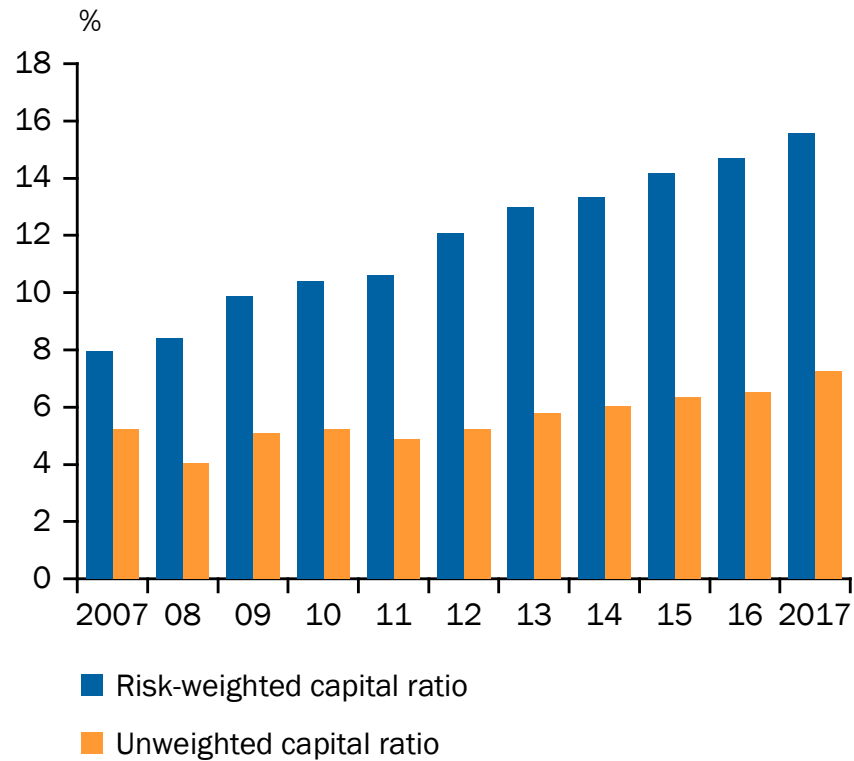
Sources: EBA, ECB, Thomson Reuters

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- Low share prices and price-to-book ratios
- Structural problems (overcapacities)
- Prolonged low-interest rate environment puts additional pressure on profits and may give rise to excessive risk-taking

Bank capital still too low, NPLs still too high

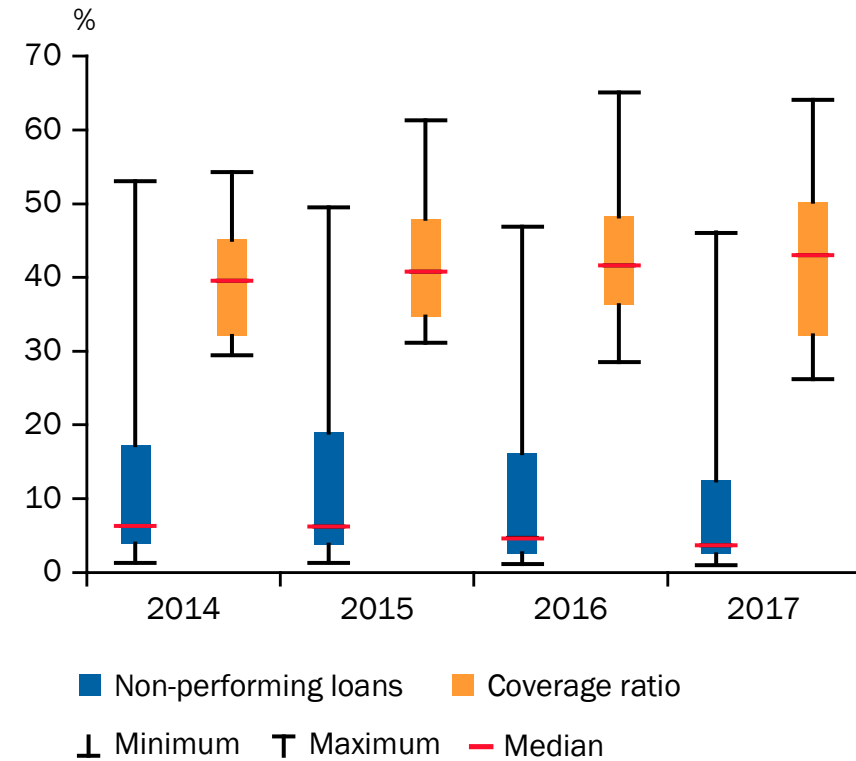
Risk-weighted and unweighted capital ratios in the euro area



Sources: EBA, ECB, Thomson Reuters

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Euro area non-performing loans and risk provisions

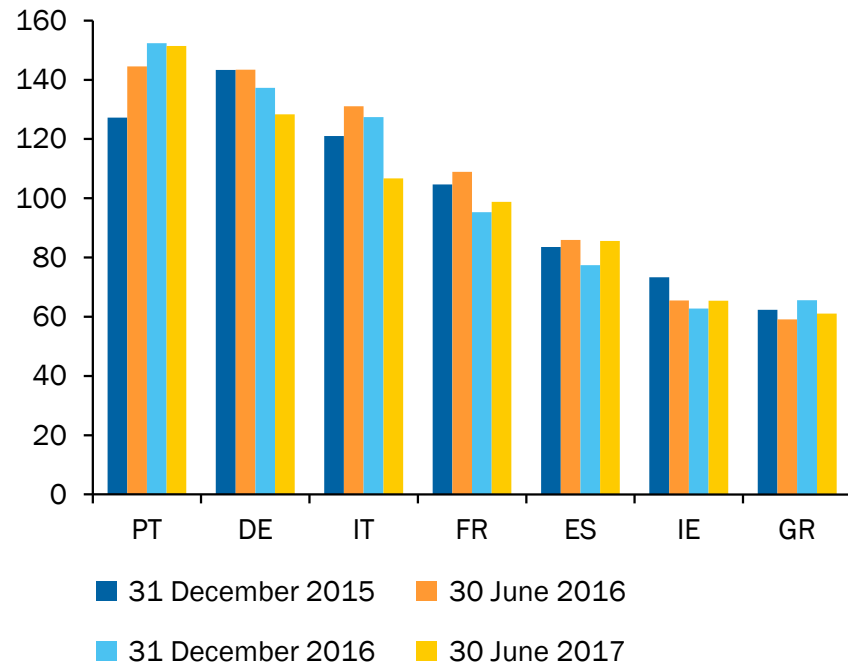


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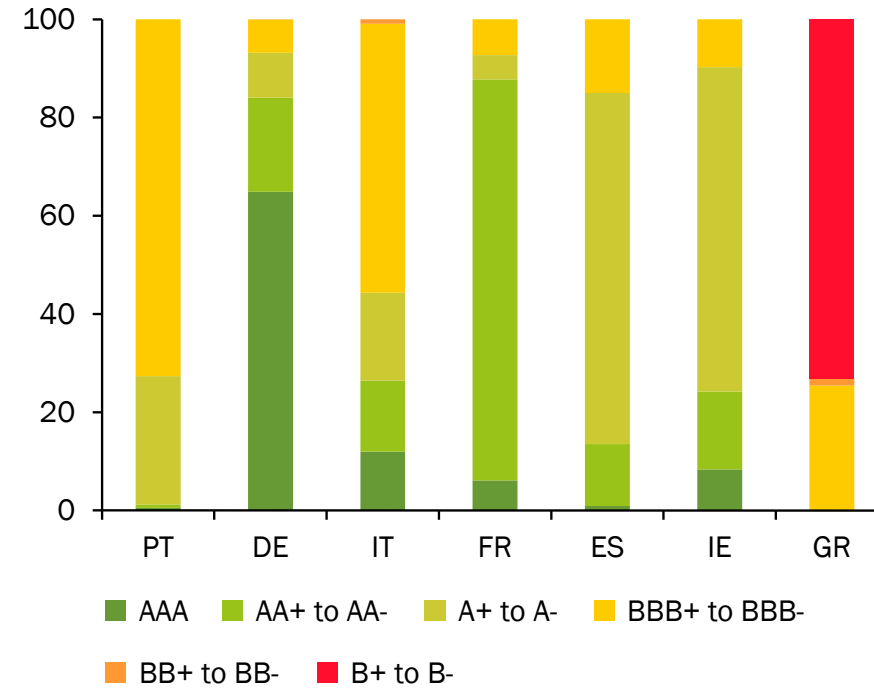
Strong home bias in banks' sovereign exposures

Ratio of exposures to its host country to own funds



Sources: EBA, own calculations

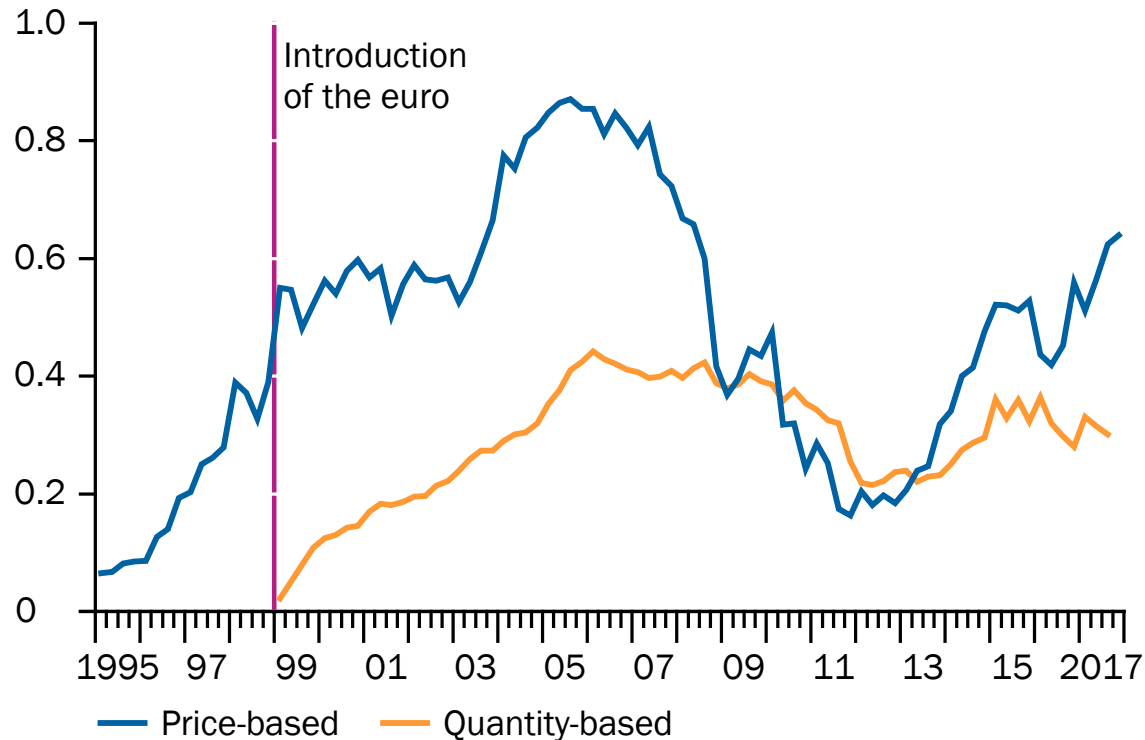
Distribution of exposures to EU member states by rating category



Sources: EBA, Standard & Poor's, own calculations

Low financial integration in the euro area

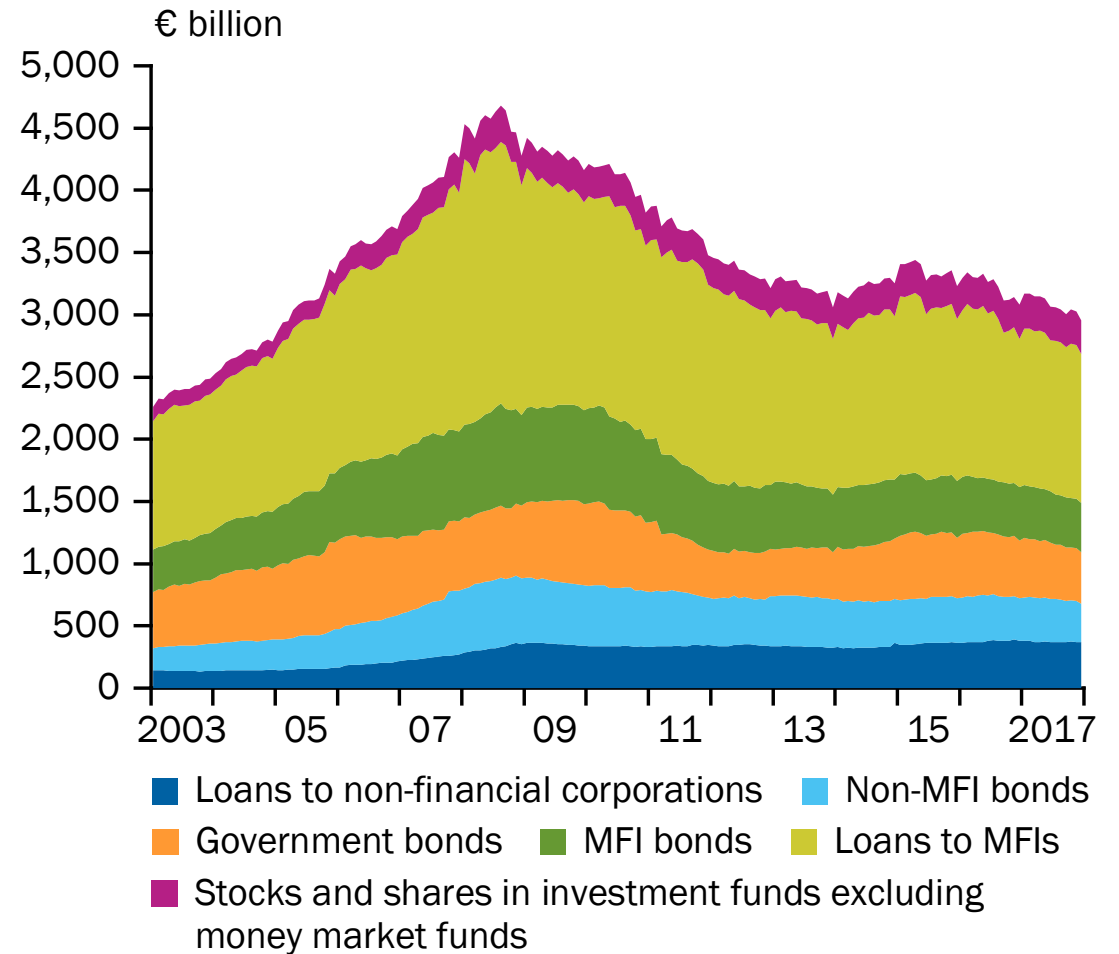
Euro area financial integration indicators



Source: ECB

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MFI cross-border assets

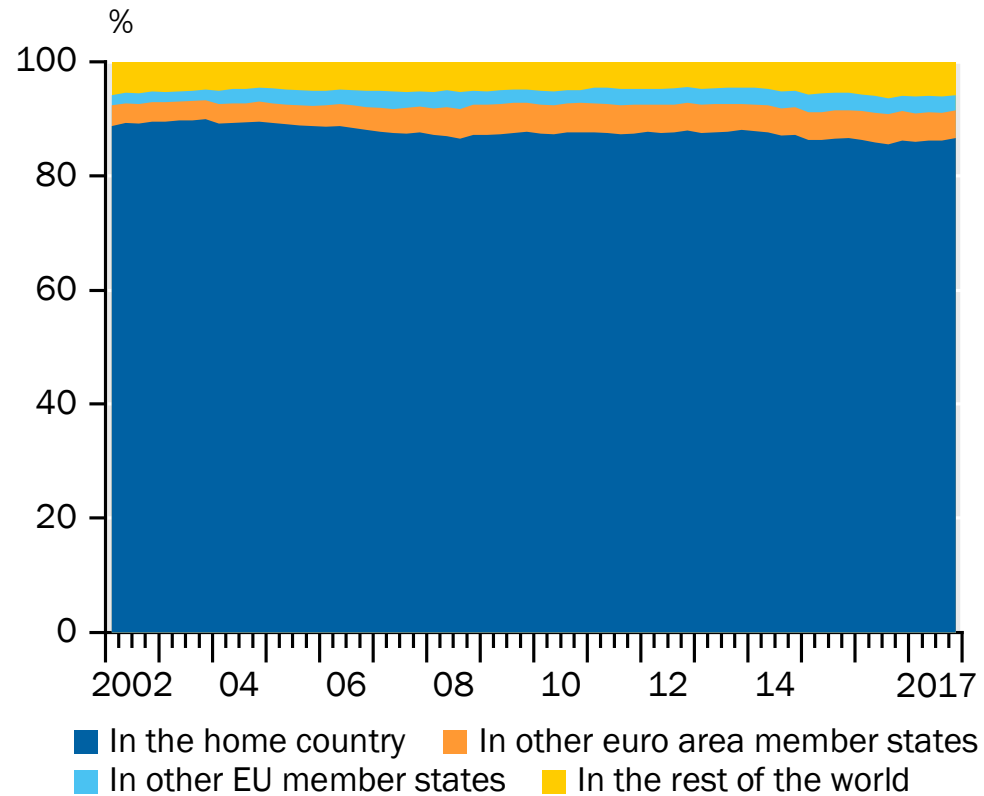


Sources: ECB, own calculations

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Segmentation of banking markets

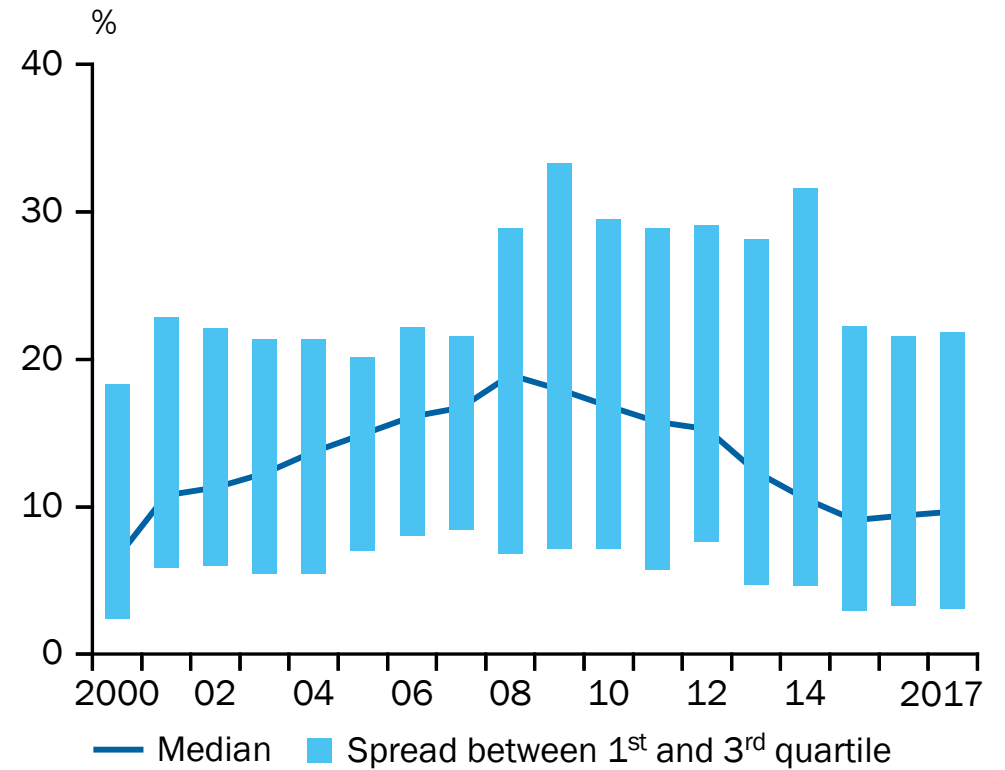
MFI loans to non-MFIs



Sources: ECB, own calculations

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Share of foreign bank assets in the euro area



Sources: ECB, own calculations

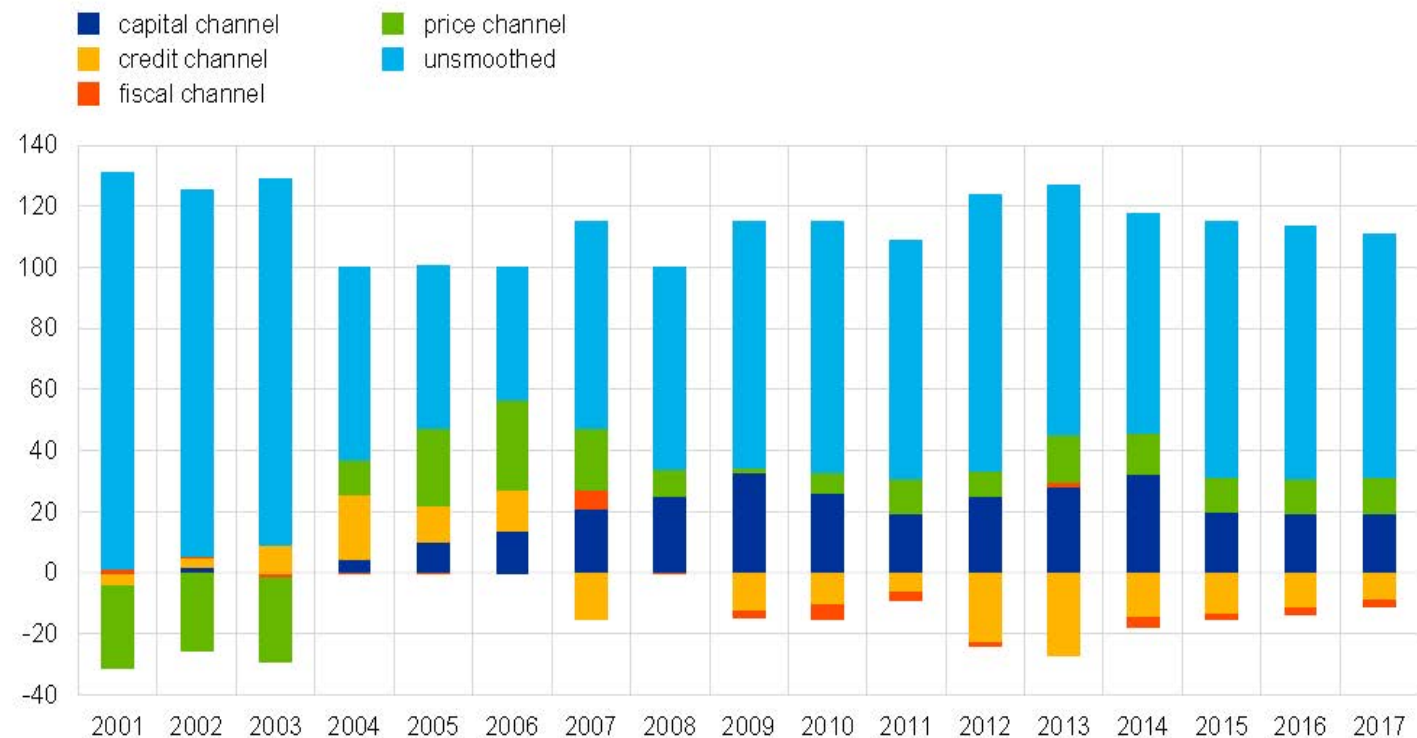
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(Too) little risk sharing in the euro area (ECB, 2018)

Chart 2

Consumption risk sharing in the euro area and its channels

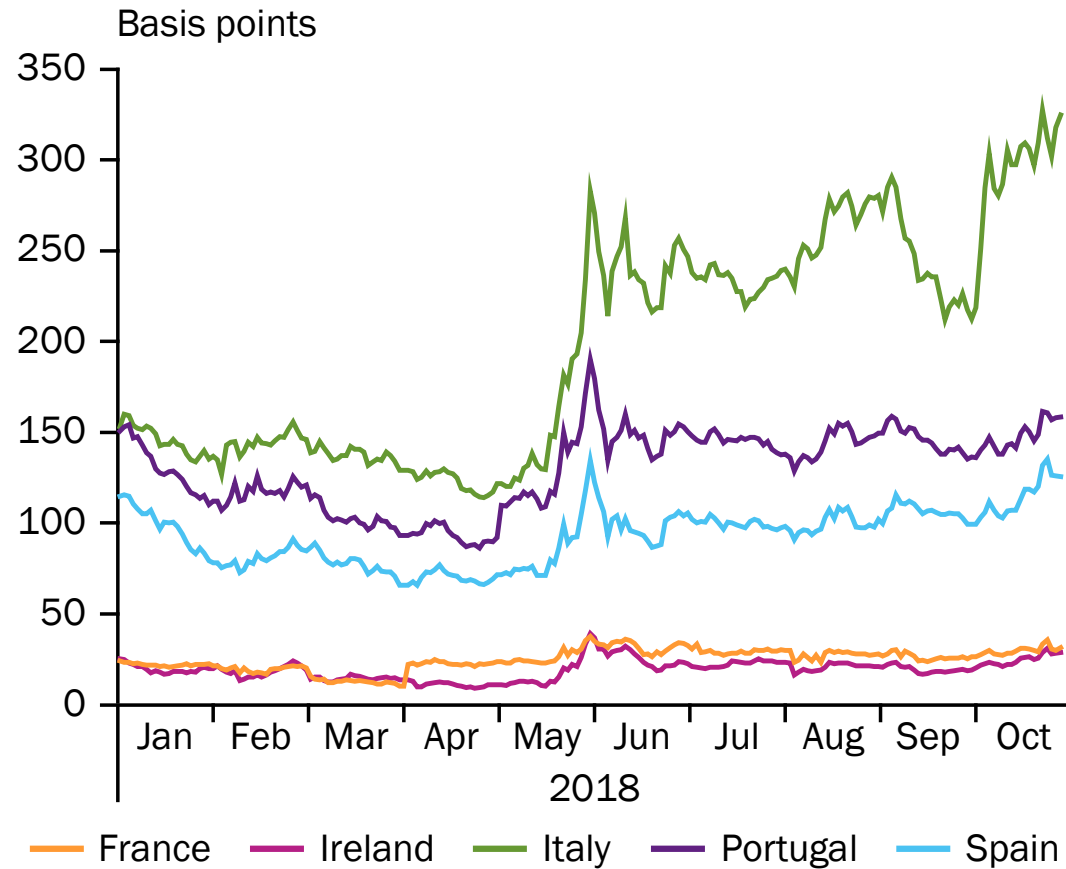
(percentages)



— Three fourths of shocks are not smoothed at all

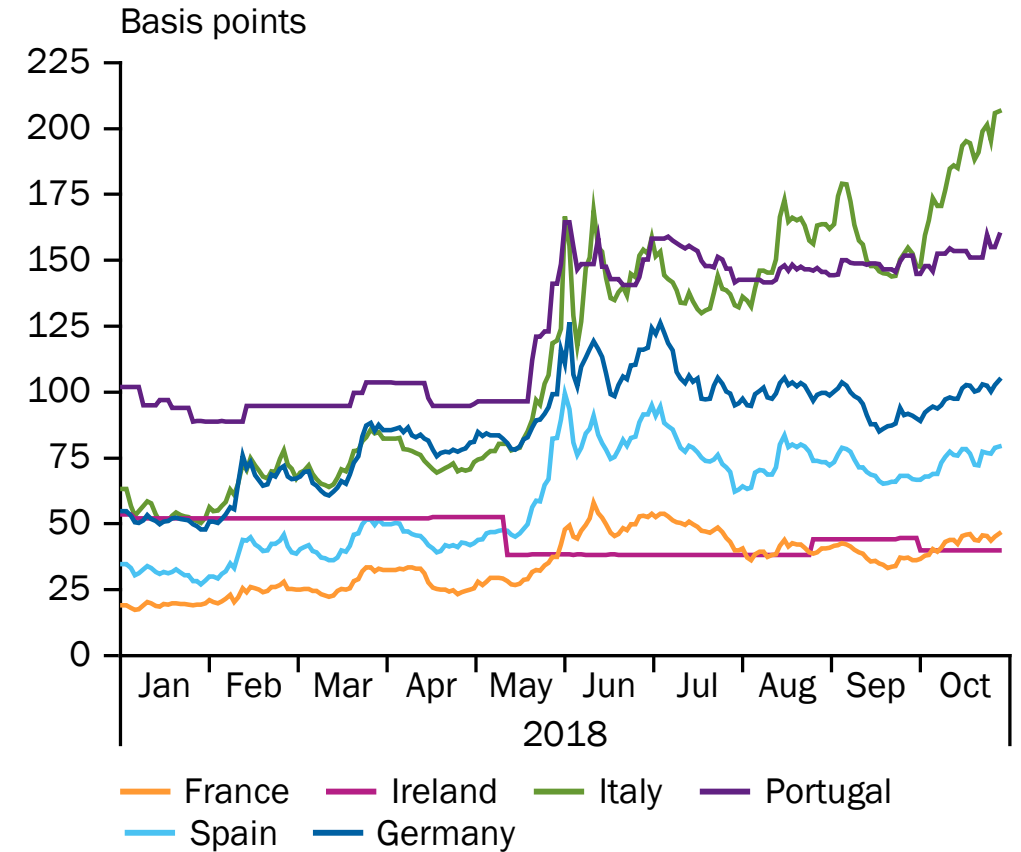
A wake-up call from Italy

10-year government bond spreads



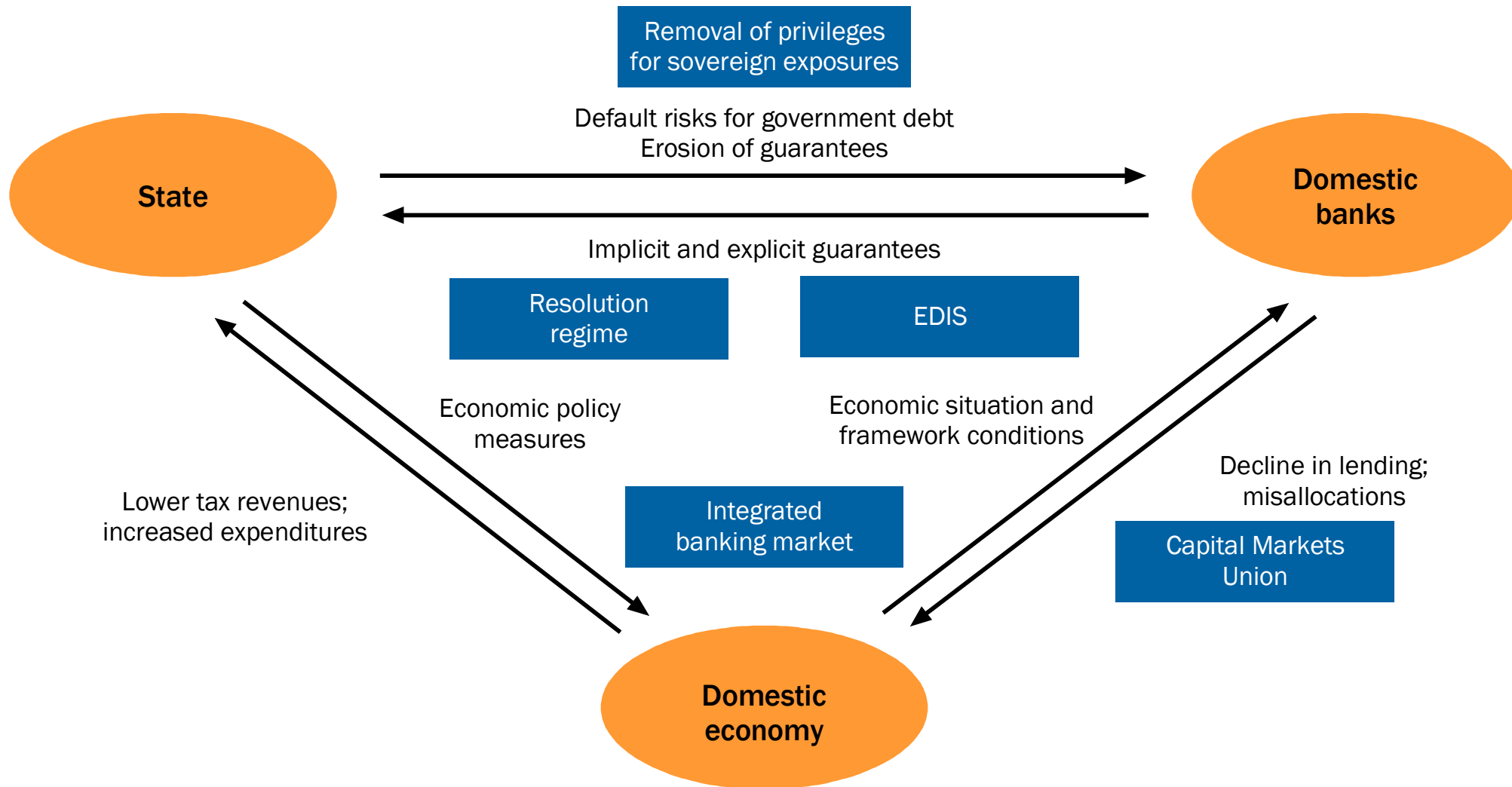
Sources: Thomson Reuters, own calculations

Senior CDS spreads of banks



Sources: BankFocus, Thomson Reuters, own calculations

Sovereign-bank nexus as a major source of vulnerability



Source: own illustration based on Shambaugh (2012) and Schnabel and Véron (2018)

II. Deepening Banking Union

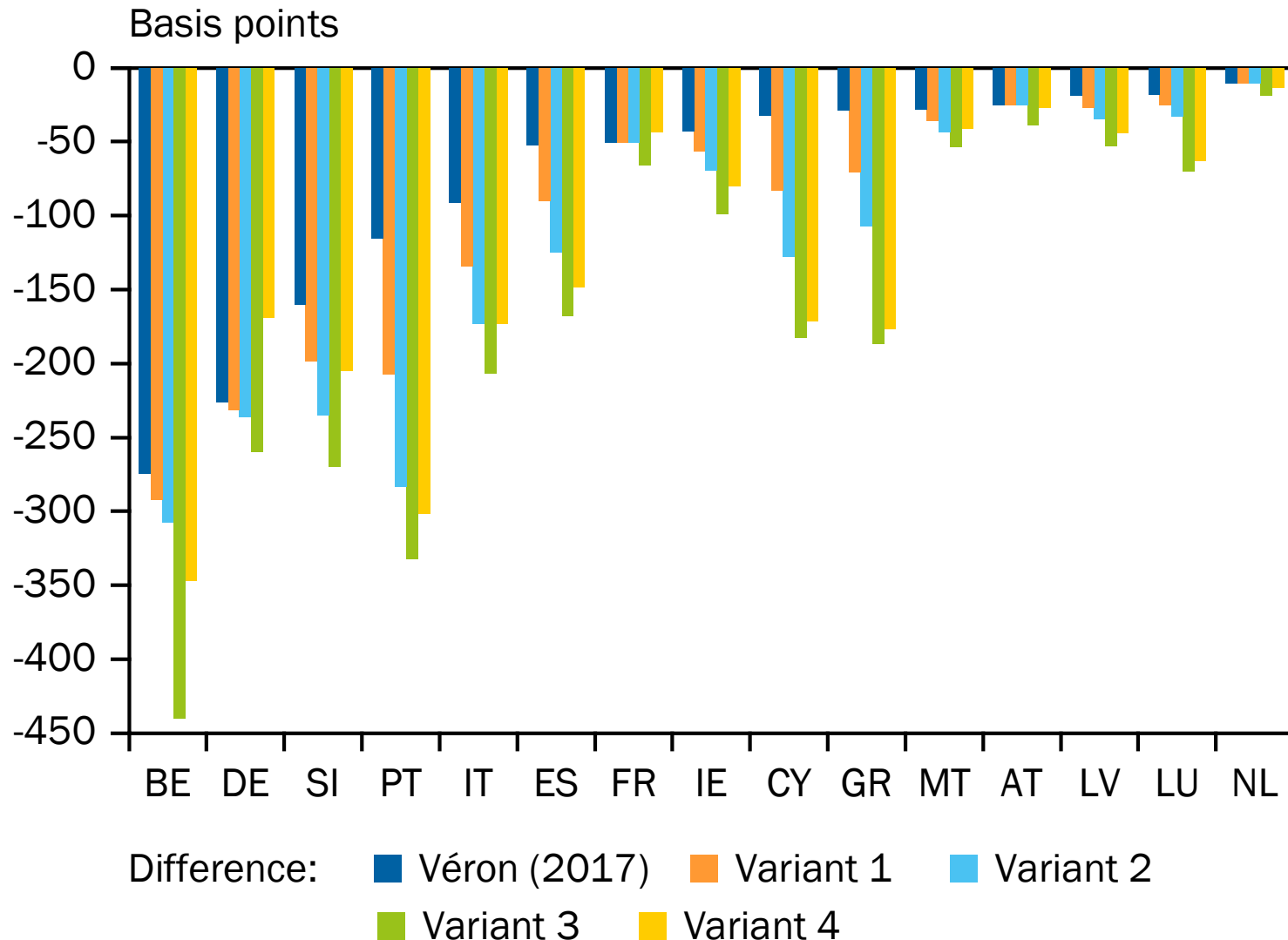
How to strengthen the bank resolution framework

- Raise the **credibility** of the bank resolution framework
 - Strengthen the role of the SRB
 - Tighten conditions for state aid and precautionary recapitalization
 - Harmonize national bank insolvency laws
 - ESM as **fiscal backstop** to the Single Resolution Fund (SRF)
- Need for **special liquidity facility** for banks in resolution
- Calls for national or European champions are counterproductive
 - Modify **merger control** to include systemic relevance as a criterion?

How to complete Banking Union: European deposit insurance

- National deposit insurance...
 - ... fosters sovereign-bank nexus through implicit government guarantees
 - ... promotes ring-fencing
- **Incentive-compatible design** (Schnabel and Véron, 2018):
 - **Reinsurance system**: Mutualization only when the national compartment is depleted
 - Bank-specific premia containing a country component
- System is “country-blind” from the depositors’ perspective but not from the funding perspective
- Requires a **regulation of sovereign exposures**

How to regulate sovereign exposures: Concentration charges



- Concentration charges should take the credit risk of sovereign debtors into account
- But: Diversified portfolios could be exempted, long transitions needed

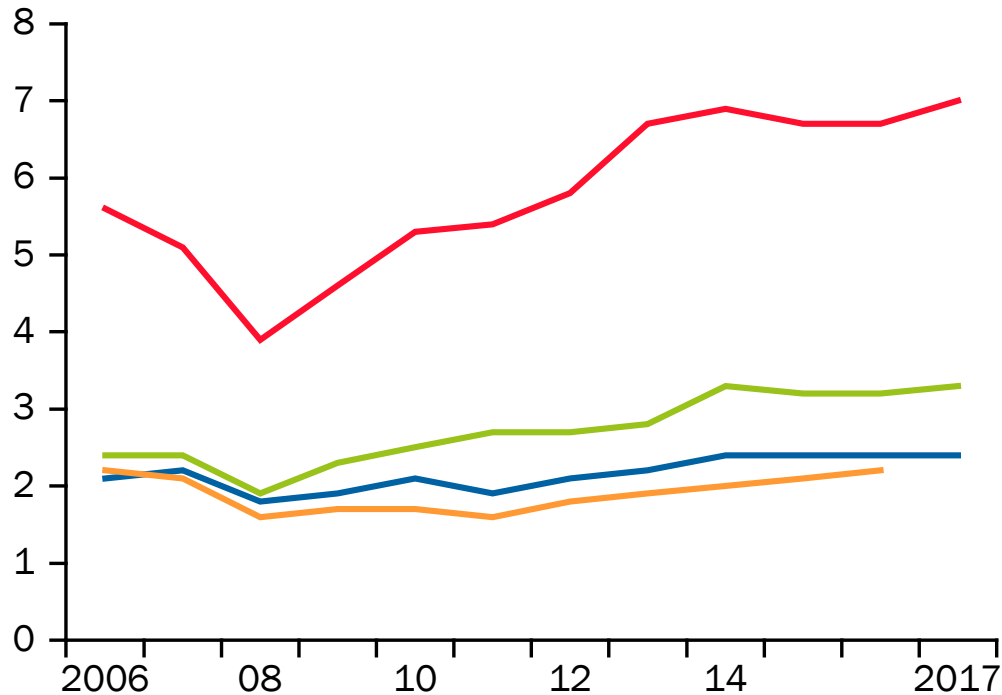
Is there a need for a safe asset?

- Requirement for larger diversification would push some banks into riskier securities, which could make banks riskier
- Risks could be reduced by creating a „safe asset“
 - ESBies? E-Bonds?

III. Fostering Capital Markets Union

European financial system remains strongly bank-based

External financing of companies



Ratio of capital market financing to bank financing:

- United States
- United Kingdom
- Germany
- Euro area (excluding Germany)

- Market-based financing plays a much smaller role in Europe than in the United States
- Strong focus on debt financing
- Capital Markets Union should especially foster resilient capital flows:
 - Equity, FDI, long-term debt, retail

Sources: Eurostat, ECB, OECD, Klapper et al. (2015)

How to foster Capital Markets Union

- Progress on CMU is slow
 - Partly due to supervisory authorities' reluctance to give up power
 - Limited willingness to put political capital into CMU, trends towards nationalization
- Strengthen **capital supply** by expanding capital-based pension systems
- **Standardization** and **harmonization** (e.g. insolvency law)
- Strengthen **ESMA** to harmonize implementation of rules
- **Remove debt bias** in taxation
- Foster **financial literacy**

IV. How to proceed

How to proceed?

- Status quo is unstable
- Stabilization of the euro area requires **more market discipline** and **more risk sharing** (Bénassy-Quéré et al., 2018)
- Rather than rejecting reforms, policymakers should focus on how risk sharing instruments can be designed in an **incentive-compatible** way
- Reforms are likely to come too late to deal with current issues but help to stabilize expectations regarding the future of the euro area