A Banking Union for the Euro Area

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Three essential elements

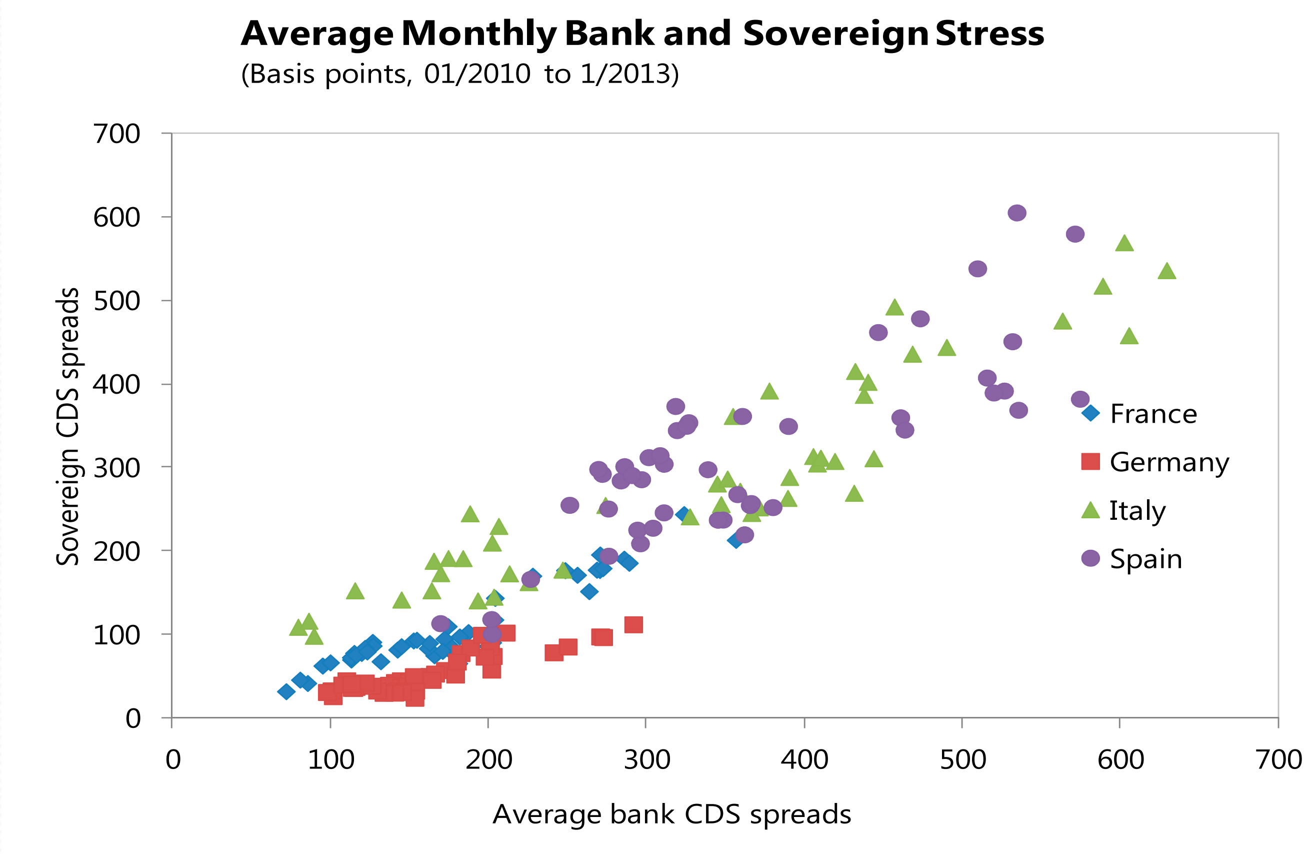
- Single supervisory mechanism
- Single resolution authority/mechanism
- Common safety nets
  - deposit insurance/common backstops

Incomplete Architecture

- Single currency and Single market for financial services.
- But national financial architecture
- It worked well for a while:
  - Financial Integration, uniform interbank market
  - Convergence of inflation and interest rates
- Then the crisis –
  - Large increase in sovereign debt
  - High private sector indebtedness
  - Weaker banks

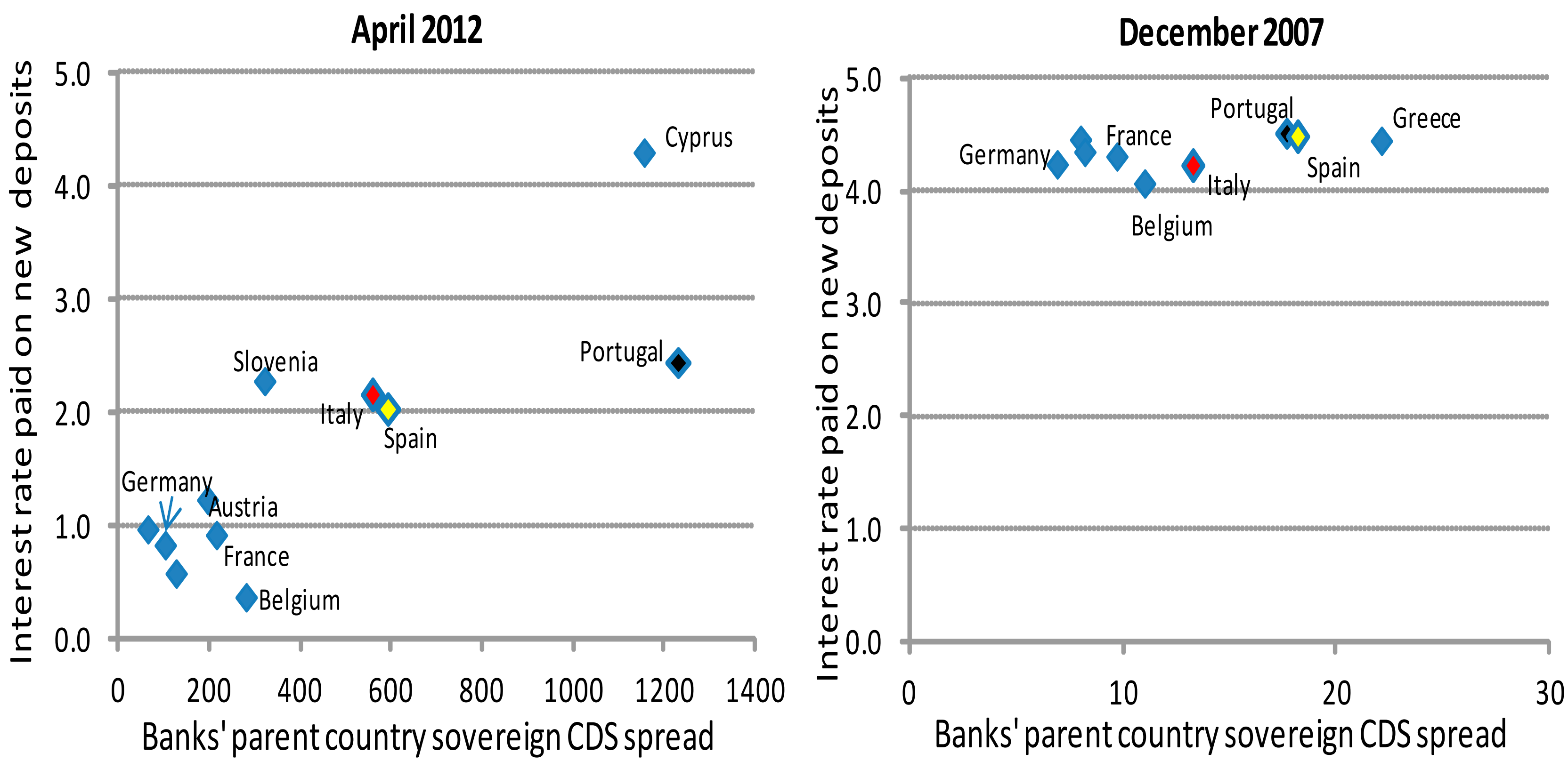
Adverse sovereign-bank-real economy links & fragmentation

Divergence of Bank funding costs



Substantial divergence of deposit rates

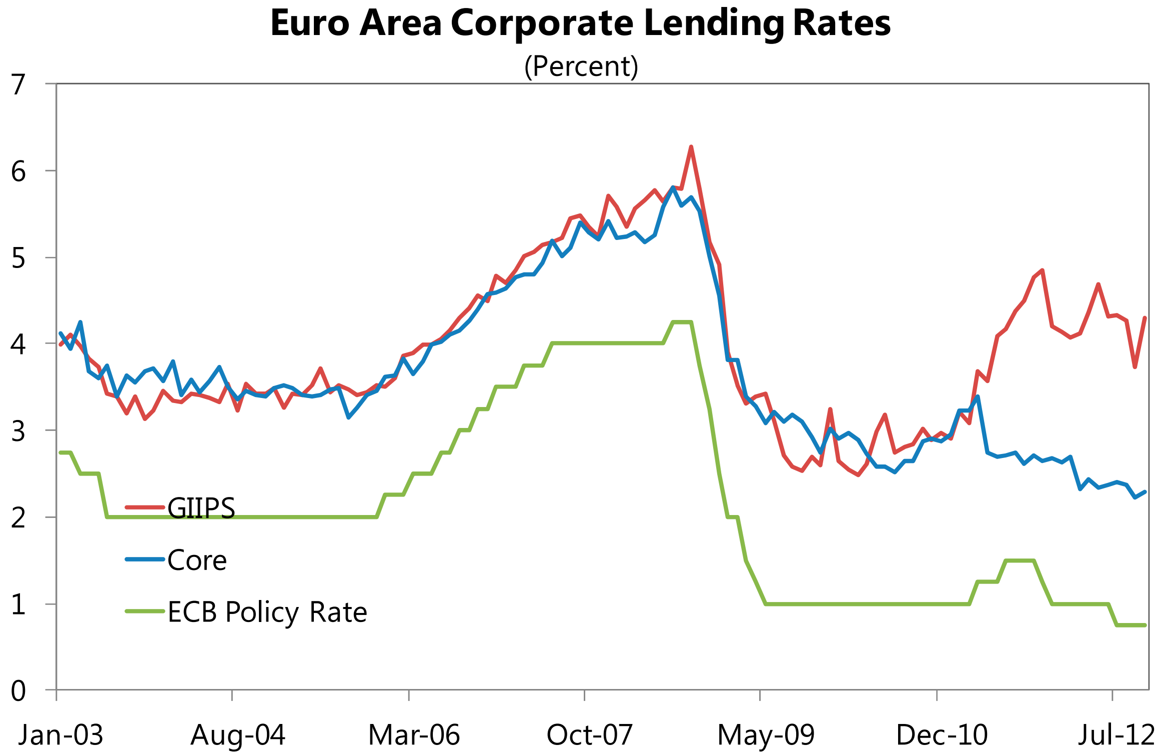
Retail deposit rates now reflect perceived strength of the sovereign and safety net 1/



Source: ECB, Bloomberg, and IMF staff calculations.

Notes: 1/ Average interest rate paid by MFIs on new deposits with agreed maturity up to 1 year. Available data for Greece in April 2012 are not plotted due to being far away of the rest of the sample (the avg. interest rate was 4.8 and the sovereign greek CDS spread was 8751 bps).

Transmission of monetary policy impaired



Note: Unweighted average; MFI lending to corporations over €1 million, 1-5 years. Belgium and Portugal reflect rates on all maturities.
Core: Germancy, France, Belgium, Netherlands.

How will the Banking Union help?

- Single supervision:
  - Systemic and coordinated approach to supervision
  - Avoid national ring-fencing
  - Timely intervention in banks (resolution power)

- Single resolution:
  - Least cost and swift resolution (cross-border banks)
  - Funding

- Common safety nets and backstops:
  - Weaken sovereign-bank links

Scope

- What banks?
  - SIFIs
  - Large banks in small countries
  - But: correlated risks, avoid regulatory arbitrage

    → All banks

- What countries?
  - Essential for eurozone
  - Open to other EU…
  - …but issues with multiple central banks, LOLR, currencies

ESM direct recapitalization

- For frail domestically systemic banks
  - Close failing non-systemic banks
- Risk sharing mechanism
  - Eliminate tail risks for sovereigns
- Importance of asset valuation
  - Definition of “Legacy”
  - Some expected losses borne by sovereign

Burden sharing and backstops

- Hierarchy of claims:
  - Pecking order (Bail in)
  - Depositor preference
- Backstops and safety net:
  - Common resolution fund and DGS
  - ECB line of credit (with guarantees)
- Lender of Last Resort:
  - Centralized at the ECB

EU Council agreements

- Single supervisory mechanism (SSM)
  - By March 2014 or one year after adoption of SSM regulation
- Single rule book
  - CRR/CRDIV: "utmost priority" (March 2013)
  - Bank Recovery & Resolution and DGS Directives by June 2013
- Framework for ESM recapitalization
  - First Semester of 2013
- EC Proposal for Single Resolution Mechanism
  - By Summer 2013

Summary: all elements are necessary

- SSM without single resolution and safety net:
  - Bank-sovereign vicious circle intact
  - Effectiveness of SSM impeded
- Single Resolution without backstops / safety nets:
  - Resolution not credible
  - Effectiveness of supervision impeded
- Common backstops and safety nets without effective supervision and resolution:
  - Incentives to forbear and shift losses to euro area level