

MONITORING BANKS AND STATES: GOVERNANCE AND REFORMS IN EUROPE

SIRE Lecture,
University of Edinburgh, October 7, 2013

Jean Tirole

I. INTRODUCTION

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

Cannot abstract from incentives and interests of nation-states.

(2) *Our knowledge is rather patchy.* This talk emphasizes an **incentive view of Eurozone institutions**:

- some based on existing research
- most based more on “gut feeling”

(3) *Outline:*

II. European institutional reforms

III. Banking union

IV. Banking reforms

V. Concluding remarks on monetary policy

BRIEF REMINDERS ON WHAT WENT WRONG

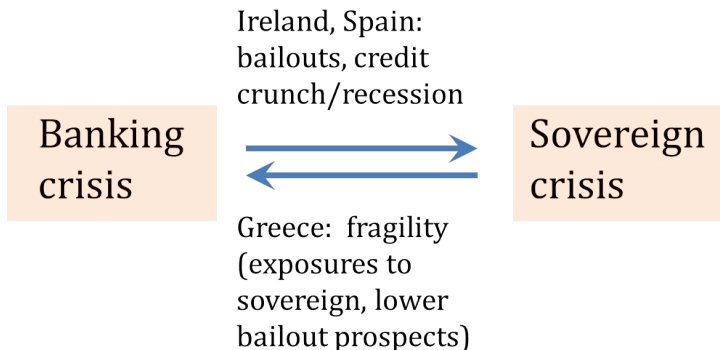
Clichéd remarks, yet heart of subsequent analysis.

a) *Dual debt and competitiveness crisis*

- large debts & spreads ▶ government
- financial crisis
- failure to implement reforms (labor market, pensions, investments in tradable sector, competition policy, tax collection/state profligacy, ...)
- Fiscal adjustment ▶ fiscaladjust

- loss of competitiveness and trade imbalances ▶ labor
 - no possibility of nominal devaluation,
 - a bit of fiscal devaluation,
 - and much internal devaluation in a subset of Southern European countries (sufficient? sustainable?) ▶ restoring

b) *Coupling of banking and sovereign crises*



- A “reverse accountability” insight.
- That private debt is public debt was ignored by Maastricht treaty. ▶ coupling

c) *Weak European institutions*

Political bias toward laissez-faire understandable:

- lack of pivotality: why get into a country's bad books?
- political agendas
- anticipation of quid-pro-quo.

Outcome: no-man's land in which neither the market nor the official sector was monitoring.

d) *Financial sanctions vs. reduction in sovereignty*

e) *Europe's handling of the crisis was not stellar*

Shifting the blame; conducting lenient stress tests; making confusing announcements on PSI; buying time ("whack a mole" style).

II. REFORMING EUROPEAN INSTITUTIONS

(1) *Solidarity within the Eurozone*

- Insurance/moral hazard tradeoff
 - policies leading to lack of competitiveness
 - policies leading to public debt concerns.
- Ambiguous allocation of risk
 - perception of (implicit) joint-and-several liability turns into PSI
 - sovereign risk-free regulatory tag
 - no-man's land: neither market nor official sector was monitoring
 - US historical example [▶ US historical ex](#)

(2) *Which solidarity?*

Spontaneous/ex post?

- ex-post bailouts

Contractual/ex ante?

- Eurobonds/Eurobills [▶ eurobonds proposals](#)
- other mechanisms involving joint liability (banking union ...)
- reserve fund

Solidarity area puzzle

Bailouts and refinancing capability are intertwined

J. Tirole *“Country Solidarity, Private Sector Involvement, and the Contagion of Sovereign Crises”* (2012):

- Collateral damages imposed on other countries through default are de facto country's collateral
[spillovers: economic linkages (trade, banking exposures, fear of runs) and geopolitical considerations (empathy or nuisance power; European construction)].
- Joint & several liability (“JL”; e.g., Eurobonds) would boost countries' refinancing ability at cost of
 - cross-subsidies if asymmetric situation
 - contagion.

- *No JL in asymmetric situation*: JL increases total surplus, but no feasible compensating transfer

[not in the self-interest of healthy countries to accept JL and assume the concomitant cross-subsidy, even though they realize that they will be hurt by a default and thus will ex post show some solidarity in order to prevent spillovers.]

- Like for an insurance contract, JL more agreeable if behind veil of ignorance:

JL emerges provided that country shocks are sufficiently independent and spillovers costs sufficiently large relative to default costs.

- Both cases: debt brakes desirable. In the absence of credible discipline, incentive to minimize spillovers/solidarity.

Toward a full-fledged federalism?

- Fiscal integration, or even Eurobonds, require being behind veil of ignorance. We are not. Direction of transfers too predictable
[Worry about exit might be too narrow: Gerxit. The case of Catalonia.]
- Institutions? Implications of a majority rule?

(2) *Changing institutions to restore sustainability of Eurozone*

- Countries must accept (permanent) *loss of sovereignty* if they want to preserve European construction:
 - European-level financial regulation
 - independent fiscal councils
 - further interference when in trouble.
- No federal budget, but *incentivizing transfers*
 - labor market remains big issue in Southern Europe
[is subsidiarity principle applicable? Affects competitiveness and debt; also makes austerity harder to bear.]
- Transfers based on cyclical, but not structural differentials?

Monitoring sustainability

- Fiscal compact (March 2012)
 - maximum primary deficit of 0.50 % (cycle adjusted);
 - automatic sanctions (reverse majority voting);
 - ECJ enforcement;
 - unanimity rule abandoned (12 out of 17 needed).
- Complexity and manipulations of public accounts ▶ Measuring publ indebt
 - sanctions hard to implement \implies also need ex-ante control
 - need supranational oversight of budgets.

Independent fiscal councils: Ideally

- nomination validated by EU, report to EU/ECJ as well
[like ECB: no regional diversity requirement; recognized standing and professional experience. Contrast French HCFP] [▶ French council](#)
- forecast of growth rate for budget
- broader remit (Swedish fiscal council)
 - assessment of consequences of government policies
 - assessment of sustainability, surveillance of competitiveness
- need European independent fiscal council, plus democratic process.

The appropriation issue

- Bi-partisan in Sweden, Germany, Chile, ... In Southern Europe too, but opposite.
- Independent Councils, like golden rules (1840s in US), optimally would be voluntary/appropriated. We no longer can afford this luxury.

III. BANKING UNION

Current state:

- Home rule for regulation
- Bailouts are nationally financed
[Compare US: Washington Mutual was not bailed out by state of Washington!]
- Recent European institutions: EBA (microprudential) and ESRB (macroprudential): too few control rights.

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

Spain: a lesson for Europe?

[IMF Financial Stability Assessment June 2012]

▶ IMF on Spain

Bird's-eye view:

- Excellent supervisory authority (Banca de España); quickly identified real estate boom and concomitant hazards.
- Hardly any corrective effort.
- Too much politics
 - Ministry of Economy (sanction and resolution capacity)
 - Regional governments (Cajas)

European Commission (September 12, 2012)

- Strong supervisor located at ECB ▶ Likely overall struct.

[Centralization: Germany's condition for €500 bn of ESM to be usable for direct bank rescues. In 2013 for banks receiving ESM money. January 1, 2014 for the others]

- oversees 6, 000 banks
 - important: Cajas, Landesbanken
 - some (including Germany) wanted 25 large banks that are TBTF/TBTSC (Too Big To Save)

[National supervisors still in charge of day-to-day supervision.]

- orders inspections, carries out stress tests
- can withdraw banking license

- *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
 - national supervisor employee/reports to ECB.

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.]

IV . BANKING REFORMS

Some progress

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

Question marks: many, among them:

- Liquidity regulation? [▶ Rationale and LCR](#)
- Retail-investment bank separation?
- Future of internal models?
- Asset income runs? [▶ Asset income runs](#)
- Decoupling banks-sovereign?
- Legal harmonization of resolution?

STRUCTURAL REFORMS

SEPARATING RETAIL AND INVESTMENT BANKS

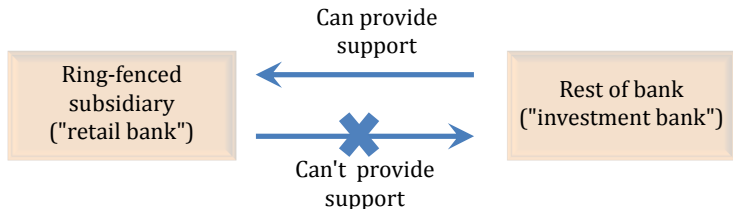
Philosophy: insulate basic banking services from investment banking risks. In a sense, reflects the view that regulators will always lose in the cat and mouse game (may be right).

(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).

V. CONCLUDING COMMENTS ON 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
- Sows 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 (Spain, ...) 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).