Unravelling economic solidarity: A systemic view on risk-sharing in the European banking sector

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Yuri Biondi (French National Center for Scientific Research-CNRS)

M. Cecilia del Barrio Arleo (University of Trento)

Outline

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III. **The US framework: An illustrative and comparative example**

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IV. **Strengthening solidarity in the EU: Hints & perspectives**

Beyond risk sharing vs risk reduction dichotomy: Solidarity and responsibility (i)

- Artificial dichotomy between risk sharing vs. risk reduction dominated the debates on the post-crisis euro area reform

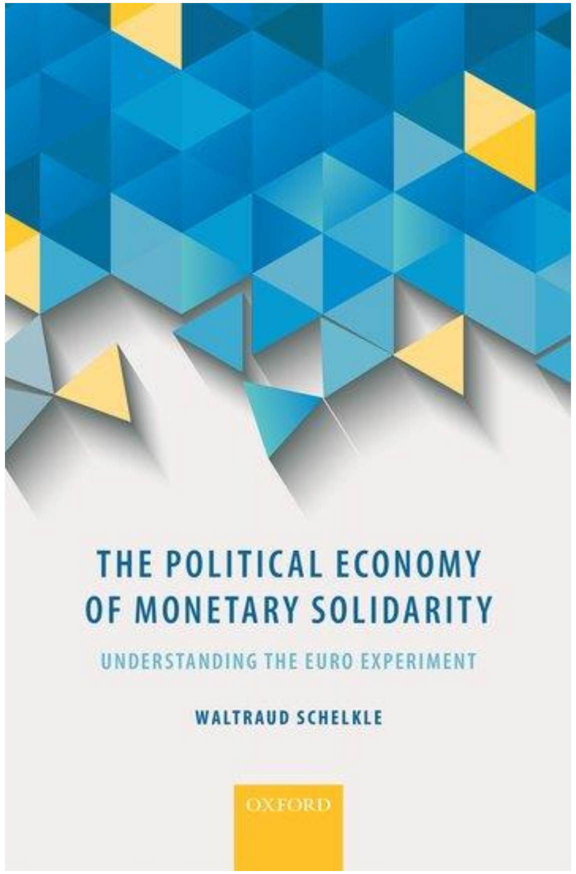
→ EMU politics struggle between **national responsibility and European solidarity** (Jones 2019)

- Policy alternatives to overcome tensions:

- Market discipline to mitigate moral hazard risks (Bénassy-Quéré et al. 2018)
- **But** market dynamics can degenerate into a debt run, involving a systemic confidence crisis that affects resilience of the €

Beyond risk sharing vs risk reduction dichotomy: Solidarity and responsibility (ii)

- Economic *responsibility*: risk-originator should bear the risk, and pay if it materialises,
- Economic *solidarity*: actors within a system which are exposed to that risk (including the risk-originator) protect each other in case of risk realisation.
- EMU + BU → *de facto* and *de jure* solidarity

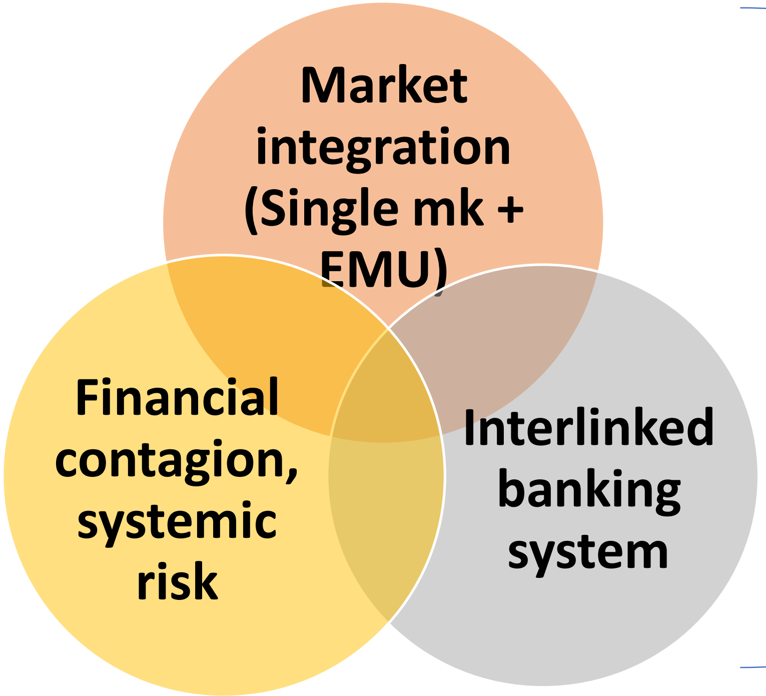


Why economic solidarity (i)


Banking union must halt Balkanisation

European efforts are doomed without federal deposit guarantees

Patrick Jenkins SEPTEMBER 10 2012



Structural interdependencies

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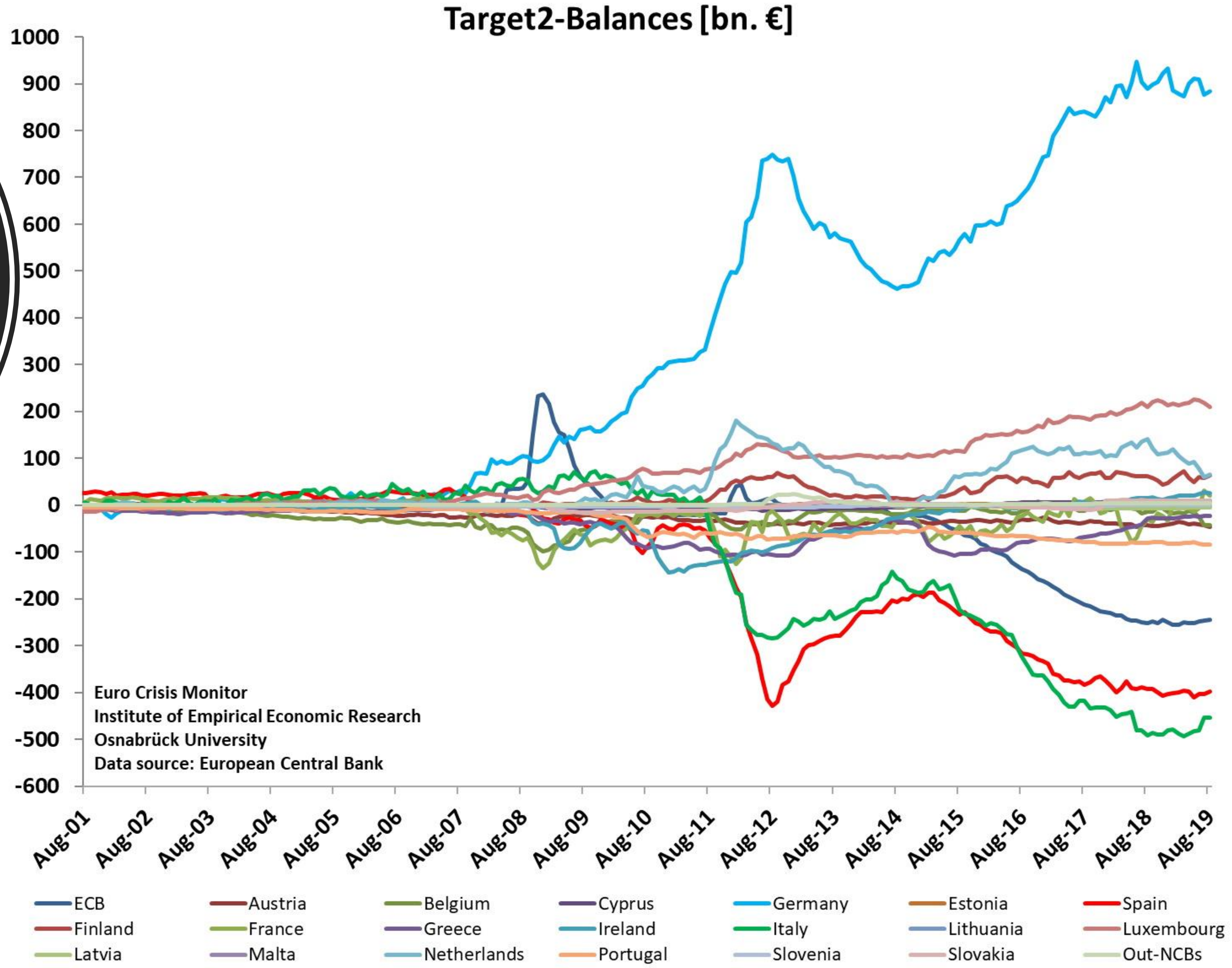
Policy coordination & Solidarity Mechanims

Monetary policy design ⟷ banking sector

Why economic solidarity (ii): Transnational dimension and interdepedencies



Why economic solidarity (iii): Shortcomings in the regulatory design

- Post-cris(e)s reforms have focused on strengthening:

- Liquidity: LCR, NSFR, ILAAP reloaded, ELA
- Solvency: Pillar I, II (P2R, P2G, Buffers), ICAAP reloaded, Precautionary recap, DRI
- Resolution & its financing: loss internalisation, external financing

- In distress times, illiquidity & insolvency overlap: "practically synonymous terms" (Morton 1939, 272)

- Beyond loss absorption: resilience & capacity to deal with systemic risk (quickly and possibly before some default)

- DGS: beyond paybox function → intervention and involvement post *Tercas*?

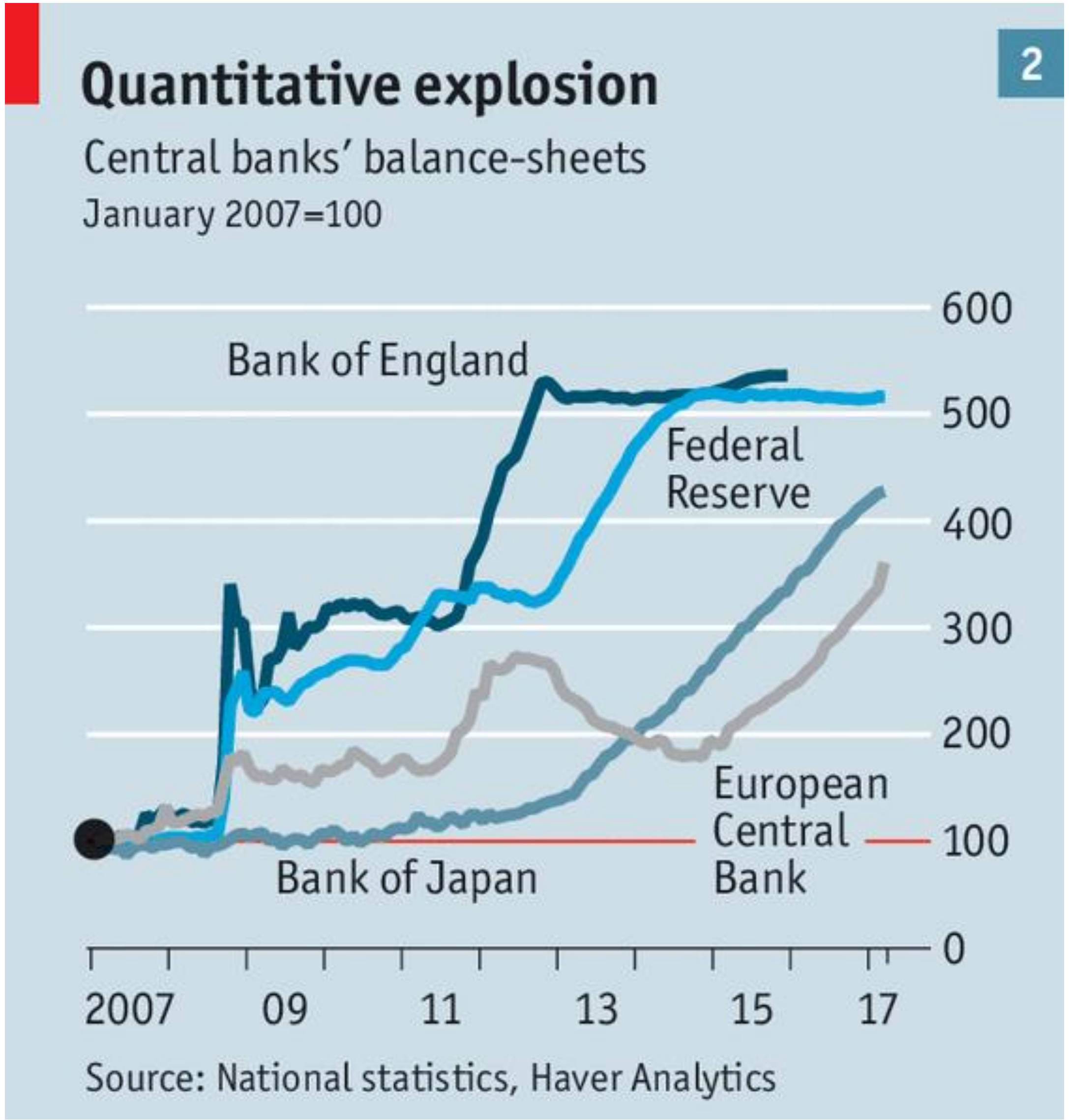
- Lack of institutionalisation of solidarity mechanisms

The US framework: An illustrative and comparative example (i)

US monetary and banking union: lessons for EMU and BU?

- Central banks: response to crisis *passively* or *actively*
- Wide lending to nonbank financial firms to avoid systemic failure
- Every major category of private-money claim specifically targeted
- Emergency measures directly aim to stabilise short-term funding markets (i.e., money markets)

→ **modern banking as essentially a monetary activity**



Central Banks' balance sheets 2007- 2017. Source: The Economist (2017).

The US Framework (ii): Monetary and banking design

"Public private partnership" **(Ricks 2016)**

- 1933 Banking Act and modern banking rules

➢ explicit acknowledgement that **money supply**, when represented by **insured deposits**, constitutes a **public good**; within the insured perimeter, money was considered a sovereign obligation, even if the task of issuing monetary instruments in exchange for credit assets was outsourced to private banking firms.

➢ goal of the insurance: **restore confidence in the liquidity of bank deposits** than to protect small depositors (Golembe, 1960, cited by Demirgüç-Kunt and Kane 2002).

- Monetary function of bank insurance: put in practice in 2007-09, when the cap on deposit insurance covered was directly removed, and hence a 100% was insured
- Use of public debt securities as safe assets in the money base management

The US framework (iii): Public debt as a safe asset

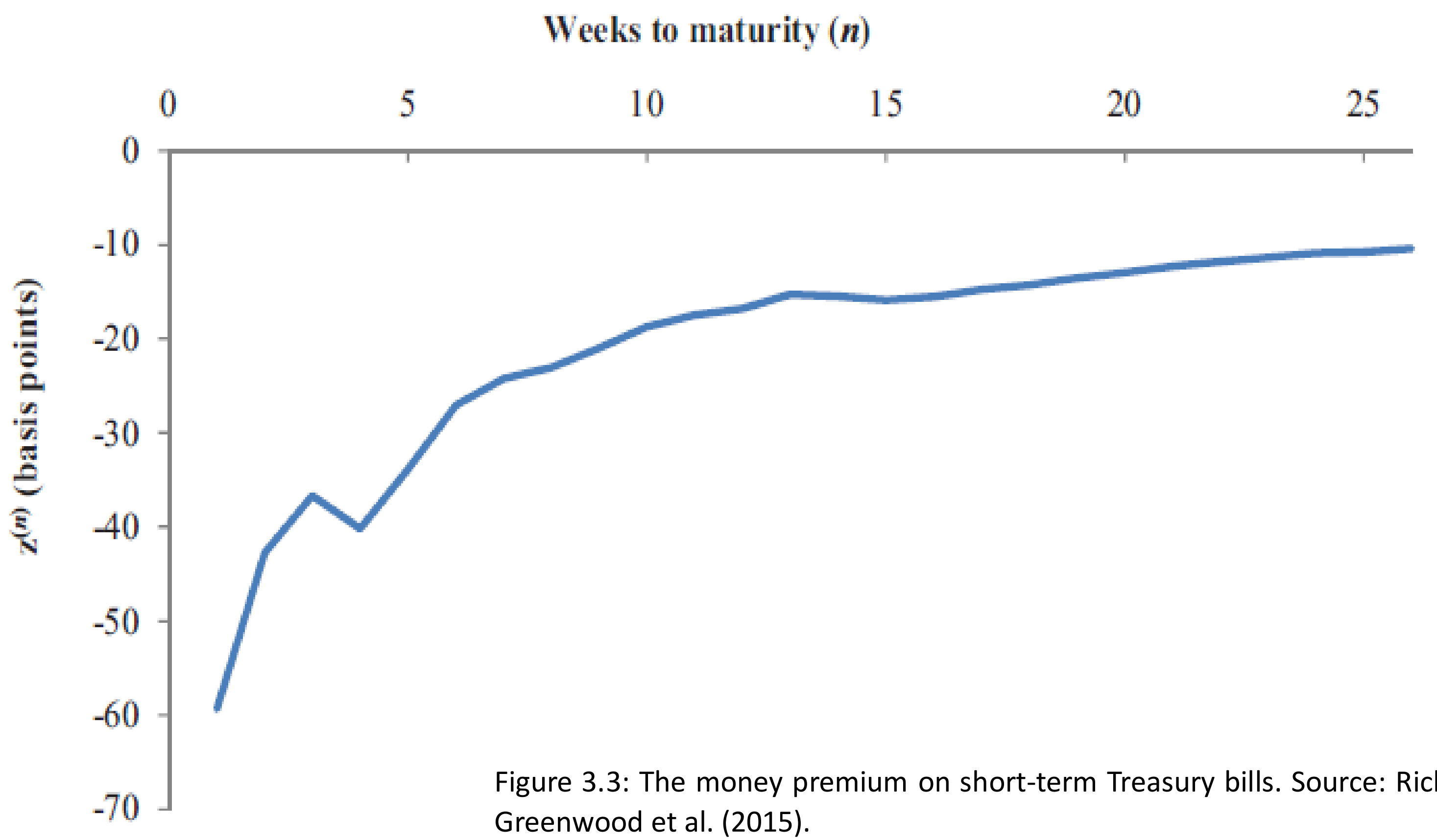


Figure 3.3: The money premium on short-term Treasury bills. Source: Ricks (2016), taken from Greenwood et al. (2015).

Use of public debt securities as quasi-monetary assets

- high-quality short-term debt instruments (especially governmental securities) that are *not* medium of exchange are equally relevant when it comes to money demand.
- interconnectedness between public debt monetisation and monetary base management

Strengthening solidarity in the EU: Hints and Perspectives (i)

- Have the ECB crisis measures and subsequent reforms been enough?

> In the absence of collective safety nets, national supervisors tried to protect their domestic banking systems and thus created externalities for others. The example also shows how this *lack of coordination* during a crisis leads to risks being shifted onto the weakest parts of an incomplete union. (Schelkle 2017, 301, emphasis added)

- Enhance system coordination:

➢ Layered mechanisms to disincentivize moral hazard: local actors insure each other but are eventually backed by central actors (US example)

➢ Extending the DGSs functions beyond the paybox one (Institutional Protection Schemes example).

- **Connection between monetary and banking systems → solidarity mechanisms in EMU and BU architecture**

Strengthening solidarity in the EU: Hints and Perspectives (ii)

- Market integration complemented by non-market institutions that stabilise and compensate in case of dysfunction:

> The notion that private and public insurance are substitutes, and so if the euro area focuses on deepening private risk-sharing, greater public risk-sharing will not be required [. . .] misunderstands how private insurance develops in the first place. It emerges from deep and resilient financial integration, especially of retail banks, and that only arises in the shelter of public risk-sharing, such as strong backstops and deposit insurance schemes. (Draghi 2019, 3).

- Enhance non-market institutions:

➢ Voluntary borrowing between DGSs under certain conditions (Art. 12 DGSD): providing for a mandatory lending scheme? → *Member States should be able to allow DGSs to lend money to each other on a voluntary basis* (Recital 37 DGDS, final sentence).

- **The two incomplete unions (EMU & BU) and the CMU involve material interdependencies across Member States that demand clear institutionalized solidarity mechanisms**