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

FSC Research Workshop 2019
Berlin, 29 October
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Outline

I. Beyond risk sharing vs risk reduction: Solidarity and responsibility

II. Why economic solidarity in the EU
   ➢ Transnational dimension and interdependencies
   ➢ Regulatory design shortcomings

III. The US framework: An illustrative and comparative example
   ➢ Fed’s crisis management in 2007-09
   ➢ Monetary and banking design
   ➢ Public debt use as safe asset

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 \(\rightarrow\) de facto and de jure solidarity
Banking union must halt Balkanisation
European efforts are doomed without federal deposit guarantees

Why economic solidarity (i)

Market integration (Single mk + EMU)
Interlinked banking system
Financial contagion, systemic risk

Structural interdependencies
Policy coordination & Solidarity Mechanisms

Monetary policy design → banking sector
Why economic solidarity (ii): Transnational dimension and interdependencies
• 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
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
“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
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