“Centrifugal and Centripetal Forces in Euro Area Banking Integration”

David Vegara, ESM

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I. Centrifugal forces

“Market driven”?

General uncertainties regarding the banking business...

Note: cumulative returns of DE/US 10 year yields, Gold, EUR vis-à-vis CHF, JPY, NOK, euro area consumer goods vis-à-vis the index and high US dividend firms vis-à-vis S&P 500
Latest observation: 4 March 2013
Source: Bloomberg, ESM calculations
I. Centrifugal forces

With questions arising from P/B values: lack of trust? What is in the closet?

<table>
<thead>
<tr>
<th>Country</th>
<th># of Large Banks</th>
<th>Market cap. (EUR million)</th>
<th>Mean P/B value</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>5</td>
<td>334.2</td>
<td>0.8x</td>
</tr>
<tr>
<td>France</td>
<td>3</td>
<td>91.6</td>
<td>0.5x</td>
</tr>
<tr>
<td>Germany</td>
<td>2</td>
<td>39.4</td>
<td>0.4x</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2</td>
<td>34.4</td>
<td>0.9x</td>
</tr>
<tr>
<td>Italy</td>
<td>4</td>
<td>47.8</td>
<td>0.3x</td>
</tr>
<tr>
<td>Spain</td>
<td>2</td>
<td>99.4</td>
<td>0.8x</td>
</tr>
</tbody>
</table>

Source: Rothschild, Feb. 2013
I. Centrifugal forces

... in times of stress are compounded by questions about “asset quality” and RWAs in different jurisdictions.

20 largest banks. Blue dots are initial “Global Charge (RWA + EL (expected losses) over Exposure at default). Red dots are what is left “unexplained” after taking into account the type of method in use (SA or IRB) and the portfolio composition. Around half of the difference is not explained by these factors.

Source: EBA (2013) “Interim results of the EBA review of the consistency of RWA”.
I. Centrifugal forces

Liquidity hoarding

Risk aversion in bank lending supply - ECB deposits
I. Centrifugal forces

... all topped up by the sovereign debt crisis ... with feedback loops with the banking sector

Asymmetries in bond market volatility - 10-year government bond rates

Note: Annualised 22 days rolling volatility. Vertical lines on 29 February 2012 for LTRO2 and 6 September for the announcement of the OMT.
Latest observation: 4 March 2013
Source: Datastream and ESM calculations
II. Consequences

Malfunctioning of interbank market not conducive to cross-border (banking) flows. (cross border banking was not only about retail banking in other countries)
II. Consequences

...and cross-border divestments play a significant role

Banks worldwide have divested $722 billion of assets since 2007, with more than half coming from European banks

Divestitures, January 2007–December 2012

<table>
<thead>
<tr>
<th>Nationality</th>
<th>Examples</th>
<th>Cumulative deal value</th>
<th>Cross-border % of cumulative deal value</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>RBS, HSBC, Standard Chartered</td>
<td>161.8 (308)</td>
<td>55</td>
</tr>
<tr>
<td>France</td>
<td>Credit Agricole, BNP Paribas, Societe Generale</td>
<td>79.9 (208)</td>
<td>62</td>
</tr>
<tr>
<td>Spain</td>
<td>BBVA, Santander</td>
<td>77.3 (215)</td>
<td>45</td>
</tr>
<tr>
<td>Italy</td>
<td>Intesa Sanpaolo, UniCredit Bank</td>
<td>43.1 (234)</td>
<td>14</td>
</tr>
<tr>
<td>Germany</td>
<td>Commerzbank, Deutsche Bank</td>
<td>24.4 (222)</td>
<td>52</td>
</tr>
<tr>
<td>Belgium</td>
<td>KBC, Dexia</td>
<td>21.0 (44)</td>
<td>63</td>
</tr>
<tr>
<td>Total Western Europe</td>
<td></td>
<td>434.5 (1,499)</td>
<td>51</td>
</tr>
<tr>
<td>United States</td>
<td>Citi, Bank of America</td>
<td>167.6 (655)</td>
<td>42</td>
</tr>
<tr>
<td>Rest of world</td>
<td></td>
<td>120.0 (1,296)</td>
<td>26</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>722.1 (3,450)</td>
<td>45</td>
</tr>
</tbody>
</table>

1 Includes retail and commercial banks. Deal value of some divestitures not reported.
2 We found data on 23 divestiture deals of Swiss banks. The six deals with values total less than $1 billion.

SOURCE: Dealogic; McKinsey Global Institute analysis
II. Consequences

... with banks’ willingness to lend being different in different countries

Changes in credit standards applied to the approval of loans or credit lines to enterprises.
(net percentages of banks contributing to tightening credit standards)

Source: ECB and national central banks
Note: Net percentages are defined as the difference between the sum of the percentages of banks responding “tightened considerably” and “tightened somewhat” and the sum of the percentages of banks responding “eased somewhat” and “eased considerably”.
II. Consequences

... while different costs of funding (among other reasons) impair the transmission mechanism of monetary policy and hence euro area financial integration...

Interest rates: Loans to small and medium sized enterprises

Latest observation: December 2012
Source: ECB and ESM calculations
III. Why is this important?

- Comparative share of banking credit in overall credit in euro area vs. US (70/30, 30/70)

- It’s not only about cross-border banking
  
  - Balance of payments financing within euro area
  - Monetary policy transmission mechanism
  - No “euro area risk-free” asset

- Fragmented financial system along national lines:
  
  - Precludes efficient risk-taking
  - Facilitates sudden stops because of home bias inherent in the system
  - Fails to reap the benefits of monetary union
IV. Centripetal forces

- “Policy-driven”?
- Macro adjustment is underway

Current Account Balance (as % of GDP)

Fiscal balance, Euro area vs USA and Japan (as % of GDP)

Source: EC European Economic Forecast - Winter 2013
IV. Centripetal forces

- Market developments followed by policy developments in the financial sphere:
  - Coordinated guarantees framework
  - Coordinated DGS up to €100 K
  - European Systemic Risk Board (ESRB)
  - European Supervisory Authorities (EBA, ESMA, EIOPA)
  - EFSF (temporary mechanism)
  - ECB’s LTRO
  - Single rule-book
IV. Centripetal forces (policy-driven)

- **Outright Monetary Transactions (OMT)**
- **ESM** (permanent mechanism, combined lending capacity with EFSF of €700 bn, 7.4 % of euro area GDP)
  - Loans to sovereigns
  - Precautionary credit lines
  - Primary market purchases
  - Secondary market purchases
  - Indirect recapitalisation of financial institutions
  - When SSM is in place, direct recapitalisation of financial institutions is a possibility
- **Single Supervisory Mechanism (SSM)**
- **Next banking union steps under discussion: DGS and bank resolution regime**
IV. Conclusion

- Macro adjustment is underway – should support “reintegration”
- Policies are supporting “Reintegration”
- SSM is a cornerstone in the “reintegration process”
- EFSF/ESM is supporting (and will support) this process by providing financial assistance, including to financial institutions (indirectly, and when agreed by MS, directly)
- Next steps for coherent banking union needed (DGS/resolution) and work is underway.
Thank you