Increase in cross-border banking over time

Source: Claessens and van Horen (2013)
Percentage of foreign banks among all banks in 2009

Source: Claessens and Van Horen (2013)
Merger activity becoming international

Source: Buch and de Long (2010)
Desirable Cross-Border Banking

- A “healthy” amount of cross-border banking is likely to be beneficial
  - Diversification benefits for domestic banks
  - Diversification benefits for domestic borrowers
  - But: higher volatility of flows
  - But: contagion costs
Why regulate cross-border banking?

- Failure of cross-border bank imposes costs on foreign stakeholders that are not taken into account by home country supervisor (Beck, Todorov and Wagner, 2013)
- Contagion effects through common asset exposures, fire sale externalities, informational contagion, interbank exposures etc.
  - Does not depend on direct cross-border engagements by banks and – on bank-level – not even on direct exposures to international markets
  - More prominently as banks move towards market finance
- Within-in monetary union: additional externalities
  - Close link between monetary and financial stability
  - Lack of exchange rate tool exacerbates impact of asymmetric shock
  - Common lender of last resort leads to tragedy of commons problem
- Regulatory arbitrage
...but one size does not fit all

- Differences in legal systems
- Differences in preferences
  - On government intervention
  - On fiscal independence
  - On return-risk trade-off
- Informational and interest asymmetries
  - Small host country with market-dominating foreign subsidiary (e.g., Uganda) vs. large home country for whom foreign subsidiary does not matter (e.g., UK)
Heterogeneity

- Supervisory colleges, MoUs
  - Asymmetric home-host country interests: stand-alone subsidiaries
  - Strong ex-ante agreements on resolution and burden-sharing

- Broader cooperation among stakeholders; regulatory convergence
  - Closer cooperation, especially on G-SIFIs, regulatory convergence
  - Joint regulatory and supervisory authority

Externalities
Need for cross-border bank regulation varies across regions/country pairs

- Low externalities, high heterogeneity: Memorandum of Understanding, Colleges of Supervisors
  - India, .... Low share of cross-border banking, “closed” financial systems
- Low externalities, low heterogeneity: move towards extended versions of MoUs and colleges
  - East Africa: joint historic background
- High externalities, high heterogeneity
  - US/Europe/Japan – Europe/UK
  - Focus on G-SIFIs, coordination on market support
- High externalities, asymmetric interests
  - Stand-alone subsidiaries
  - Latin America, Sub-Saharan Africa vis-a-vis European/US banks
- High externalities, low heterogeneity
  - move towards closer cooperation: extended versions of MoUs and colleges; ex-ante burden-sharing agreements
  - Nordic-Baltic
- Banking union
Heterogeneity

Joint regulatory and supervisory authority

Closer cooperation, especially on G-SIFIs, regulatory convergence

Asymmetric home-host country interests: standalone subsidiaries

Strong ex-ante agreements on resolution and burden-sharing

Supervisory colleges, MoUs

Broader cooperation among stakeholders; regulatory convergence

Externalities

Joint regulatory and supervisory authority
Banking Union for Europe: after Cyprus

Thorsten Beck
Banking Union for Europe
Risks and Challenges

Edited by Thorsten Beck

With contributions from:
Banking Union – the new kid on the block? Or a mis-behaving teenager?

- Crisis development can be followed via buzz words
  - Remember fiscal compact, growth compact, big bazooka? LTRO, OMT…
  - Banking union seemed the latest buzz word in 2012
  - …but this one seems to stay with us
  - But what kind of banking union? For whom? Financed how? And managed by whom?
  - New insights after Cyprus?
The main messages

• No piecemeal approach! Centralizing supervision alone is not only unhelpful but might make things worse!

• A banking union is part of a larger reform package that has to address sovereign fragility and the entanglement of banks with sovereigns.

• Immediate crisis resolution vs. long-term reforms

• Bank resolution and banking union critical part of growth compact
1. A deposit insurance scheme is only as good as the sovereign backing it

- Deposit insurance is for idiosyncratic bank failures
- In case of systemic bank crisis: needs public back-stop funding
- What if fiscal situation does not allow it?
- Need for Eurozone-wide deposit insurance, with back-stop funding by ESM
2. A large financial system is not necessarily growth enhancing

- Financial intermediation or facilitator view
  - Finance as “meta-sector” supporting rest of economy

- Financial center view
  - One of many sectors
  - Nationally centered financial center stronghold based on relative comparative advantages such as skill base, **favorable regulatory policies, subsidies**, etc.
What kind of financial sector – financial intermediation vs. financial center view

- Private Credit to GDP vs. Value added of financial sector in GDP

- Long-term: intermediation matters, not sector size
  - Higher growth and lower volatility
- Short-term: size is associated with higher volatility in high income countries, intermediation with higher growth in low-income countries
- Kneer (2012): evidence for brain drain from skill-intensive industries to financial sector
3. Crisis resolution as political distribution fight

- Whose idea to include small depositors in hair-cut?
- National champions?
- Fortis
- Savings and cooperative banks in Germany
4. Plus ca change, plus c'est la meme chose

- Many special cases!
- One common thread: close ties between government and banks
5. If you kick the can down the road, you will run out of road eventually

- Not recognizing losses and allocating them risks increasing losses further
- Greece, Cyprus….
- Eurozone
6. The Eurozone crisis – a tragedy of commons

- Interest to share the burden, through ECB’s liquidity support or Target 2
- Eurozone decisions are sum (or smallest common denominator?) of national interests
- Nobody internalizes externalities
- No Eurozone authority
7a. Learning from the Vikings

Minimizing external costs

Bailing them out

Eurozone crisis resolution so far

Bailing them in

Iceland, Cyprus

Enforcing discipline
7b. Learning from US

- US history suggests large gains from buffering currency unions with a union-wide deposit insurance, and partial debt mutualisation…
- … but it is a long process: 12 systemic banking crises over 200 years, lots of failed deposit insurance schemes and lots of institutional experimentation, even after introduction of FDIC
- Eurozone crisis is a governance crisis! Lots of representatives of national interests (typically cut along creditor/debtor lines)
- Who represents the Eurozone?
8. Banking union with just supervision does not work

- Centralizing supervision alone, while leaving bank resolution and recapitalization at the national level, is not only unhelpful but might make things worse
  - Supervision without consequences
  - Walking zombies that cannot be resolved
  - Cannot solve vicious cycle between bank and sovereign fragility
- Banking union for all financial institutions, not just large institutions
  - Monetary and financial stability linked through systemic channels, not just large institutions
9. A banking union is needed for the Eurozone, but won’t help for the current crisis!

- Status quo: short-term fixes with enormous pressure and burden on ECB and piece-meal approach to long-term reform
- BUT: Urgent need to address banking and sovereign fragility – transitional solutions
  - Suggestion: European Recapitalization Authority
  - Banking union takes longer time to build necessary institutional framework
- Don’t mix crisis resolution with long-term reforms
  - Introducing insurance after the accident
  - Distributional fights
  - Political sensitivity
10. A currency union with capital controls?

- Cypriot Euro that cannot be used outside Cyprus contradicts idea of currency union
- Transitory, or beginning of the end?
- Precedence?
- Symptomatic for disintegrating European banking and capital market
  - Need for Eurozone supervisor
11. Finally, there is no free lunch

- Dutch savers attracted by high interests in Icesave
- Cypriot banks piling up on Greek government bonds promising high returns even in 2010
In summary

- No sustainable Euro-zone without an effective banking union
- Banking union will NOT help us for the current crisis
Thank you

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