NOVA SCHOOL OF BUSINESS & ECONOMICS

SEMINAR IN EUROPEAN ECONOMICS

CHALLENGES FOR FINANCIAL STABILITY: THE ROLE OF THE BANKING UNION

PRACTICAL CLASS 7

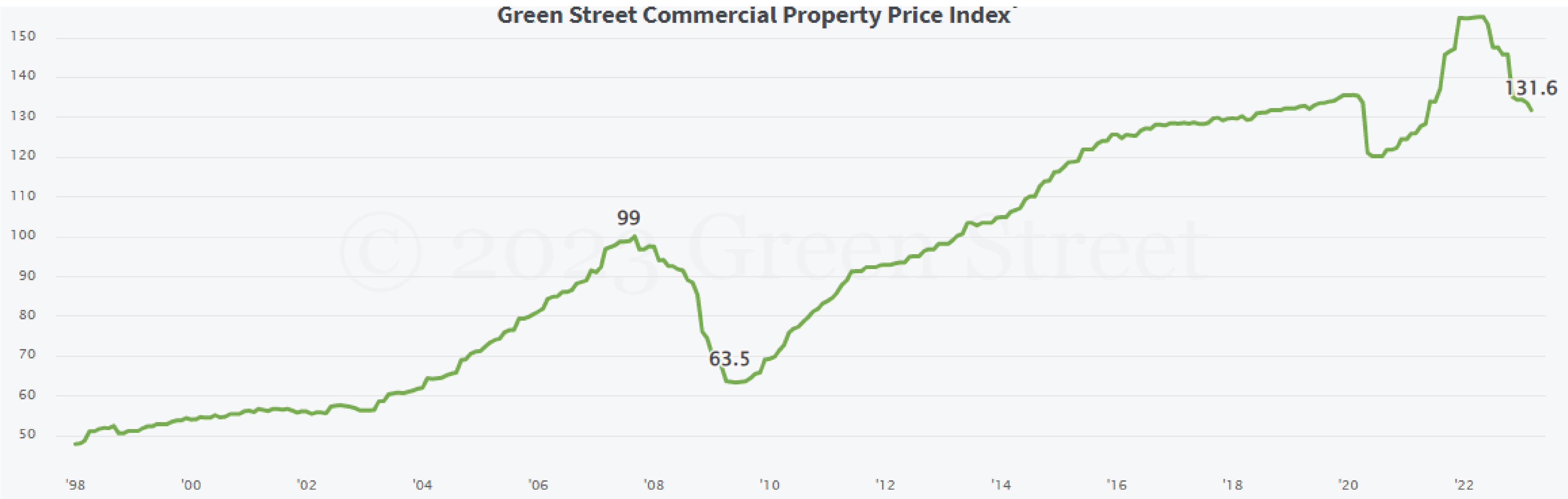
2024-2025 S2

CONTEXT

- The financial crisis and its impact on the global economy have questioned the analysis and policies conducted so far for financial stability

- General consensus that risks arising from **excessive credit growth and signs of speculative bubbles** were largely neglected before the crisis

- The need to develop a policy and institutional framework able to prevent and mitigate financial crises



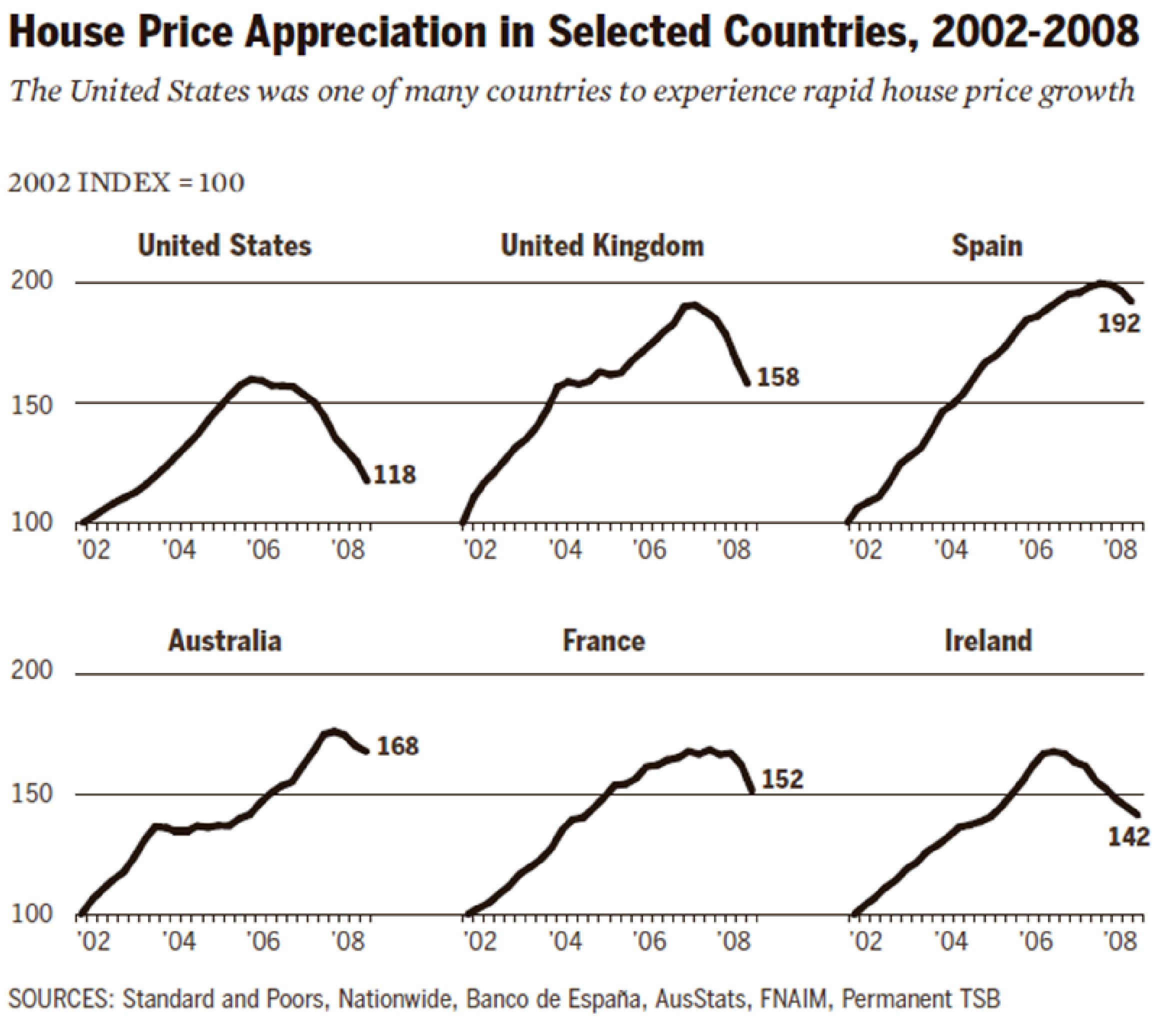
All Property CPPI® weights: retail (20%), office (17.5%), apartment (15%), health care (15%), industrial (10%), lodging (7.5%), net lease (5%), self-storage (5%), manufactured home park (2.5%), and student housing (2.5%). Retail is mall (50%) and strip retail (50%).

Core Sector CPPI® weights: apartment (25%), industrial (25%), office (25%), and retail (25%).

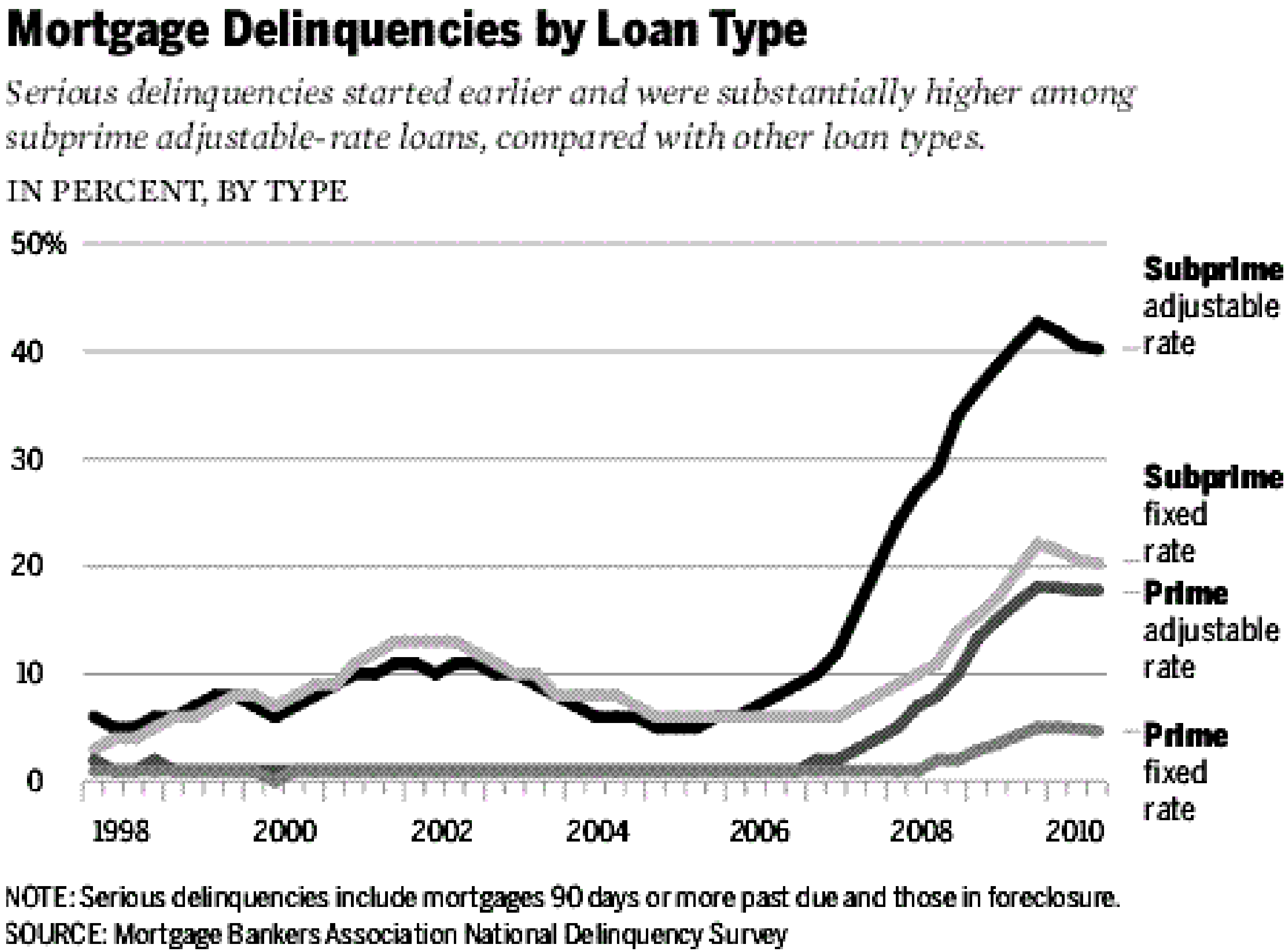
WHAT WAS NEGLECTED?

- Periods of low inflation and stable output growth (‘great moderation’) coincided with the accumulation of risks and vulnerabilities:
  - Excessive credit growth and leverage
  - Inefficient output composition (excessive expansion of some sectors)
  - Over-indebted agents
  - Excessive maturity mismatch of assets and liabilities in banks’ balance sheets
- **Financial innovation** and insufficient regulation allowed the transfer of risks out of banks’ balance sheets and outside the perimeter of regulation – more difficult to detect
- **Interconnectedness** within the financial system between the financial system and the real economy: **bank-sovereign debt risk correlation**

HOUSING MARKET – BOOM AND BUST



MORTGAGE DEFAULT RATES – US



WHY WERE RISKS NEGLECTED?

"The lack of a timely identification of existent risks resulted from the prevailing paradigm for macroeconomic stability, which relied essentially on monetary policy to guarantee price stability and on micro-prudential policy to ensure the solvability of the financial system, which was revealed to be insufficient to avoid serious systemic risks that undermined financial stability" - Blanchard

- Role of the central bank was that of controlling price inflation – not enough for economic stability: prices of financial assets also matter and **excessive credit growth can coincide with low inflation**

- The function of **financial regulation and supervision was restricted at ensuring the solvability of institutions** (focused on the resilience of the individual institution) with the purpose of avoiding disruptions caused by possible bank runs

- Most of the **regulatory requirements were directed almost exclusively at banks**, in the assumption that financial markets could be disciplined through auto-regulation

➢ The systemic and macroeconomic implications of financial system fragilities were not properly accessed.

EVIDENCE SEEMS TO CONFIRM POLICY FRAMEWORK PARADIGM

For several decades, considerable progress in the control of inflation and in the promotion of macroeconomic stability, i.e., the Great Moderation

- **Low and stable inflation**, despite the strong growth of credit and historically low interest rates. (globalization allowed the imports of low-cost goods and monetary expansion reflected in the growth of real estate prices and financial asset prices)

- **Significant reduction of business cycle fluctuations**

- The **contained impact of the shocks** (stock-market shock in 1997, dot.com bubble, oil prices) seemed to confirm that the policies implemented were translated by a significant progress in the control of inflation and were also appropriate to deal with shocks related to financial market vulnerabilities

- The many crises of the 90’s were seen as exclusive phenomena of emerging markets, where the incapacity to manage the impact of capital flows was a characteristic of less developed financial systems

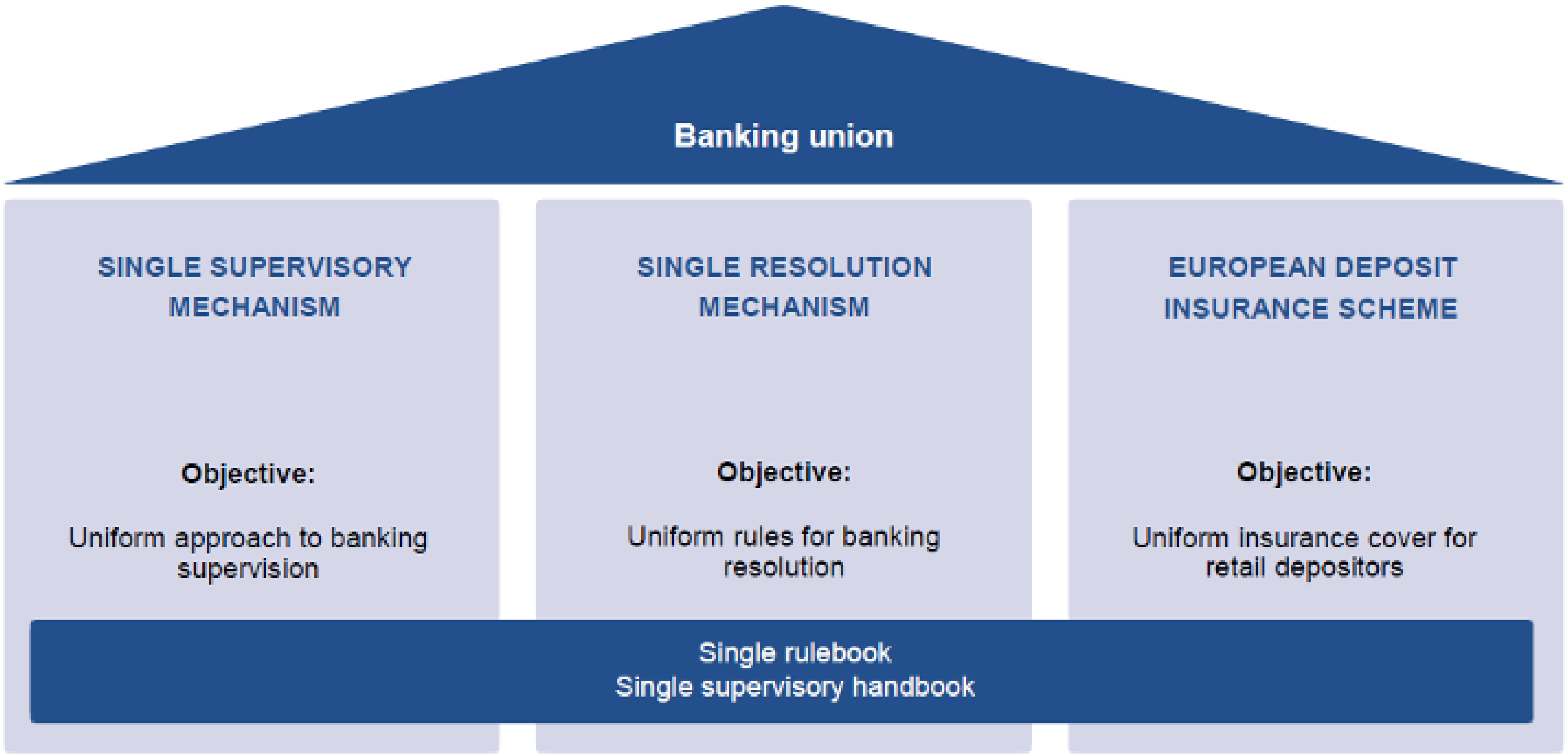
PRESENT FRAMEWORK

- Monetary policy
- Micro-prudential supervision
- Macro-prudential supervision: aimed at preventing systemic risks in the financial system which can arise from:
  - Excessive credit growth and leverage
  - Maturity mismatch and market illiquidity
  - Exposure concentrations
  - Excessive risk-taking by systemically important institutions

THE BANKING UNION

- Motivation:
  - ➢ Reduce fragmentation in financial markets
  - ➢ Break correlation of banking and sovereign risk

THE BANKING UNION: AN INCOMPLETE PROJECT



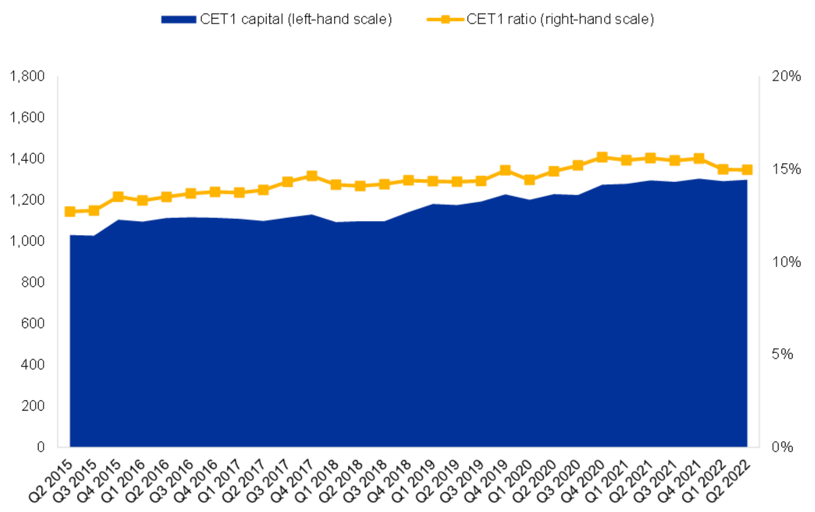
The Single Rulebook is set of rules that provides legal and administrative standards to regulate, supervise and govern the financial sector in all EU countries more efficiently. It includes rules on capital requirements, recovery and resolution processes and a system of harmonized national Deposit Guarantee Schemes.

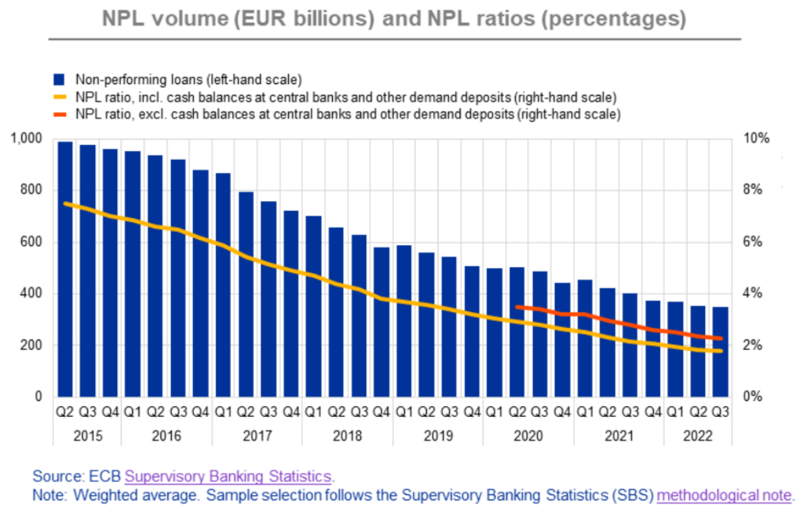
THE BANKING UNION: INTEGRATION AS A RESPONSE TO THE FINANCIAL CRISIS

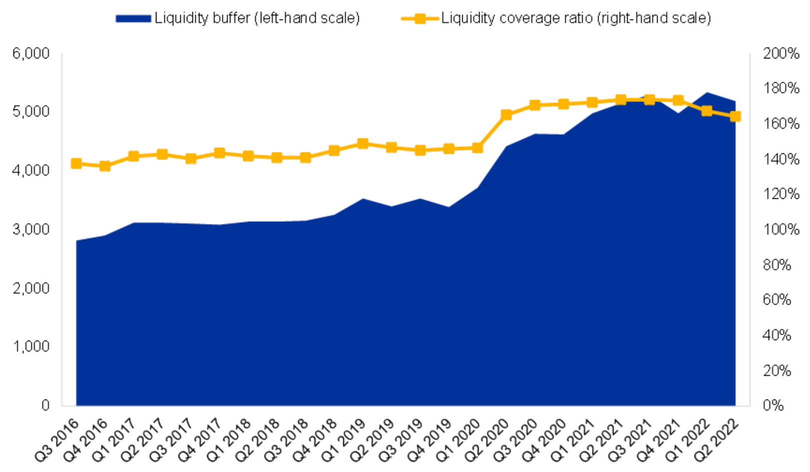
The purpose of the banking union is to make European banking:	
more transparent	by consistently applying common rules and administrative standards for supervision, recovery and resolution of banks
unified	by treating national and cross-border banking activities equally and by delinking the financial health of banks from the countries in which they are located
safer	by intervening early if banks face problems in order to help prevent them from failing, and – if necessary – by resolving banks efficiently

The completion of the banking union could be an important step towards a genuine Economic and Monetary Union. It allows for the consistent application of EU banking rules in the participating countries. The new decision-making procedures and tools help to create a more transparent, unified and safer market for banks.

CURRENT CHALLENGES FOR FINANCIAL STABILITY







- Overall, European banks are showing sound capital and liquidity positions and their asset quality has significantly improved since the global financial crisis;
- However, many unknows persist:
  - Contractionary monetary policy => Good for banks' net interest margin, but there is a significant risk of increasing NPLs. Also, access to liquidity will be scarcer;
  - Geopolitical tensions (e.g., War in Ukraine, China & Taiwan) => Can new adverse financial impacts emerge?
  - Potential contagion to Europe from the recent banking crisis in the US?

Final Exam January 2018

1) The latest economic and financial crisis triggered a strong debate about the need for institutional reform in the EU, which has led to several changes. These latest reforms accelerated a process that had started before the crisis.

b) Which institutional changes took place to address banking and financial risks in the EU?

One of the most important reforms in order to address banking and financial risks in the EU, implying significant institutional changes, consists in the creation of the Banking Union. It consists of a Single Supervisory Mechanism, a Single Resolution Mechanism and a European Deposit Insurance Scheme. The Banking Union, aims at disentangling the link between sovereign and banking risks and, thereby, contributing to mitigate financial risks in the EU.

The major institutional change consists in transferring to the ECB, through the Single Supervisory Mechanism, the responsibility over supervision and regulation of the banking sector of the euro area.

c) Does the democratic legitimacy of the EU institutions interconnects with the reduction of banking and financial risks? Please explain why.

The transfer of national sovereignty over regulation and supervision to a supranational authority can reduce democratic legitimacy as a supranational authority has, in general, less democratic legitimacy than an elected government. However, the degree of accountability and responsibility of the institution also matters for democratic legitimacy. A supranational authority can have democratic legitimacy if it represent the interests of EU citizens and is accountable and responsible for its actions. The fact that the banking union is still uncompleted undermines both democratic legitimacy and effectiveness in reducing banking and financial risks. The sovereign-bank risk nexus can only be reduced with the creation on a resolution and deposit guarantee funds – as if the costs related to a bank failure remain national, the risk of the sovereign affects the banking sector. The fact that the ECB cannot be made accountable for a failure in supervision (as costs are borne by national) undermines its legitimacy.

The willingness of governments to transfer competencies over the two other pillars of the Banking Union is key to the reduction of banking and financial risks. Since this willingness by governments depends on the support of its citizens (conferring democratic legitimacy to the Banking Union) democratic legitimacy can interconnect with the reduction of banking and financial risks.

Final Exam May 2018

1) In the last ten years the European monetary policy has been very active, especially if compared with the initial decade of the monetary union.

c) Which new tasks, besides monetary policy, were attributed to the ECB after the crisis and what is the objective?

The ECB has been attributed supervisory tasks, in the context of the Single Supervisory Mechanism (SSM) of the Banking Union.

The need for a banking union emerged more clearly after the sovereign debt crisis. The greater uncertainty caused by the financial crisis and the related change in market sentiment affected severely more vulnerable countries, which were penalised with higher sovereign risk premiums.

The correlation between bank and sovereign risk implied that these costs were extended to the banking sector. In addition, it also became clear that in a monetary union, problems caused by close links between public sector finances and the banking sector can easily spill over national borders and cause financial distress in other EU countries. The Banking Union, with its burden-sharing mechanisms (Single Resolution Mechanism and a single deposit insurance scheme – not yet concluded) and a common regulatory and supervisory framework (SSM) was created as a solution to decouple bank and sovereign risk and to improve financial integration in the euro area.

Final Exam May 2020

1) The ongoing pandemic crisis has been posing important challenges to the EU project.

b) Why would a fully working banking union be important nowadays?

The aim of a banking union is to reduce the correlation between sovereign and bank risk and to prevent market fragmentation in the euro area.

A fully working banking union would be important nowadays as the consequences of the coronavirus outbreak may give rise to sovereign and bank risk and greater market fragmentation.

Many countries have implemented measures to mitigate the negative effects of the pandemic crisis on employment and firms (e.g. subsidies, tax deferrals, guaranteed loans or direct grants) which will lead to an increase in public debt. This may raise concerns about debt sustainability in some countries triggering a change in market sentiment which can affect the whole economy.

In addition to these effects (via bank-sovereign risk correlation), banks are also directly affected by the negative impact of the pandemic crises on firms and households, which may face solvency problems leading to higher non-performing loans.