The vicious circles between sovereign and banking crises: case studies from the euro area and policy responses

Professor Dr. Christos Gortsos

Presentation at the 22nd Forum Financial Market Regulation
(URPP Financial Market Regulation, Universität Zürich)

10 March 2016

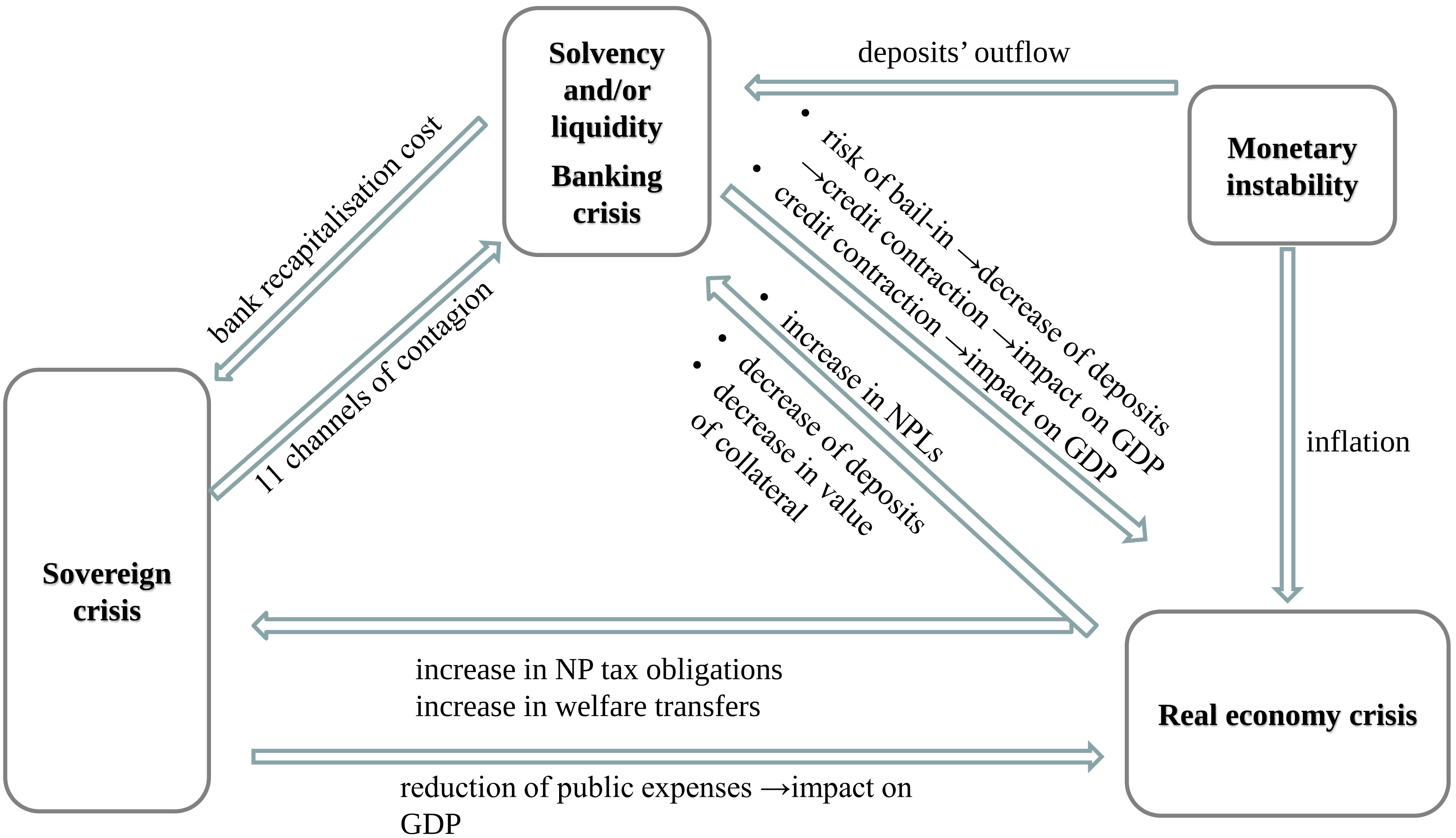
TABLE OF CONTENTS

D. The EU response to the recent crises: the European Banking Union (EBU)

1. Adoption of EU rules and (in some cases) establishment of EU institutions pertaining to the various components of the EU bank safety net
2. The various components as a by-product of the two crises
3. The impact of public international banking law on the content of the single rulebook
4. Variable perimeter of application
5. Legal sources: a mixture of legal acts adopted on various legal bases – contestability
6. Selected important elements of the institutional framework

E. Concluding remarks

A. Vicious circles: A general overview



2. In particular: the channels of transmission from a sovereign crisis to the banking system

a) Direct channels of transmission (see Committee on the Global Financial System (2011):

(i) impact of negative sovereign ratings on (individual) bank ratings and hence to their funding conditions in wholesale markets,
(ii) losses incurred by banks from their sovereign debt holdings,
(iii) the ‘collateral/liquidity channel’,
(iv) losses from state guarantees granted to banks (explicit and implicit),
(v) the ‘risk aversion channel’:

- rise in investors’ risk aversion may increase the *premia* demanded on banks’ securities and hence reduce their funding availability,
- generalised decline in asset prices, triggering losses,

(vi) impact on banks’ non-interest (fee and trading) income,
(vii) crowding-out effects on banks’ debt issuance (up to the point that markets are closed for both the sovereign and the banks), and
(viii) close correlation between sovereign and financial CDS indices.

2. In particular: the channels of transmission from a sovereign crisis to the banking system

b) Indirect channels of transmission:

- negative impact on the performance of bank loans (in the (most probable) event of a related recession),
- liquidity shortage in the economy, negatively affecting bank liquidity, and
- (in particular) decline in deposits held by households and non-financial corporations (enterprises).

B. The cases of Ireland and Greece as the two extreme opposite examples

1. A general overview

Since 2007, the EU banking system has been hit by two severe economic crises:

(a) The ***recent (2007-2009) international financial crisis***, which was unprecedented in terms of duration, extent and intensity, originated in the US banking system and seriously impacted the banking systems of many other states through a spillover process. The crisis spread to the euro area, mainly through the exposure of large European banks to US investment products, the spillover of the banking crisis to the real economy and the subsequent international capital market distortions.

In particular, the consequence of this crisis, especially after the failure of the US investment bank *Lehman Brothers Inc.*, was that several banks and other financial firms around the world (small or big, even 'systemically important' institutions) were not able to absorb the losses from their risk exposure. This development:

1. A general overview (cont.)

- resulted, *inter alia*, in negative effects on the real economy, and
- obliged several governments (especially in the United States and the EU) to adopt rescue packages and recovery plans in order to support or even bail out individual banks (and, in some cases, the entire banking system).

Such governmental interventions weighed on state budgets and, in some cases, created serious fiscal imbalances, some of which evolved to fiscal crises, which, in turn, spread to become new financial crises.

(b) In 2010, Greece's public deficit, which had been widening over the years, leading to the accumulation of external public debt, accompanied by a continued loss of competitiveness and a worsening of the current account deficit (twin deficits), resulted in a surge in borrowing costs and risk *premia* on Greek sovereign debt, as well as in Greece's exclusion from international interbank and capital markets. This triggered the ***(current) euro area fiscal and debt crisis***:

1. A general overview (cont.)

- **fiscal crisis**: violation of the (hard limit =3%) deficit/GDP ratio
- **debt crisis**: increase of the (soft limit = 60%) debt/GDP ratio and, mainly, debt non-sustainability

Apart from Greece, three other Member States, for different reasons each, were severely affected by this crisis, were excluded from international interbank and capital markets and resorted, like Greece, to the sovereign lending of last resort facilities of the IMF and newly built (during this crisis) EU facilities (EFSM – EFSF – ESM):

- Portugal,
- Ireland, and
- Cyprus.

(c) A common problem for (almost) all Member States of the euro area (monetary union) – **disaster myopia**: in the absence of ‘local’ funding foreign exchange risk after the introduction of the euro, it was perceived that banks were bankruptcy remote.

1. A general overview (cont.)

(d) A similar **institutional deficiency**: The Treaty on the Functioning of the European Union (TFEU) did not contain any provision (similar to the IMF financial assistance mechanisms) for financial assistance to euro area Member States having lost their access to international interbank, money and capital markets (even euro-denominated). Accordingly:

- the initial financial support to Greece was provided on the basis of **Article 122(2) TFEU** laid down for national disasters or exceptional circumstances beyond a Member State's control (!),
- the subsequent financial support mechanisms (EFSM, EFSF, ESM) were based on bilateral and multilateral agreements outside the TFEU,
- the TFEU-anchor for the ESM was laid down only in 2014 with the insertion of **Article 136(3)**, and
- the IMF was logically involved.

2. The case of Ireland
2.1 The banking system before the recent (2007-2009) international financial crisis

(a) The situation in the Irish financial system before the crisis can be summarized as follows:

- the Irish banking system was exceptionally large and highly leveraged (like the one in Iceland and Cyprus): the ratio of bank assets to GDP came to 400%,
- the balance sheet was funded heavily by access to international interbank and debt markets (wholesale funding) at low cost floating rates (exposure to liquidity risk),
- loan-to-deposit ratios were high, with an over-exposure to mortgage loans (encouraged, like in the US, by public policy),
- inadequate collateral of mortgage loans (mainly by personal guarantees), and high degrees of loan-to value (LTV).

2. The case of Ireland
2.2 The crisis and the guarantee

- At the beginning of the Irish banking crisis in 2008, two credit institutions were mainly affected (Anglo-Irish Bank – Irish Nationwide Building Society), even though the entire system was exposed to risks.
- In order to restore confidence to the banking system, despite the existence of an explicit deposit guarantee scheme (operating under the EU rules laid down by Directive 94/19/EC), but in the absence of a mechanism for direct bank recapitalisation, **the Irish Government issued a 'blanket guarantee'** not only for retail deposits **but for all (non-equity) bank liabilities in all credit institutions (including the ailing ones)**.
- The initial guarantee extended for two years.

3. The case of Greece

(a) The recent (2007-2009) international financial crisis did not directly and particularly affect the Greek banking system. The main reason for this was the low, if not zero, exposure of domestic banks to securitised financial products issued by US banks. In more detail, over that period Greece's fiscal position had started to deteriorate, but the banking system had not yet been affected. It is indicative that Greek credit institutions recorded their second highest profitability level in 2008, just a few months after the collapse of *Lehman Brothers* (15.9.2008), at the height of the international financial crisis.

(b) In 2010, Greece's fiscal and sovereign debt problems directly affected, as reasonably expected, the Greek banking system through all the eleven (11) channels of transmission (**see above under A 2**).

TABLE 2
A typical bank balance sheet in Ireland and Greece before the recent (2007-2009) international financial crisis

Assets	GR	IR	Liabilities	GR	IR
Totally liquid assets: • cash • reserve requirements of the Central Bank • 'deposit facility' of the Central Bank	5	3	Liquidity provided by the Central Bank in the course of the conduct of the monetary policy through: • 'open market operations' • 'lending facilities'	2	2
			Last resort lending from the Central bank		
Loans and credit to: • businesses • households (mortgage and consumer lending) • institutions (public and private)	73	70	Deposits of: • businesses • households • institutions (public and private)	79	39

TABLE 2 (cont.)
A typical bank balance sheet in Ireland and Greece before the recent (2007-2009) international financial crisis

Assets	GR	IR	Liabilities	GR	IR
Capital market instruments issued by: • governments • other banks and financial firms • other corporates	10	15	Debt instruments not included in own funds Interbank deposits	10	50
Holdings in other banks, financial firms and corporates (including ‘qualified holdings’ and subsidiaries)	8	8	**Debt instruments included in regulatory own funds**	2	4
Real estate – other assets	4	4	**Share capital and provisions**	7	5
	100			**100**	

TABLE 3

Lending to Greek credit institutions related to monetary policy operations denominated in euro and other claims (emergency liquidity assistance-ELA) (in million euro)

End-December	2008	2009	2010	2011	2012	2013	2014	2015
Lending to Greek credit institutions related to monetary policy operations denominated in euro	38,355	49,655	97,669	76,120	19,347	63,226	56,039	35,918
Other claims on Greek credit institutions denominated in euro (emergency liquidity assistance-ELA	76,800	72,800	71,600	52,009	101,851	9,791	1,095	77,488
TOTAL	**38,432**	**49,728**	**97,740**	**128,129**	**121,198**	**73,017**	**56,040**	**113,406**

Source: *Bank of Greece, Financial Statements, Annual Accounts and Monthly Balance Sheets*

C. The bank safety net: the sum of policy instruments employed with regard to the preservation of the stability of the banking system

TABLE 4 **The ‘bank safety net’**		
Policy instruments	**Competent institution**	**Attributes of the institution**
Bank authorisation	Supervisory authority	Central bank or other administrative authority
Micro-prudential and macro-prudential regulation of banks	Parliament Supervisory authority	General regulator upon delegation
Micro-prudential supervision of banks	Supervisory authority	Central bank or other administrative authority
Macro-prudential oversight of the financial system (including the banking sector)	Central bank or monetary authority/agency (in most cases)	

TABLE 4 (cont.)
The ‘bank safety net’

Policy instruments	Competent institution	Attributes of the institution
Specific crisis prevention and resolution of banks	Supervisory or judicial authority Resolution authority and resolution fund	On a case-by-case basis
Deposit guarantee	Deposit guarantee scheme	Entity of private or public law
Last-resort lending	Central bank or monetary authority/agency	
Provision of state subsidies to banks (government ‘bailout’) in form of equity participation and/or liquidity guarantees	National Ministry of Finance or other delegated governmental agency	

D. The EU response to the recent crises: the European Banking Union (EBU)

The **six (6) main elements** of European banking law after the establishment of the European Banking Union:

- adoption of EU rules and (in some cases) establishment of EU institutions pertaining to the various components of the bank safety net
- the various components as a by-product of the two crises
- the impact of public international banking law on the content of the single rulebook
- variable perimeter of application
- legal sources: a mixture of legal acts adopted on various legal bases - contestability
- selected important elements of the institutional framework

TABLE 5
The key legal sources of the three main pillars of the EBU

	Prudential supervision and regulation of credit institutions	Resolution of non-viable credit institutions	Deposit guarantee schemes
European 'Single Mechanisms and Funds'	Single Supervisory Mechanism: • Council Regulation (EU) No 1024/2013 **('SSMR')** • ECB Regulation (EU) No 468/2014 **('ECB Framework Regulation')** • other ECB legal acts	Single Resolution Mechanism and Fund: • Regulation (EU) No 806/2014 of the European Parliament and of the Council **('SRMR')**, and Commission delegated and implementing acts • Intergovernmental Agreement (2014) **('SRF')**	Proposal for a Regulation of the European Parliament and of the Council "amending Regulation EU No 806/2014 in order to establish an **'EDIS'**"

TABLE 5 (cont.)
The key legal sources of the three main pillars of the EBU

	Prudential supervision and regulation of credit institutions	**Resolution of non-viable credit institutions**	**Deposit guarantee schemes**
Harmonisation of substantive rules (‘single rulebook’)	• Regulation (EU) No 575/2013 of the European Parliament and of the Council **(‘CRR’)**, and Commission delegated and implementing acts • Directive 2013/36/EU of the European Parliament and of the Council **(‘CRD IV’)**, and Commission delegated and implementing acts	• Directive 2014/59/EU of the European Parliament and of the Council **(‘BRRD’)**, and Commission delegated and implementing acts	• Directive 2014/49/EU of the European Parliament and of the Council, and a Commission delegated act **(‘DGSD’)**

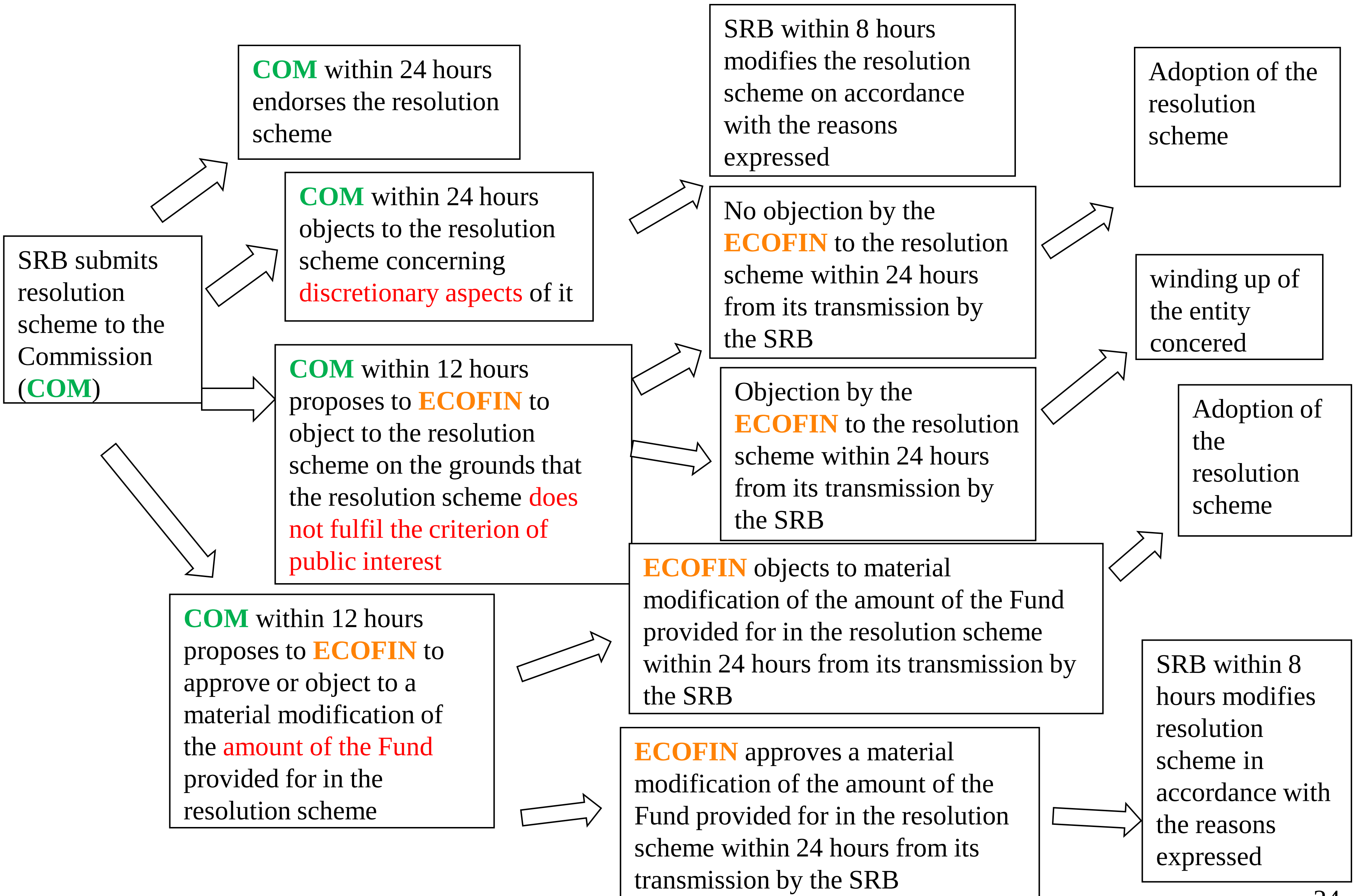
TABLE 6
The partial Europeanisation of the 'bank safety net' (even) with regard to significant credit institutions

Financial policy instruments	**Scope of application**	**Level of action (*italics* denotes national)**
Granting and withdrawal of authorisation	Euro area (+ Member States under close cooperation)	**ECB** within the SSM (also applicable to less significant credit institutions)
Macro-prudential oversight	EU	**ESRB** and **ECB** (specific tasks)
Micro-prudential supervision	Euro area (+ Member States under close cooperation)	**ECB** within the SSM (with regard to the specific tasks conferred on the ECB)
Recovery planning and early intervention	Euro area (+ Member States under close cooperation)	**ECB** within the SSM
Recapitalisation by public funds	• EU • Euro area • Euro area	• *National governments* • *Indirectly by the ESM* • Directly by the **ESM** ('DRI')

TABLE 6 (cont.)
The partial Europeanisation of the ‘bank safety net’
(even) with regard to significant credit institutions

Financial policy instruments	**Scope of application**	**Level of action** **(*italics* denotes national)**
Drawing up of resolution plans, assessment of resolvability and resolution	Euro area (+ Member States under close cooperation)	Single Resolution Board (‘**SRB**’) within the SRM *(as of 1 January 2016)*
Winding up	EU	*National administrative or judicial authorities*
Deposit guarantee	EU	*National deposit guarantee schemes* European Deposit Insurance Scheme (**EDIS**) *(proposal)*
Last resort lending (‘ELA’)	Euro area	*National central banks*-*members of the Eurosystem*

TABLE 7


SRB submits resolution scheme to the Commission (COM)
COM within 24 hours endorses the resolution scheme
COM within 24 hours objects to the resolution scheme concerning discretionary aspects of it
COM within 12 hours proposes to ECOFIN to object to the resolution scheme on the grounds that the resolution scheme does not fulfil the criterion of public interest
COM within 12 hours proposes to ECOFIN to approve or object to a material modification of the amount of the Fund provided for in the resolution scheme
SRB within 8 hours modifies the resolution scheme on accordance with the reasons expressed
No objection by the ECOFIN to the resolution scheme within 24 hours from its transmission by the SRB
Objection by the ECOFIN to the resolution scheme within 24 hours from its transmission by the SRB
ECOFIN objects to material modification of the amount of the Fund provided for in the resolution scheme within 24 hours from its transmission by the SRB
ECOFIN approves a material modification of the amount of the Fund provided for in the resolution scheme within 24 hours from its transmission by the SRB
Adoption of the resolution scheme
winding up of the entity concered
Adoption of the resolution scheme
SRB within 8 hours modifies resolution scheme in accordance with the reasons expressed

E. Concluding remarks

1. Breaking the vicious circles between the banking system and the sovereign may partly be achieved through an appropriate design of the ‘bank safety net’.

2. In the EU (mainly but not exclusively in the euro area), through the ‘European Banking Union’ project, the focus has been on:

2.1 In terms of rules:

- enhancing micro- and macro-prudential banking regulation,
- establishing a framework for the resolution of credit institutions,
- harmonizing the level of deposit guarantee at a maximum level

2.2 In terms of institutions:

- creating a European Systemic Risk Board for macro-prudential financial oversight,
- creating pan-European mechanisms and funds for banking micro-prudential supervision and resolution, and
- planning the Europeanisation of deposit guarantee

3. Sound fiscal and monetary policies are, however, indispensable (outside the reach of this presentation).

- Monetary policy has been centralized within the euro area **(Article 127 TFEU) – monetary union**
- Fiscal policies, even within the euro area, remain still national **(Article 120 TFEU)**, under the constraints laid down by the principles of economic coordination **(Article 121 TFEU)** and fiscal discipline **(Articles 123-126 TFEU) – economic union**

4. A point of concern: the accuracy and forward-looking perspective of the monitoring mechanism provided by pan-European and international institutions and bodies and potential adverse implications.

An important remark by **B. Eichengreen (2015)**: *"Ireland was blessed by external surveillance of its financial regulation, and of its economic and financial policies generally, by the European Union and the IMF"*: