EUROPEAN CENTRAL BANK

EUROSYSTEM

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10 years since the banking crisis: what has changed?

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Disclaimer: the views expressed in this presentation do not necessarily reflect the views of the European Central Bank or its Governing Council.

Overview

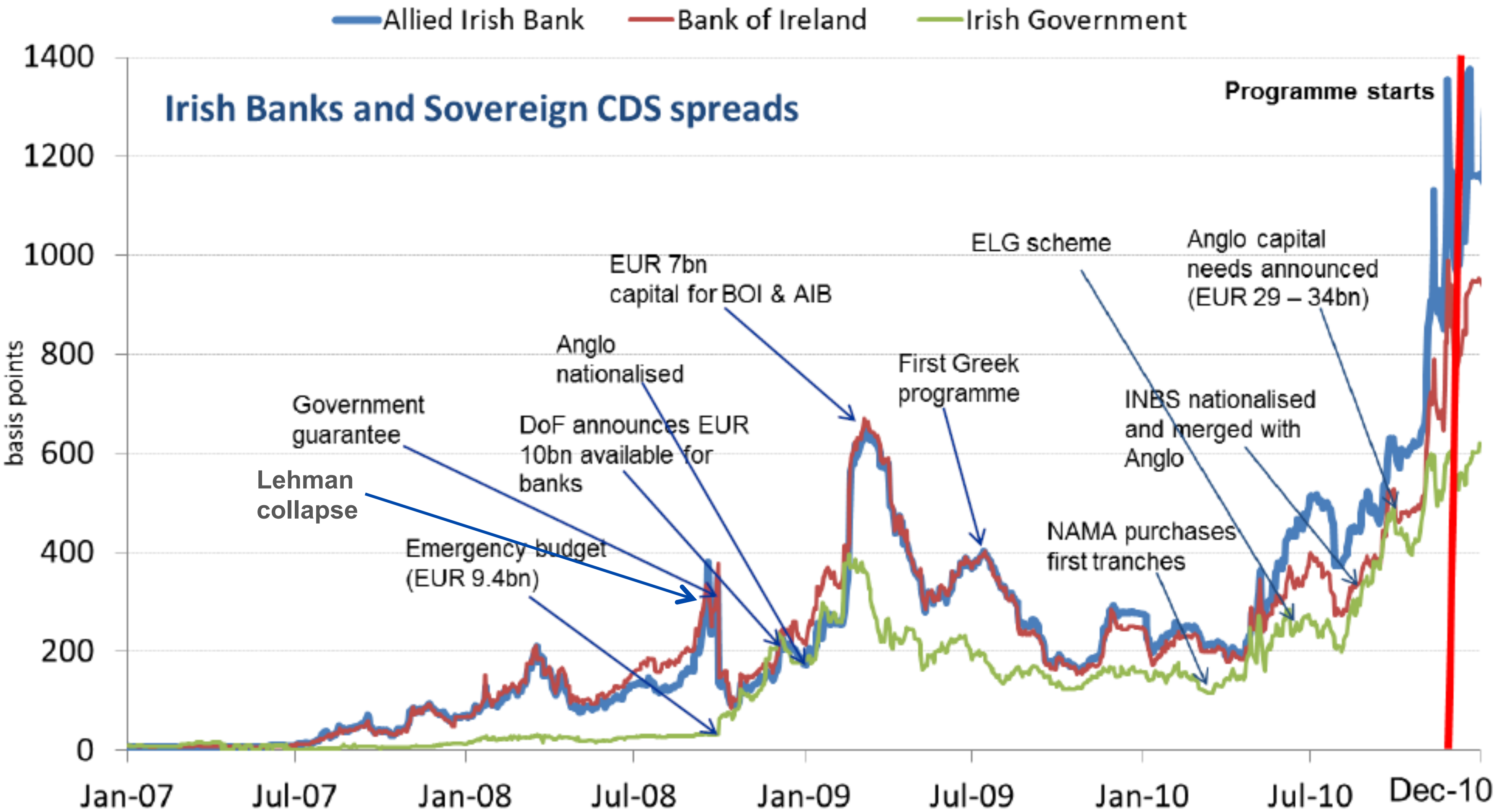
I	Preamble – What happened 10 years ago?
II	What were the underlying vulnerabilities, in retrospect?
III	What reforms have been implemented since then?
IV	Closing remaining gaps
V	Concluding remarks

I. Preamble – What happened 10 years ago?

The sovereign-bank nexus: too big to rescue

Sovereign-bank feedback loop emerged in late 2008 and deepened in 2010…

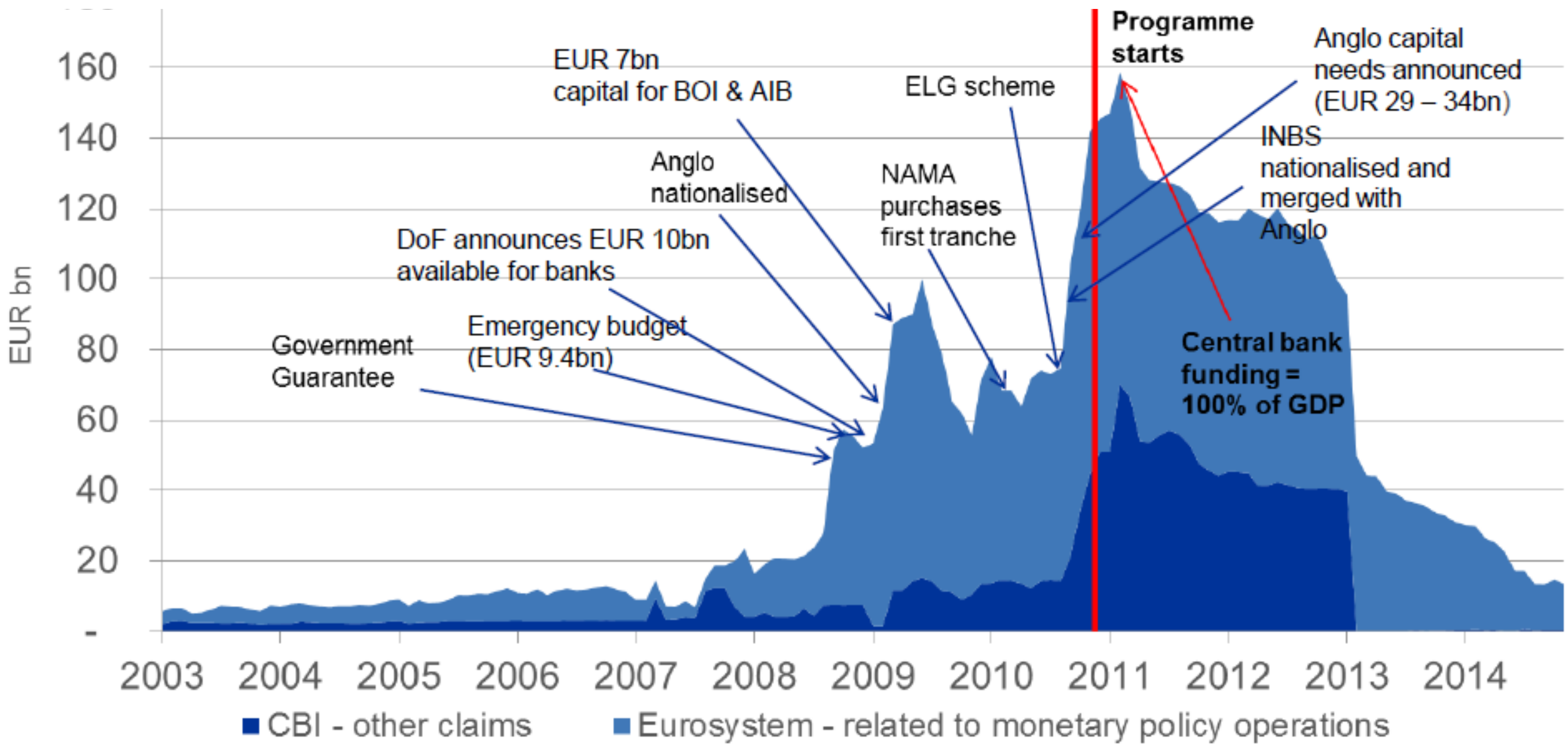
…as fears for ever-growing losses from the banking sector impacted the sovereign



Source: Bloomberg and IMF

A funding-solvency nexus emerged as well

- funding vulnerabilities were unearthed by global risk aversion;
- which the guarantee could not fully offset;
- asset quality concerns (including of sovereign) impacted collateral availability;
- fears over contingent liabilities of the State added to the funding challenges;
- central bank funding, which surged to 100% of Irish GDP, avoided fire-sales

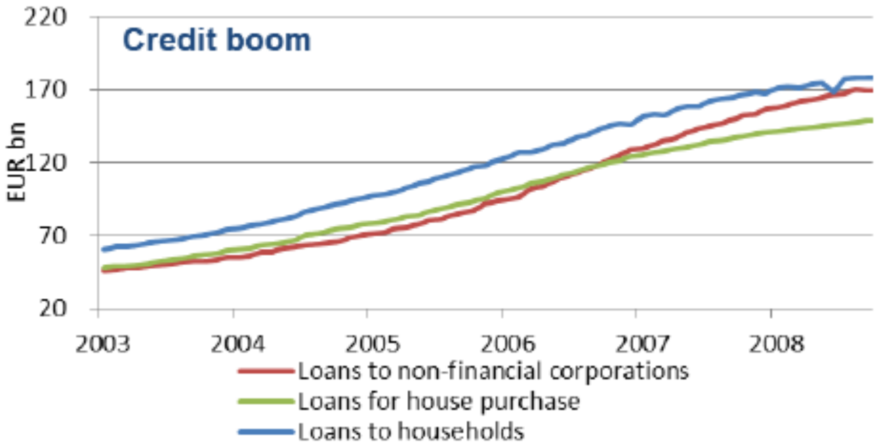


Source: European Central Bank; Central Bank of Ireland, International Monetary Fund

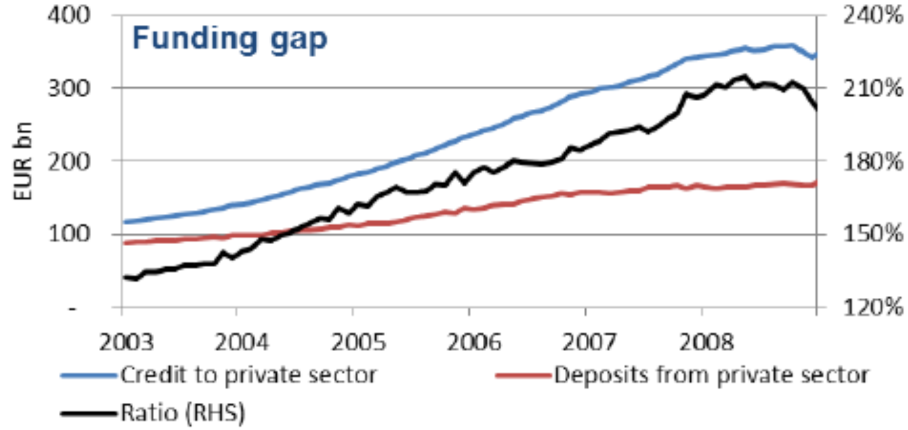
II. What were the underlying vulnerabilities, in retrospect?

A debt-financed real-estate boom that ultimately proved unsustainable

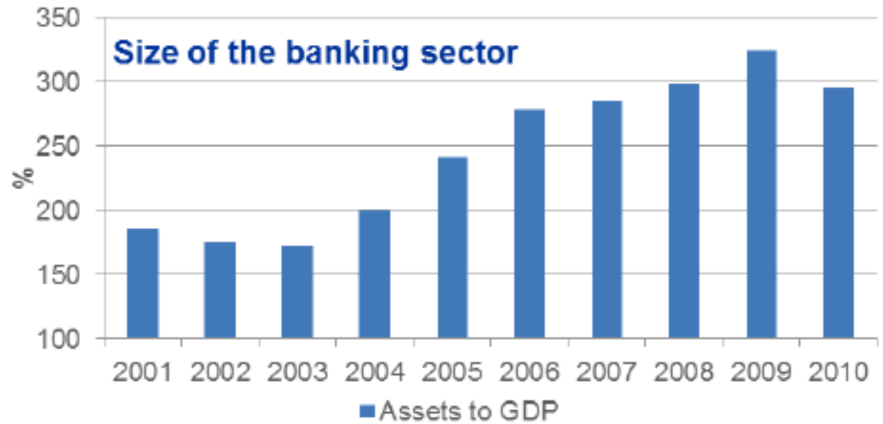
Unsustainable credit growth opened up a burgeoning funding gap, leading to severe funding vulnerabilities



Source: Central Bank of Ireland. Note: outstanding loans to Irish residents, including securitised loans.



Source: Central Bank of Ireland. Note: domestic market group, loans and deposits to Irish residents.

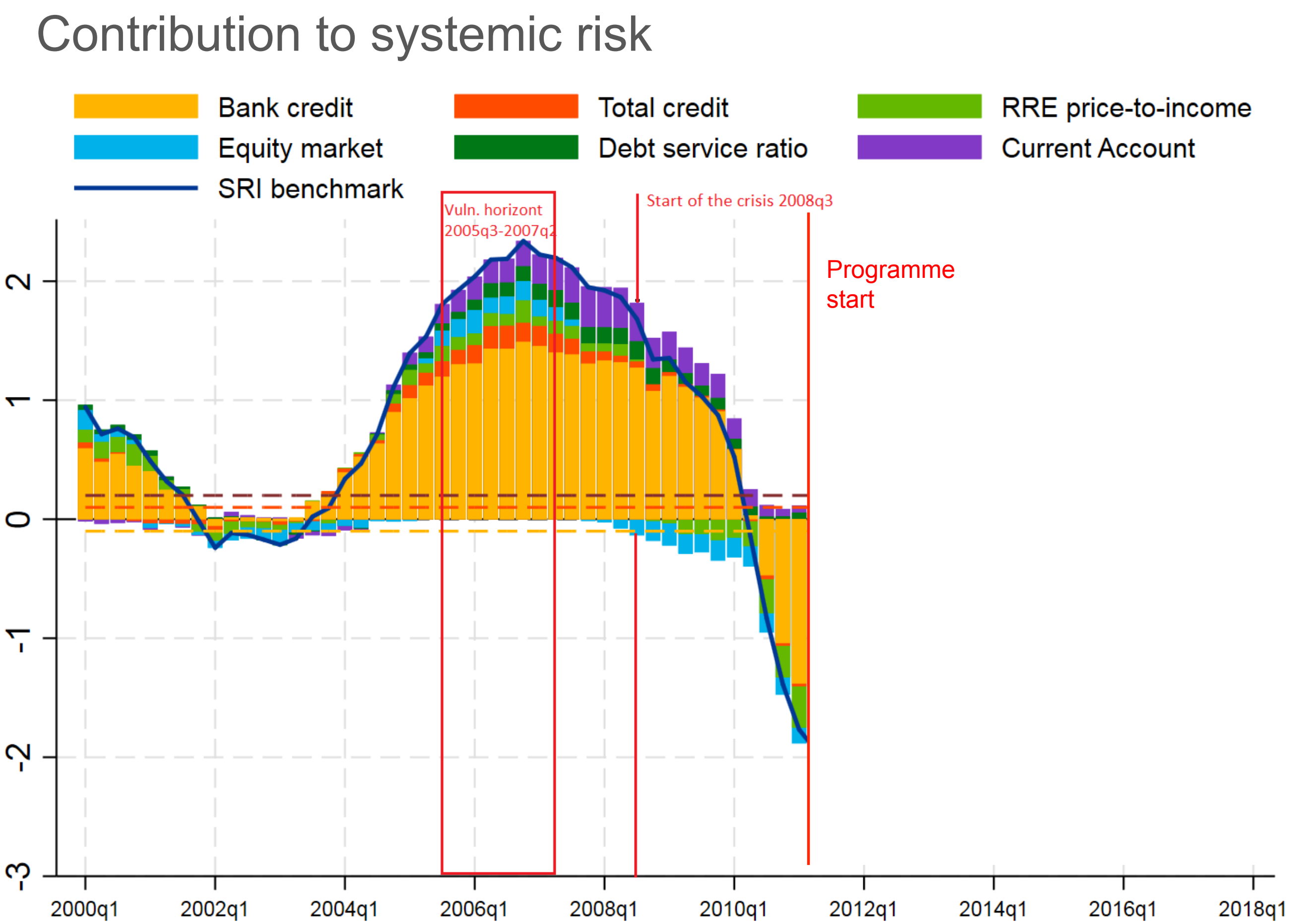


Source: Central Bank of Ireland, Financial Measures Programme Report. Note: data for six covered banks .

Wholesale funding as % of total liabilities (2010)	
ILP	64%
Anglo	62%
EBS	49%
INBS	41%
AIB	39%
BOI	35%

Source: Central Bank of Ireland.

An Early Warning monitoring system would have signaled the build-up of systemic risk vulnerabilities



Note: Domestic Systemic Risk Indicator and its subcomponents. See details of methodology in: ECB Financial Stability Review Special Feature B, May 2018. The y-scale axis measures standard deviations from the historical euro area median.

II. Underlying vulnerabilities: Inadequate European institutional framework

No financial stability framework existed …

Crisis prevention:

- European **supervision of banks** ☒
- European **Deposit Insurance** ☒
- **Common macro-prudential framework**
  - Surveillance ☑
  - Assessment (incl. banking sector stress tests) ☒
  - Policy instruments ☒

Crisis management:

- European bank **crisis management framework** ☒
- European **Emergency Liquidity Assistance** ☒

Euro area had **insufficient tools** at its disposal to, on the one hand, **prevent crises**…
…and, on the other hand, **mitigate their impact** if they occurred

… instead, there was reliance on cooperation across national authorities…

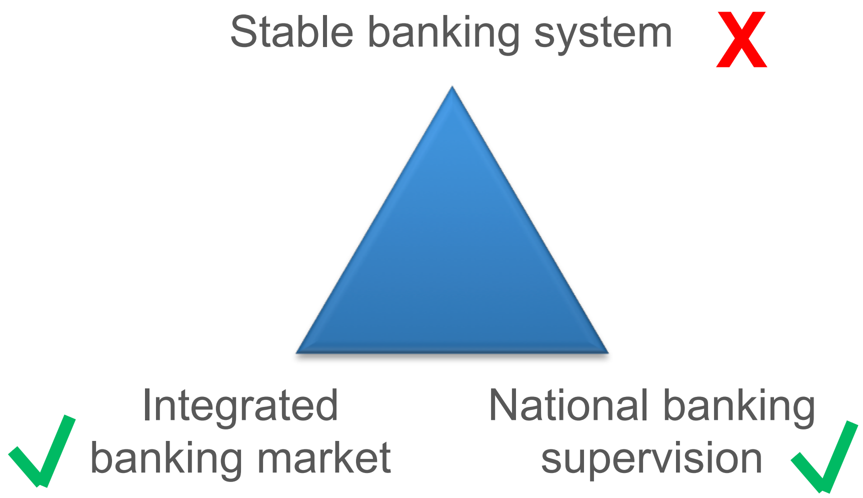
- Challenges of a decentralised approach were clear from the beginning of EMU (Prati and Schinasi, 1999)
- Principle of **'home country control',** plus cooperation: Memoranda of Understanding – soft tools, ignored when most needed, i.e. during the crisis; ex-post burden sharing and "improvised cooperation" not effective (Freixas, 2003; Goodhart and Schoenmaker, 2009)
  In short: decentralization, segmentation (multiple authorities)**, and cooperation** (Nieto and Schinasi, 2007)
- **Fallacy of composition**: illusion that focus on micro stability would be sufficient to also ensure macro stability

...leading to a "financial trilemma"

- **Asymmetry** between the national nature of supervision and crisis management and the increasingly integrated, pan-European nature of banks

  → risks of financial instability

- **Financial trilemma** (Schoenmaker, 2005 and 2011): financial stability, financial integration and national supervision – only two can be achieved at the same time. National supervision with financial integration led to financial instability



The lack of a European economic and fiscal policy coordination framework was also at odds with the monetary union

- **Governance of economic and financial policies** remained a national competence
- **No fiscal policy at the European level** (no stabilisation function to deal with asymmetric shocks that may exacerbate fragmentation and create redenomination risk)
- **No mechanism of financial assistance** for Member States at the European level when the crisis struck

III. What reforms have been implemented since then?

The financial measures programme was successful in restoring confidence

Solvency & Asset Quality

- ✓ Rigorous AQR
- ✓ Bottom-up stress test
- ✓ Minimum capital ratios

"Right-sizing" & Funding

- ✓ PLAR programme
- ✓ Deleveraging of non-core
- ✓ Funding support & waiver

- ✓ Confidence restored
- ✓ Solvency-funding feedback loop reversed
- ✓ Sovereign-bank correlation reduced

International regulatory response aimed at lowering both probability and potential impact of crises

- **Increasing resilience and reducing the probability of crises**
  - **Basel III (2010):** increase of minimum quantitative and qualitative levels of regulatory capital and new liquidity requirements

- **Reducing Loss Given Default, if crisis occurs**
  - **Financial Stability Board (2011)**: principles for new resolution frameworks, to make failure possible, even for the largest, most complex and global financial firms, with no burden on taxpayers and no systemic impact – tackling too-big-to-fail
  - Shifting burden from taxpayers to private creditors
  - Minimum requirements for banks' loss-absorbing capacity – TLAC for G-SIBs (2015) – to ensure effective functioning of bail-in

Reform of the euro area institutional set-up and financial regulatory framework…

Crisis prevention:

- European **supervision of banks**
- European **Deposit Insurance** ?
- **Common macro-prudential framework**
  - Surveillance
  - Assessment (incl. stress test)
  - Policy toolkit

Crisis management:

- European bank **crisis management framework**
- European **Emergency Liquidity Assistance**

Better ex ante regulation of the financial systems with both **macroprudential and microprudential policies …**
… and, ex post, better **resolution/crisis management framework**

… aimed at fixing the fallacy of composition with a framework for both micro and macro supervision…

European System of Financial Supervision

Microprudential

European Supervisory Authorities

- European Banking Authority (EBA)
- European Insurance and Occupational Pensions Authority (EIOPA)
- European Securities and Markets Authority (ESMA)
- National supervisors (incl. supervisory colleges and SSM)

- Ensure EU-wide technical supervisory standards to implement the Single Rulebook
- Coordination of supervisors

Macroprudential

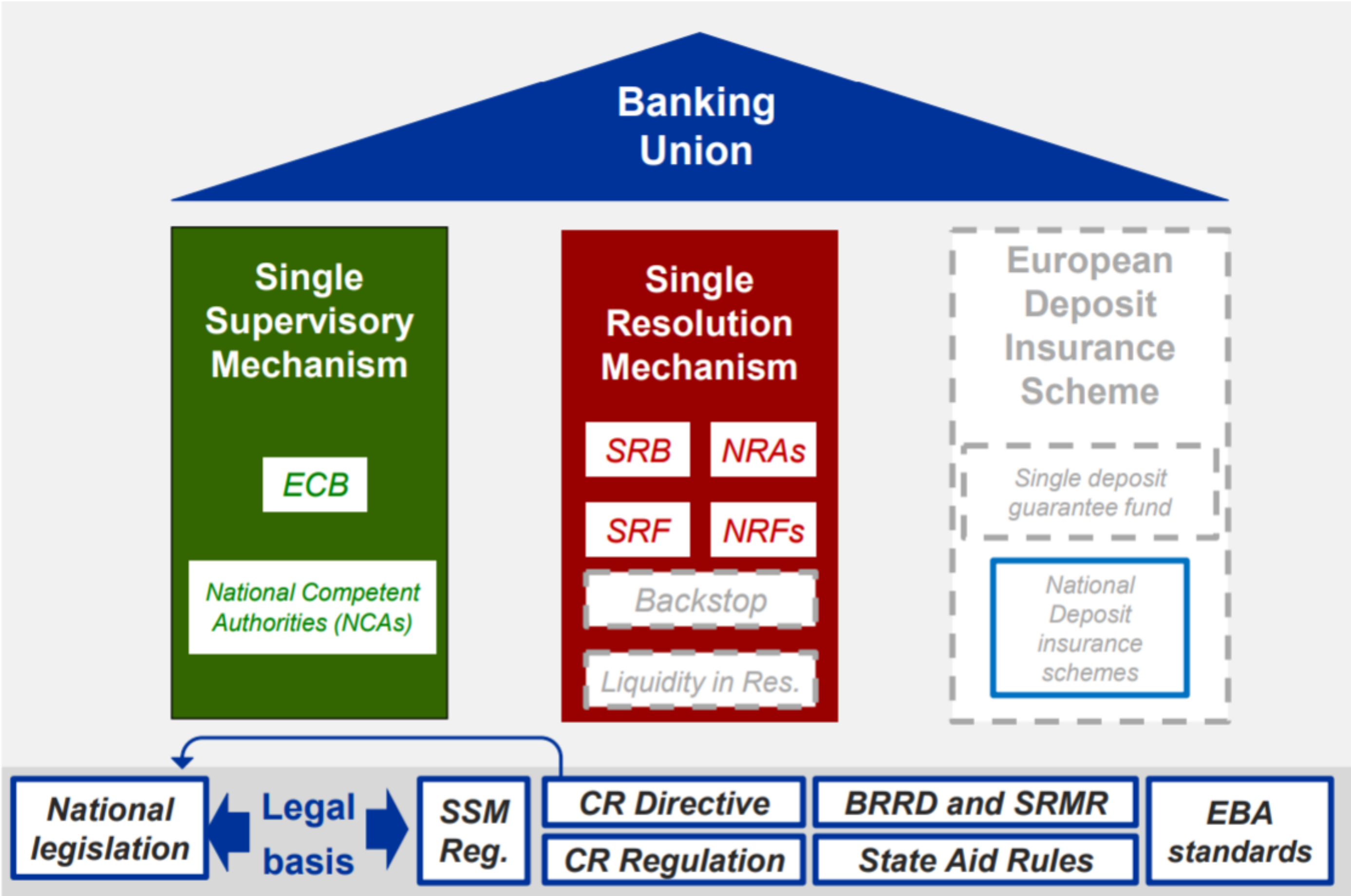
European Systemic Risk Board

- ECB
- National central banks
- European Supervisory Authorities
- **European Commission**
- **National Supervisors** *(non-voting)*
- **President of the Economic and Financial Committee** *(non-voting)*

- Issue risk warnings and macro-prudential recommendations
- Onus on national authorities +ECB top-up and ESRB role in coordination/reciprocity

… and fixing the financial trilemma with the establishment of a Banking Union…

- Three pillars:
  - common supervision (completed)
  - common crisis management/resolution framework (almost complete)
  - common deposit insurance (to be completed)



… with the following objectives:

- **Tackling asymmetry** between European nature of banks and national dimension of supervision/crisis management
- Ensuring **level playing field** and **fostering integration**
- Tackling the **sovereign-bank nexus**
- Tackling the **"too-big-to-fail"** problem with the new resolution framework, also through the new bail-in tool
- Avoiding the risks related to ex-post burden sharing and creating **ex-ante, predictable crisis resolution mechanism**
- **Solving the financial trilemma** by targeting financial integration and financial stability and giving up national supervision

The EMU’s economic governance framework was also improved

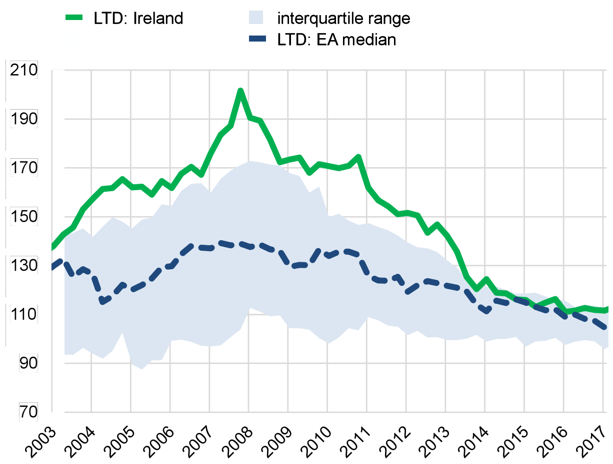
- Establishment of a **European Stability Mechanism (ESM)** for crisis management
- Strengthening of **the rules and coordination of national fiscal and economic policies**
- Introduction of a macroeconomic surveillance tool (**Macroeconomic imbalance procedure**)

- On-going discussions in the context of **“Deepening EMU”** consider the possibility to (i) enhance the ESM; (ii) introduce a Eurozone budget and potential stabilisation function

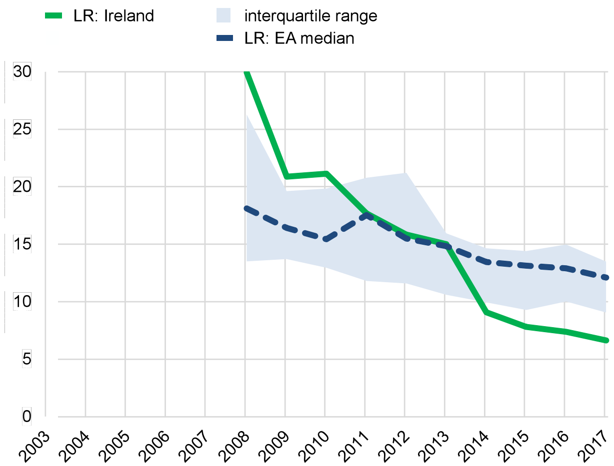
IV. – Closing remaining gaps

For most indicators, Irish banks are close to euro area norms, although legacies remain

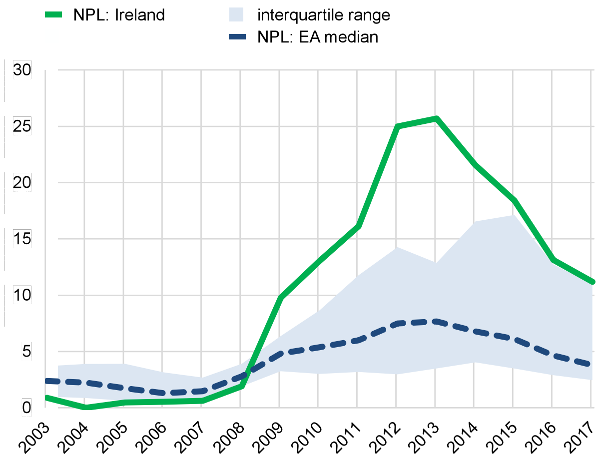
Loan-to-deposit ratio



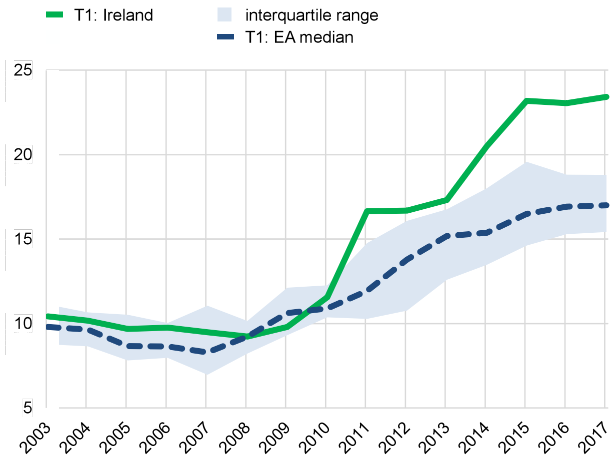
Leverage ratio (total assets / equity)



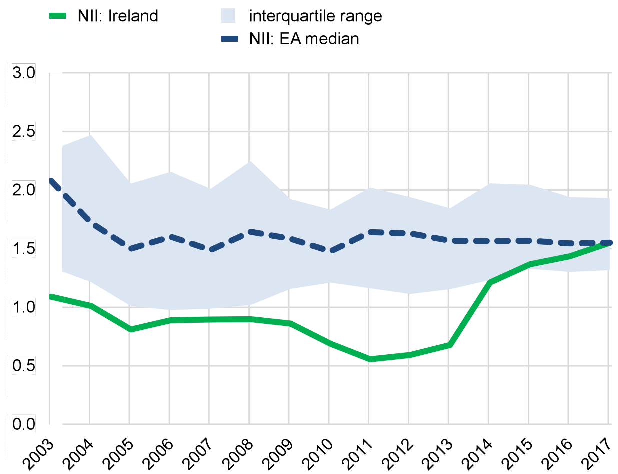
NPL ratio



Capital ratio (Tier 1)

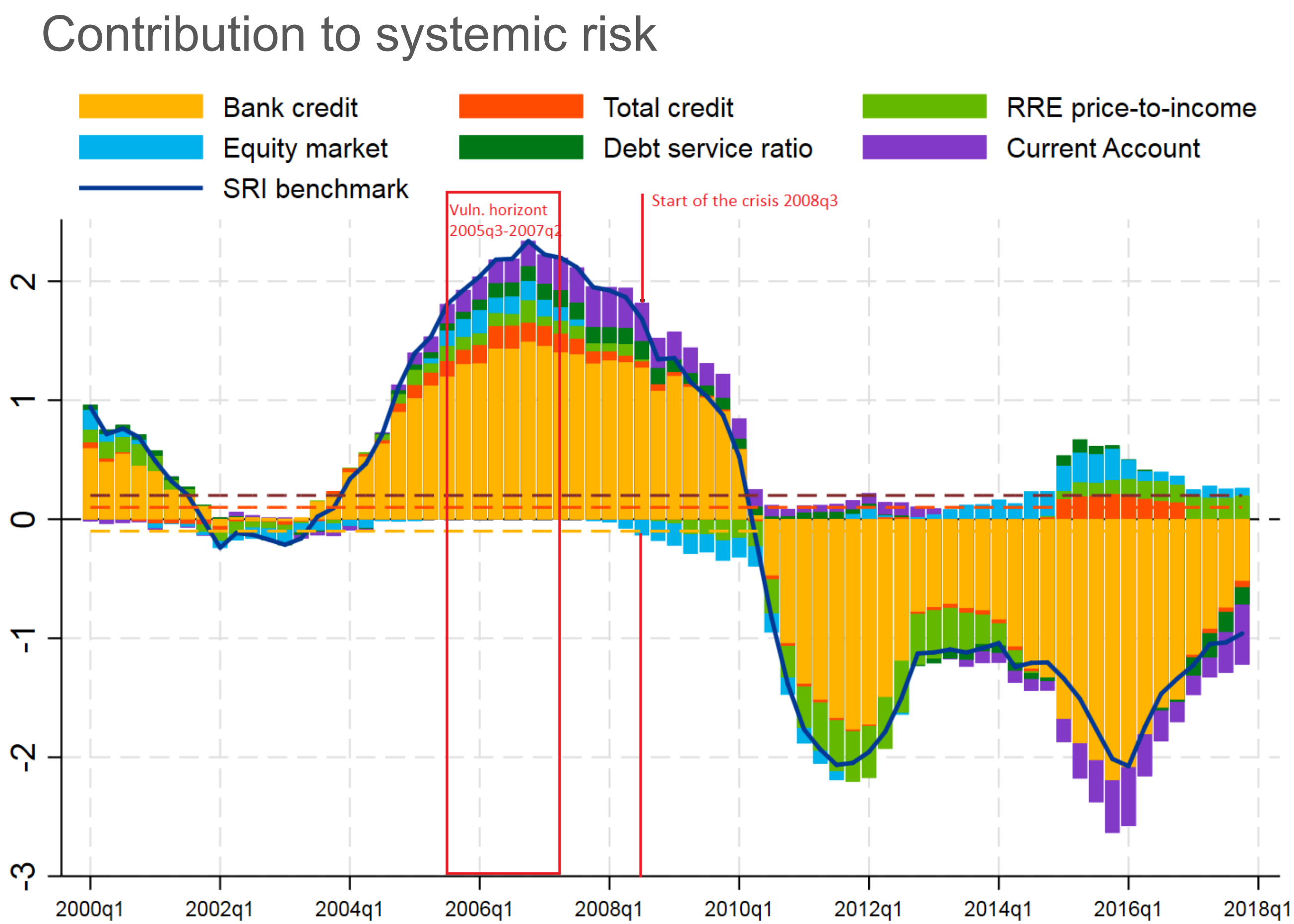


Net interest income



Sources: ECB SDW, IMF
Note: Euro area (EA) medians and interquartile ranges are computed across the 19 euro area countries

Latest readings of ECB Early Warning monitoring system shows the financial cycle is recovering



Note: Domestic Systemic Risk Indicator and its subcomponents. See details of methodology in: ECB Financial Stability Review, Special Feature B, May 2018. The y-scale scale measures standard deviations from the historical euro area median.

Banking Union still to be completed…

- First two pillars of banking union on supervision and resolution built very rapidly

- However, **Banking Union still to be completed** with:

  - The finalisation of the resolution pillar, with a **common backstop to the Single Resolution Fund** (SRF) to ensure the credibility of the resolution framework;

  - The establishment of a **framework for liquidity in resolutio**n to support orderly resolution.

  - The establishment of the third pillar, a European Deposit Insurance Scheme (EDIS) to ensure harmonised depositor protection and to avoid bank runs;

Much has already been achieved, but the work is not yet complete

We will be confronted with financial crises again…

"A fundamental characteristic of our economy is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles." – *Hyman Minsky*

… and the next crisis is likely to be different to the last one, but post-crisis reforms have strengthened the banking system and the EMU's institutional framework in all key areas:

- The **probability of occurrence** of a crisis should now be lower
- Should a crisis happen, its **impact** should be lower
- There are **tools and frameworks** in place to both prevent and to react to crises

But, several key reforms still have to be completed and implemented – **there is no room for complacency**

- In IE, action by macroprudential authorities to pre-emptively prevent the build-up of vulnerabilities is welcome
- At the EU level, completing the Banking Union and continuing reforms to strengthen EMU are of the essence
- At the international level, pressure to de-regulate should be resisted