How to Integrate a Eurozone Banking System

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Integrating European banking : objectives

- More efficiency:
  - Allocation efficiency
  - Operational efficiency (cost, revenue)
    - economies of scale
    - diversification, stability
- More competition :
  - Reduce market power
  - Reduce – delete rent
- Better regulation of risk and better risk management
- More innovation, useful innovation (Paul Volcker : next ATM)
- More financing or more banking ?

Relevant Bank components : two, three, five?

- Commercial Banking; deposits, loans (select).
- Investment Banking :
  - Underwriting, corporate finance
  - Market making, arbitrage, speculation
- Transaction Banking:
  - Brockerage, distribution (securities et al)
  - Custody
- Asset Management: own funds, management services
- Advice, Rating, etc.

Commercial Banking

- Until 1980’s : limited competition, set tariffs, national regulation and protectionism. The (quite) off-shore “euro-markets”
- Then banking directives, “Big Bang”, Basel I & II, globalisation
- Some competition, deregulation, despecialisation, some cross-border integration
- Then mergers, concentration, loss of diversity (cooperatives, mutual,…)

Commercial Banking : no need for more I

- More efficiency? :
  - Allocation: local credit decisions better, at least for retail, SME
  - Operational :
    - Economies of scale or scope, unclear
    - Only on solvency ratio,…
- More competition? :
  - Cross border banking did not do it. Mergers, concentration, and local market power.
  - Some rents (transfers) attacked, but not trough integration.
  - Competition regulation, polluted.

Commercial Banking : no need for more II

- Risk not better regulated, but more subsidised
  - Complexity and size are problems as such.
  - Modelling to reduce real risk, or perceived risk?
- Guarantees and subsidy :
  - The explicit guarantees on deposit, “harmonised at 100.000”. Rather increased the problem, more deposits, more subordinated. “Doom loop”
  - The implicit guarantee of TBTF. Not decreased
  - The regulatory subsidy of the low capital ratio. The “champion” effect and the “nationalistic” effect.
- Innovation, unclear. Product pushing dangerous. Problem of incentives (bonus)

Commercial Banking : what is needed?

- Integrated regulation could reduce regulatory subsidy, improve steering of implicit guarantee.
- The resolution, and explicit guarantee issues remain :
  - Can ECB and “various creditors” handle the bail-in?
  - Who handles explicitly guaranteed depositors?

The explicit guarantee: questions

- Should it remain at 100.000 euro? (per account, or depositor?)
- Remain national, or common fund, a EUDIC?
- A first step, covering deposits, just like bonds!!
  - Diversified assets, credits, bonds, etc
  - Guarantee fee modulated
  - Can encourage some type of credit
  - Reduces the problem for the guarantor, and the subordination aspect
  - Underlines the problem of asset encumbrance, and the seniority of various creditors

Investment Banking: Integration not the main issue

- Quite integrated, out of London, with some outfits on derivatives market making. No real evidence of operational efficiency, but size gives notoriety, information, and some superior profitability before bonus.
- Could use more competition:
- Difficult to do effective risk regulation. Funding by commercial banking is an issue.
- Remuneration issue quite strong.
- Allowed to fail?
  - If not, many issues
  - If yes, counterparty risk
  - CCP’s everywhere ?

Transaction Banking: could use more integration (I)

- Brokerage: can be Investment Banking, Commercial Banking, or (some) independent
- Institutional brokerage: quite integrated, quite efficient, competition quite high. Regulatory issues on transparency, fair trading.
- Retail brokerage: quite national; inefficiencies, tariffs and rents. Limited competition. Tax issues: limits allocation efficiency. Fixed income - shares.

Transaction Banking: could use more integration (II)

- Custody: gone a long way on integration. Specialised Banking.
- Stock exchange and settlements
  - SE mergers, MIFID exchanges. Competition of exchanges
  - Regulatory problems: transparency, concentration, competition.
  - Central counterparty to mitigate counter party risk, or could increase it? Capitalising the CCP's.

Asset Management: on the move

- Can be independent, or with Investment banking, or Commercial banking (usually then with transaction banking). From money market funds to hedge funds.
- Quite integrated, quite competitive. Some strange rents. Some strange practices as well (soft commissions, IPO allocations,…)
- UCITS globally a success. Linked with Commercial banking (continent), fragmented

Advice – Analysis: schizophrenic as ever (I)

- Debt :
  - Retail and SME debt: rather local business. Some integration through securitisation, with the problem of modelling, standardisation usefulness? The next securitisation prospect.
  - Corporate debt, some useful integration through Rating Agencies.
  - Sovereign debt, needed at all? What integration?
  - Rating Agencies efficient? Competitive?

Advice – Analysis: schizophrenic as ever (II)

- Shares :
  - Quite integrated, quite competitive, not independent
  - Should not be linked to Investment Banking. Independent, or Transaction Banking (if compatible)? Credible Chinese Walls?
- In general:
  - role of Investors in paying for advice
  - Incompatibilities
  - independence

Integration EU banking: a view (I)

- Separating the three main functions?
- Risk management;
  - Moral hazard, conflict of interest?
  - seniority of deposits
  - Capital allocation, regulation
  - Large number of commercial banks of all sizes and forms
- Integrated regulation through ECB. Guarantees and resolution through National DIC, + EUDIC. Deposits covered in favour of National DIC.
- Improve allocation:
  - Less subsidy on deposits, tax neutrality on all instruments for EU investors
- Improve corporate financing:
  - Covered deposits
  - Disintermediation: securitisation + tax neutrality

Integration EU banking: a view (II)

- Improve allocation:
  - Less subsidy on deposits, tax neutrality on all instruments for EU investors
- Improve corporate financing:
  - Covered deposits
  - Disintermediation: securitisation + tax neutrality
- Well capitalised CCP (FTT)
- More financing, less banking?