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A Big Bang for Banking in Europe

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by Jan Pieter Krahenen

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A “Big Bang” in Europe’s banking system is the possible outcome of a thrilling chess game currently being played between authorities at the European and the national level. In October 2013, the European Central Bank (ECB) unveiled its strategy for how to take command of the banking supervision process in the euro area. A short note entitled „Comprehensive Assessment“ describes in some detail the three stages of the capital adequacy exercise the ECB, together with the relevant national authorities, intends to carry out throughout much of 2014. While the note makes for a modest appearance at first glance, its content has the potential to become a true big bang for euro area banking.

The ECB move: The upcoming comprehensive risk assessment, a euro area-wide evaluation of bank balance sheets and business models, is unprecedented. Its implementation and its progress will be watched by financial markets worldwide with bated breath. This fact makes it hard to imagine that the outcome, which will not be seen until the end of 2014, will simply be a muddling-through. More likely, it will cause a significant shake-up of national banking systems across the euro area, possibly with side-effects on other EU economies.

Strengths: With the comprehensive assessment, the ECB aspires to define a set of valuation principles and models, together with a reliable data basis, that can be applied uniformly across euro area countries. For this reason, the exercise is bottom up, starting from the underlying data all the way up to finding common models for the assessment of hard-to-value products (“level-3 assets”) – ranging from complex derivatives to private equity and illiquid foreign investments.

Opportunities: If carried out properly, the 2014 comprehensive assessment will lead the euro area into a new era of banking supervision. The exercise will confront the industry, or large segments of it, with the new rules and the new governance of the supervisory process. As a very desirable side effect, it is likely that the assessment process will severely trim the colorful bouquet of national exceptions and particularities in the supervision of financial institutions that has survived the European integration process over the past 20 years and that clouds the vision of a single market for financial services in Europe.

Weaknesses: However, there are considerable risks, too. Most importantly, the comprehensive assessment is meant to put away with the so-called legacy assets that have accumulated over the crisis years. Should the exercise reveal insufficient capital at some institutions, recapitalizations will be necessary and expected. If private capital is not readily available, other measures may be required. For example, profits may be retained, assets

may be sold, business lines may be separated and consolidated in the process. While simple on paper, these responses to capital shortfalls are hard to predict unless clear procedural rules are drawn up at the national level including a definition of ultimate backstops in case the private measures do not meet the minimum threshold.

Threats: The greatest threat lies in the reaction of financial markets which provide an important part of banks' funding. In order to retain access to market funding, the backstop for banks needs to be put in place rather soon. Short term bank funding is as shy as a deer, the slightest doubt in the availability of backstop capital of any sort will cause bank creditors to run and to transfer their funds elsewhere causing systemic vibrations which will be felt throughout the whole system.

Check to National Authorities! As a result, policy makers in euro area countries are now under severe pressure to define a credible backstop framework. It is inconceivable and insufficient that such a framework will be simply a set of national backstops. Instead, a broader, quasi-European system of mutually reinforcing backstops is needed. Thanks to the ECB's bold move in ordering the comprehensive assessment, national authorities are now forced to give up their resistance, not only against more unified supervisory power at the euro area level, but also against a common reinsurance system for failing financial institutions.

Therefore: Check to national authorities! Let us watch the next move closely.