ECB: how to make Europe's banking union work

Author: Gemma Varriale
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- A single resolution mechanism (SRM) to wind down failing banks must be in place once Europe's new banking supervisor comes into force, according to a member of the ECB's executive board;
- Ahead of the definition of the framework for the SRM, the ECB has listed what it thinks its main features should be;
- These include a strong and independent single resolution authority and adequate funds for resolution financing;
- The ECB representative also highlighted the key lessons from Cyprus, saying that creditors must have a clear picture of what could happen in the event of a bank failure.

A European Central Bank (ECB) executive board member has stressed that a single resolution mechanism to wind down Europe's failing banks must be in place when the new banking supervisor comes into force, if the currency bloc is to achieve a genuine banking union.

The European banking union consists of three pillars: the single supervisory mechanism (SSM), the single resolution mechanism (SRM) and, a common system of deposit protection.

Policymakers agreed to establish a European banking union last year in an attempt to address weaknesses, uncovered during the financial crisis, within the economic and monetary union's institutional framework. But the related establishment of a resolution mechanism has provoked opposition from certain EU members, such as Germany.

Benoît Cœuré, the ECB's executive board member, said it would be a mistake to assume that there would be no more troubled banks once the SSM is in force and supervisory responsibility is transferred to the ECB.

"[If] the SSM is to be effective, it needs to be complemented by a SRM to deal with non-viable banks," he added, speaking at the International Capital Market Association's (ICMA's) annual general meeting in Copenhagen last week.

"Ending the bailout culture"

The SRM will be the second pillar of the banking union. "A timely resolution of a bank should avoid that problems in one bank spill over to other banks, possibly affecting European financial stability," said Cœuré.

"Moreover, the uncertainty surrounding the use of *ad hoc* solutions in Europe, as we all saw recently in the case of Cyprus, has shown the importance of establishing a clear and credible legal framework to underpin the resolution of banks," he said.

Any solution which does not imply an outright bailout seems to take creditors and markets by surprise, said the ECB speaker. "This will need to change. I would say that after the events of Cyprus, markets should be convinced that Europe is serious and committed to bailing in and thus ending the bailout culture."

Ending bailouts is key not only to enhancing market discipline, but also to ensuring that those who take the gains are also those who cover the losses.

It is crucial that the SRM framework is in place once the SSM is operational. From the ECB's point of view, only if the SSM is complemented by a single resolution mechanism with a common backstop can the negative feedback loop between sovereigns and banks be broken.

However, the SRM would need several components to be effective. Cœuré believed the mechanism's main features should be:

- First, the SRM should be based on a strong and independent Single Resolution Authority (SRA) entrusted with the necessary powers. This would enable prompt and coordinated resolution action to be taken, specifically where cross-border banks are concerned. "Experience has repeatedly taught us that mere coordination between national authorities does not suffice in a cross-border bank resolution," said Cœuré.
- Second, the SRA should have adequate funds for resolution financing. For the resolution framework to work well and be credible, the SRA must have access to a privately-funded European Resolution Fund. This should be pre-funded by levies from the private sector. This would ensure that the SRA has access to the necessary financing to take resolution action and achieve least-cost solutions.
- Third, it should have access to a temporary and neutral fiscal backstop at the euro area level, to be used only as a last resort.

Lessons from Cyprus

The possibility of bailing in by creditors is a key resolution tool included in the Bank Recovery and Resolution Directive.

Despite the limited spill-overs, the idiosyncratic aspects of the bail-in by uninsured depositors in Cyprus might remain a cause for concern among investors, said Cœuré. "Creditors need to have a clear picture of what could happen in the event of a bank failure," he added.

This could be achieved by respecting the hierarchy of creditors in the event of insolvency, or the order in which creditors will suffer losses in a bail-in.

Top of the ECB's pecking order was that losses and resolution costs should first be borne by the shareholders and subsequently by creditors of the failing institution. Only at that point should the private sector be called in to finance resolution via the resolution fund.

Then – and only as a last resort in case the accumulated funds in the resolution fund are insufficient – should there be a temporary public backstop providing credit to the resolution fund. This support should be fiscally neutral and recouped through *ex-post* levies on banks.

But Cœuré stressed that the use of bail-in should not create misaligned incentives to the original entity by fostering the continuation of a 'business as usual' approach.

Following the resolution process, only the critical functions and 'good parts' of the original entity should survive – either because they are sold to a private sector purchaser or because they are transferred to a bridge bank.

It needs to be clear that the aim of resolution is not to preserve the failing institution as such, but to ensure the continuity of the functions that are critical for the financial system as a whole, said Cœuré.

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ADB: Asian leaders fear Abenomics more than eurocrisis

Author: Gemma Varriale
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- Europe has topped Asian leaders' concerns for several years. But their focus has recently shifted to an issue closer to home – the Bank of Japan's quantitative easing programme;
- However, according to a senior ADB spokesperson, Europe's fate will remain of central importance to the fast-growing Asian economies;
- With Europe accounting for 40% of Asia's trade exports, Asian leaders fear that some of European sovereign debt may never be paid back;
- Deutsche Bank's global head of regulatory policy said that uncertainty surrounding the regional outlook was prompting clients to put their money elsewhere;
- The Deutsche Bank head also queried whether the European banking union would be sufficient to decouple the link between banking and sovereign crises.

Despite Asia's unprecedented economic growth in recent years, the region's leaders remained acutely aware of the risks posed by Europe's recession-plagued economies. But such concerns have now been usurped by the Bank of Japan's quantitative easing measures.

According to the Asian Development Bank's (ADB's) finance and risk management vice president, Thierry de Longuemar, the health of the eurozone is of central importance to Asia. It represents 40% of Asia's trade exports, making it the first trading partner of Asia.

By exposing structural weaknesses that existed in the eurozone's initial architecture, the eurocrisis prompted an existentialist risk that came dangerously close to toppling European economies. Market sentiment has improved over the last twelve months, but the regional outlook remains uncertain.

Even so, de Longuemar said Asian leaders' concerns about the region had recently been superseded by fears surrounding the quantitative easing decision by the Bank of Japan.

Asia's main concerns outlined

Speaking at the International Capital Market Association's (ICMA's) annual general meeting in Copenhagen, the ADB vice president outlined Asian leaders main fears about Europe.

"First, they fear that some of the European sovereign debt may never be paid back," he said. "Second, they see European banks still selling assets in Asia. And third, they question the European welfare model, which they believe is unsustainable."

"To conclude, Europe still matters, but today what's happening in Japan seems to matter more," he added.

Deutsche Bank's managing director and global head of regulatory policy, Daniel Trinder, echoed the views of the ADB.

"A lot of clients just don't understand what's happening in Europe," Trinder told ICMA conference delegates. "A lot of clients want to take their money out of Europe."

According to Trinder, when it comes to Europe, confusion reigns, particularly around initiatives like the Financial Transaction Tax [FTT].

Investment in the euro-area entailed tremendous regulatory uncertainty that was not necessarily a component of investment outside the EU, the Deutsche Bank regulatory head said.

"I know all this reform is necessary, but from a market perspective it's difficult to manage," said Trinder.

Banking union: "necessary but not sufficient"

Trinder was sceptical that the proposed EU banking union would decouple the link between banking and sovereign crises. "It's a necessary condition, but it's not sufficient," he said. "There's going to have to be a lot of structural reforms to get it through."

"If you take the single supervisory mechanism [SSM], there's got to be clarity there on powers, duties, accountability, and the delineation between national and ECB [European Central Bank] supervision," said Trinder.

On the single resolution authority, which has provoked fierce opposition from Germany, Trinder named three components he thought were necessary.

These were:

- the establishment of a clear *ex ante* burden sharing mechanism;
- strong powers to close or restructure banks; and,
- the requirement to intervene ahead of insolvency.

"Lastly some sort of resolution fund needs to be in place, the size of which needs to be able to resolve small and medium-size financial institutions," he said. "But there also needs to be some sort of access to a backstop to add credibility to that."

The need for a bank recapitalisation was another concern. While some countries have been very good at this, others have been forced into it, said Trinder.

There needs to be recapitalisation of the banks that are sustainable, he said, and winding down of the others that aren't. "For some of the frail banks [...] creditors, shareholders and other stakeholders also need to play their part," he added. "The sooner that Europe can flush these out, the sooner Europe can move on."

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Revealed: the future for asset management

Author: Gemma Varriale
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- Key industry figures have identified the major trends impacting the asset management industry since the financial crisis, and what they mean for its future development;
- Chief among these issues was a move towards retail and away from institutional;
- A trend towards passive investment, lower fees, and demand for asset allocation products also featured prominently among discussions at last week's ICMA annual general meeting;
- The barrage of regulation the industry is facing, and whether asset managers should be treated the same as banks, emerged as another key theme;
- But, said one panellist from the Government of Singapore Investment Corporation, new regulations also present new opportunities.

A shift away from institutional investors and towards retail has topped the list of issues impacting the development of the asset management industry today.

The move is visible in both the pension and life insurance markets.

The global asset management industry continues to adapt to significant challenges. Indeed, since the financial crisis, and the wave of regulations that followed, the business of managing money has been going through a period of dramatic evolution and structural change.

"If we look at the pension fund market, the trend is towards personal pensions," said Robert Parker, chairman of the International Capital Markets Association (ICMA) Asset Management and Investors Council (AMIC) and head of the Strategic Advisory Group at Credit Suisse. "In the life insurance market the trend is towards personal life insurance policies."

The second theme was a move towards passive or indexed investment.

"I stick very strongly to the view that the exchange traded fund market will continue to be one of the fastest growing markets in our industry," said Parker.

Third was the shift towards lower fees – a development that has been seen for several years. "I think that trend is very sustainable and therefore overall revenues and the growth rate will come down," said Parker.

The Credit Suisse head listed the demand for asset allocation products fourth on the list of the industry's concerns. Describing the development of the markets since the 2008 financial crisis, Parker said the key demand from clients has been for asset allocation products.

There has also been a rise in demand for illiquid assets, which is particularly the case for pension funds and sovereign wealth funds. These assets include infrastructure, real estate and private equity.

The development of emerging markets was the sixth landmark shift the industry is witnessing. One theme over the coming years will be that global managers will no longer be European or American or Japanese, said the Credit Suisse strategic advisory head. "Emerging market managers will be key players in the global asset management industry," he said.

Seventh on the list of the industry's most pressing concerns was how asset managers perform in a very low yield environment.

"We all know the most extreme case is for those that invest in Swiss government bonds," said Parker. "If you buy two year Swiss government bonds, you currently pay 20 basis points per annum for the right to lend money to the Swiss government."

The final trend Parker identified was the swathe of regulation the industry is facing. We have to challenge whether the barrage of regulation facing the investment banking industry, the markets, and the commercial banking industry, should apply to asset managers as well, he said, addressing the audience at the ICMA's annual general meeting in Copenhagen last week.

Hunting for yield

Michael Simcock, managing director and head of fixed income, Europe, at the Government of Singapore Investment Corporation, identified a further two trends. The first was more active management of publically-quoted assets. On the private side as well, he noted more direct management.

"That trend is coming from a need to control costs and, secondly, the expectation that more active management can add return," said Simcock.

Second was a move towards much more innovative asset allocation. This means a move along the risk curve in terms of both asset range and geographies that sovereign wealth funds are investing in.

Simcock identified several ways to achieve returns in a low yield environment. "I think there is an opportunity for [sovereign wealth funds] in areas that banks have either been investing or lending in," he said.

"I would say any opportunity, where there's a big gap between the economic risk and the regulatory risk involved in Basel II or Basel III, is up for grabs not just for [sovereign wealth funds] but for the whole investor community," said Simcock.

See also:

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Liikanen reveals why he had to split the banks

Author: Gemma Varriale
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- Erki Liikanen has revealed why he thinks structural separation is the best way to save Europe's banks;
- During its deliberations, the high level expert group, chaired by Liikanen, considered two separate ways forward for systemically important banks;
- Avenue one was non risk-weighted capital requirements imposed on trading activities;
- Structural separation of retail and investment banks was the second option on the table;
- A key reason behind proposing structural separation was to limit the spill-over of the effects of the deposit guarantee system and any implicit government guarantees to the trading banks.

Erki Liikanen, chairman of the high level expert group charged with examining possible structural reforms to the EU's banking sector, has revealed why he believes structural separation is the best way to save Europe's banks.

In backing the segregation of deposit banks from their riskier trading arms, one of Liikanen's priorities was enabling banks to service the real economy in the best way possible.

The Liikanen Group's five proposals are: mandatory separation of the deposit bank and trading entity; an additional separation requirement if the recovery and resolution plan isn't credible; bail-in instruments; a review of capital requirements on trading assets and real estate related loans; and, strengthening the governance and control of banks.

The challenge, said Liikanen during his address at the International Capital Market Association's (ICMA's) annual conference, is to reform the financial sector and banks to a more healthy structure and size. During its deliberations, Liikanen revealed that the expert group considered two separate routes as possible ways forward.

Avenue one was non risk-weighted capital requirements imposed on trading activities. It also included conditional requirements for separation in case banks could not prove they had a credible recovery and resolution plan.

Imposing a significant mandatory separation of retail deposit banking and investment banking operations was in fact the second of the options.

"Outlining avenue two was based on the notion that capital requirements are not by themselves sufficient to limit excessive risk-taking incentives," said Liikanen.

We assessed the pros and cons of both avenues, and after a lot of discussion the Group decided on the proposed mandatory separation route, the expert group head and Governor of the Bank of Finland told the audience.

Mandatory separation rationale

In outlining the rationale for his group's decision, Liikanen said they first wanted to limit the spill-over of the effects of the deposit guarantee system and any implicit government guarantees to the trading banks.

The expert group also saw that reducing complexity by means of separation and interconnectedness would enhance bank management.

It would facilitate supervision and monitoring by outside stakeholders such as shareholders and banks regulators and other market participants, thus reinforcing market discipline, said Liikanen.

"Third, we emphasised the need to strengthen governance by banks by altering the management structure," said Liikanen. "Separating retail banks from trading activity would reduce mixing of two very different management cultures."

"By seeking to correct the problems which result from the mixing of two management cultures, we wanted to preserve the universal banking model at the group level," added the head of the high level expert group.

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ADB outlines Asia's investment future

Author: Gemma Varriale
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- Asia is a region rich in opportunities. But it comes with significant challenges, a vice president at Asian Development Bank has said;
- The ADB vice president warned a real currency war was likely to strike the region, as result of the Bank of Japan's quantitative easing programme;
- He also listed bad relations between India and China, the China-Japan island dispute, and the 1.7 billion Asians still living in poverty as significant obstacles to regional investment;
- Topping his list of regional positives, however, was the increasing importance attributed to governance in Asia;
- He also envisaged significant opportunities in China's real estate market, as well as the region's new frontier markets.

Asia is a region rich in opportunities. But an Asian Development Bank (ADB) vice president has warned would-be investors to be mindful of its challenges.

Thierry de Longuemar, the ADB's vice president of finance and risk management, last week outlined the region's top opportunities, and its most significant challenges for foreign investors.

While Europe has been languishing in an entrenched economic crisis, Asian markets seem to have gone from strength to strength. But, alongside the emerging opportunities, the ADB has stressed the region faces real challenges ahead.

"With around 60% of the world population in Asia, [...] it's clearly a region of significant importance," said de Longuemar.

Investment challenges

Investors must remain awake to the region's challenges, however.

"We see the likelihood of a real currency war as a result of the quantitative easing of the Bank of Japan," said de Longuemar.

The second challenge was that the two biggest countries in Asia – India and China – are not on speaking terms. "They are not trading," said de Longuemar.

The impact of that could be huge. "Just to give one example: there are four flights a week between Delhi and Asia; there are 35 flights a week between London and Delhi," de Longuemar explained.

The third challenge the ADB speaker identified was the ongoing China-Japan island dispute. This, he said, was not receding and there were serious threats looming in that part of the world.

The last challenge de Longuemar listed is that 1.7 billion in Asia still live under 2 dollars a day. However, although this present challenges, it could also present would-be investors with opportunities.

Asia's growth drivers

Nonetheless, de Longuemar believed the growing importance of ***regional governance*** in Asia would present significant opportunities for investors looking to put money to work in the region. The Association of Southeast Asian Nations (the Asean group), along with Korea, Japan and China have now planned a clear agenda for a fully-fledged trade union, said de Longuemar.

He believed Asia and Europe could learn important lessons from each other.

"The ATUC [Asean Trade Union Council] is very active putting in place governance with lessons learned from the European Union," he said.

According to de Longuemar, the euro-area crisis had also significantly altered the debate in Asia around the benefits of adopting a common currency. "It was talked about a few years ago but not anymore, given what is perceived as a failure of the eurozone," he said.

He was optimistic that the possibility of including China's renminbi in the SDR [special drawing rights] would have a positive impact on regional investment. "This is likely to happen in the next five years; that's one opportunity," said de Longuemar.

Asia's rising middle class would be a major regional growth driver, he explained. While China's real estate market, and the promotion of interregional trade across Europe, the US and Asia presented additional investment opportunities.

Lastly, opportunities in Asia's new frontier markets should not be overlooked, the ADB vice president told delegates at the International Capital Market Association's (ICMA's) annual general meeting in Copenhagen last week.

Myanmar is the most recent of these emerging tiger economies. With a population of 60 million, Myanmar is huge, and geographically very important, said de Longuemar. It will create a link between the Indian Ocean and China, which is set to have significant impact on the way China trades with the rest of the world.

Although North Korea could also present an opportunity, it may be too soon to mention, said de Longuemar.

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