Completing EMU, a feasible proposal:

A Safe Portfolio and SRB+

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The troubling state of EMU: No prospect of anticyclical fiscal policy

BICC	▪ Macron promised an instrument worth several % points of GDP ▪ But now instrument only has (17bn), without any countercyclical capacity ▪ Heavily reliant on inter-governmental decision making ▪ Predominant mindset of "juste retour"

ESM Reform	▪ No interest in integrating into European Institutions
	▪ Precautionary Conditioned Credit Line will not have a fiscal stabilization capacity (Vallée, 2019)
	    ▪ Criteria for use inherently exclude several countries
	▪ Role as backstop to SRF subject to confirmation by national parliaments
	    ▪ Regardless, lingering questions as to the capacity of the SRB to resolve any systemically important bank

Unemployment Reinsurance	▪ Opposition is similar to the one experienced in BICC discussions:
	    ▪ Risk sharing vs. risk reduction logic
	    ▪ No permanent fiscal transfers, simply liquidity support?
	    ▪ Should we expect a purely symbolic outcome?

References: Vallée, S. 2019, 'The proposed reform of the European Stability Mechanism must be postponed', DGAP, German Council on Foreign Relations, External Publications, December 11.

The troubling state of EMU: Diabolic loop alive and well

None of key sources of contagion eliminated

- Sovereign debt holdings

- National deposit insurance
- Non-SRB resolutions
- Liquidations
- State Aid

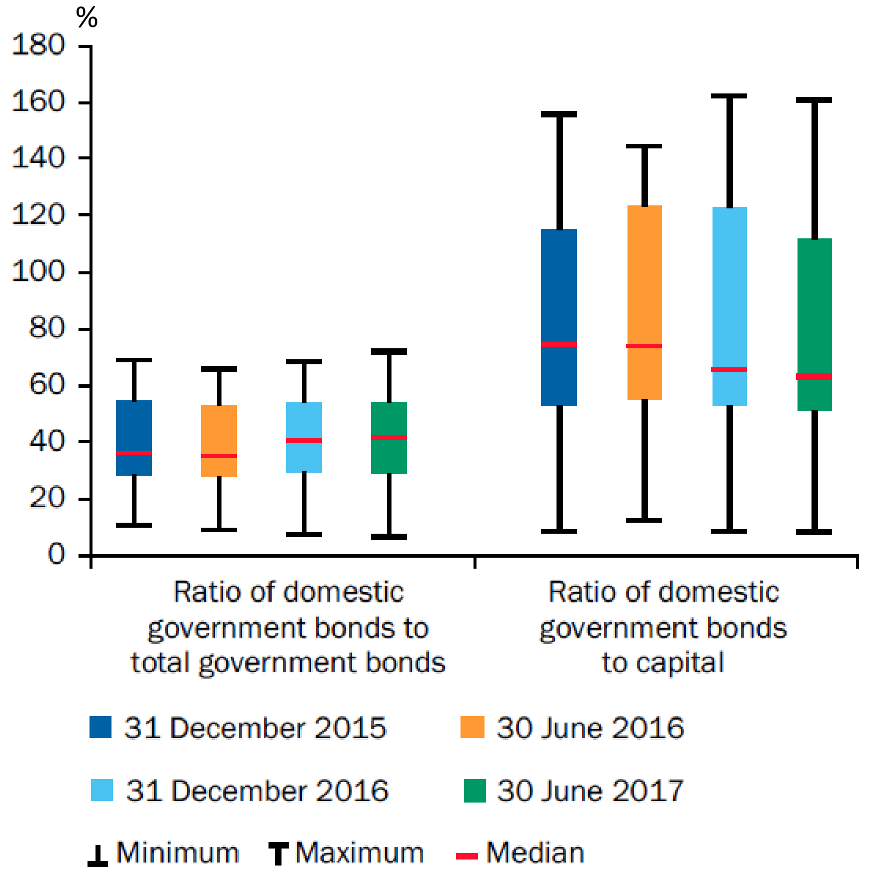
Safe Asset scarcity

Debt securities issued by governments and European institutions as a % of euro-area GDP in 2016

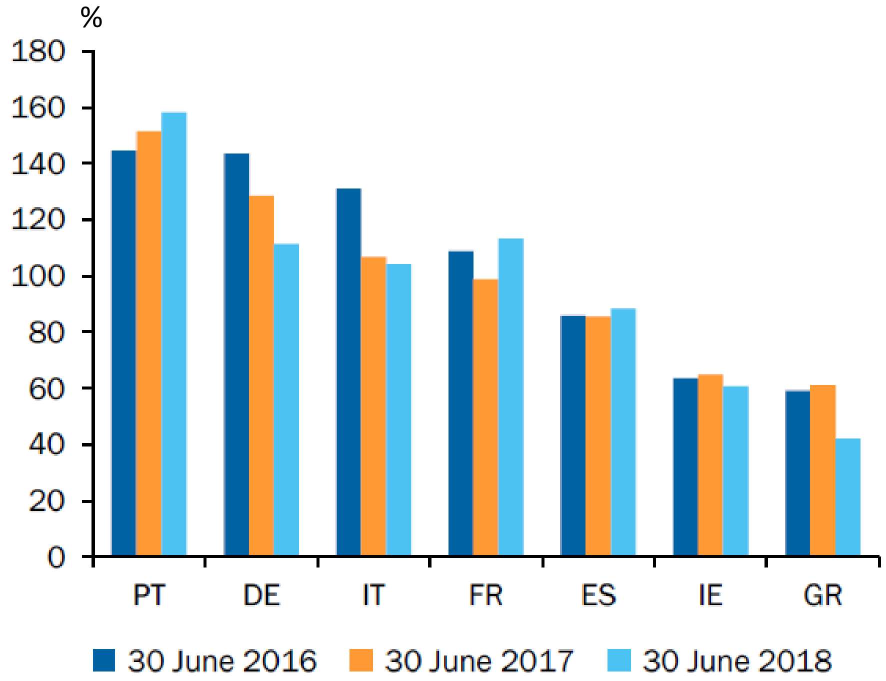
(1) Outstanding sovereign debt of Germany, Netherlands and Luxembourg.
(2) Triple A-rated issuances of EU institutions (EIB, ESM, EFSM, BOP Facility and the Macro-Financial Assistance Programs).

No drop in sovereign exposures

Bank sovereign exposures

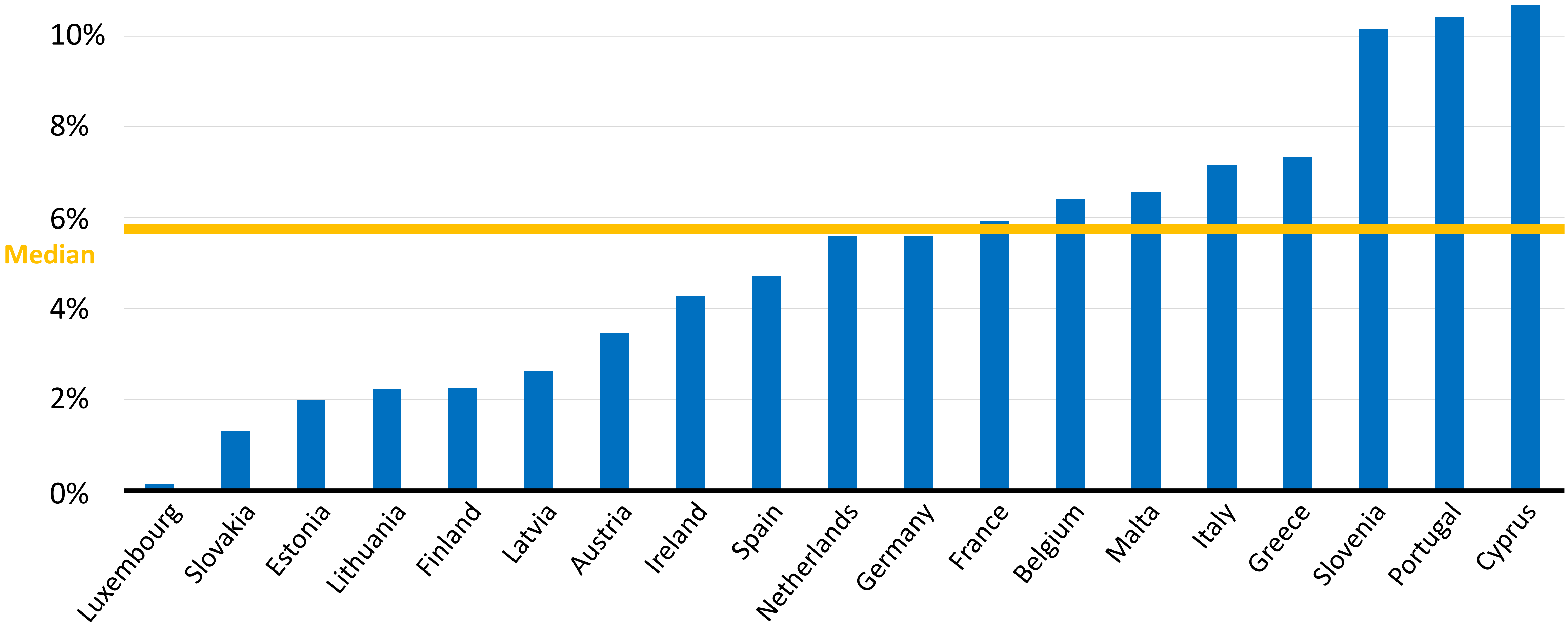


Ratio of exposures to its host country to own funds



References: Schnabel, I. 2019, ‘The sovereign-bank nexus: why it matters and what to do about it’ (conference), Frankfurt, European Central Bank, DG-E Seminar, July 25.

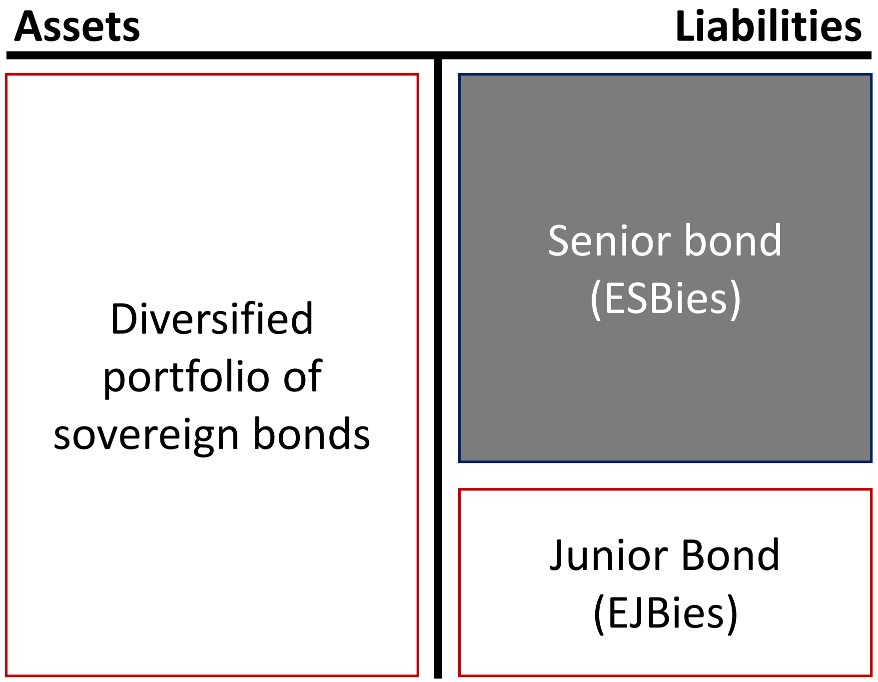
Host sovereign exposures as % of total assets



References: European Central Bank 2019, 'Financial Stability Review', *European Central Bank Financial Stability Review,* May 2019.

ESBies is the solution

Safety in tranches



Pooling brings diversification

Tranching brings seniority

Political State of Play

- Commission Proposal in May 2018
- European Parliament approved its position April 2019
- Consensus in the council to block any discussion on it
- Driven by fears ESBies will increase funding costs of peripheral countries

References: Brunnermeier, M. et al. 2011, 'European Safe Bonds (ESBies)', Euronomics Group.

Nicolas Véron’s proposal

Sovereign concentration charges

- First significant calibration of BIS proposal
- Concentration defined relative to Tier 1 Capital
- Marginal risk-weight add-ons increasing with concentration

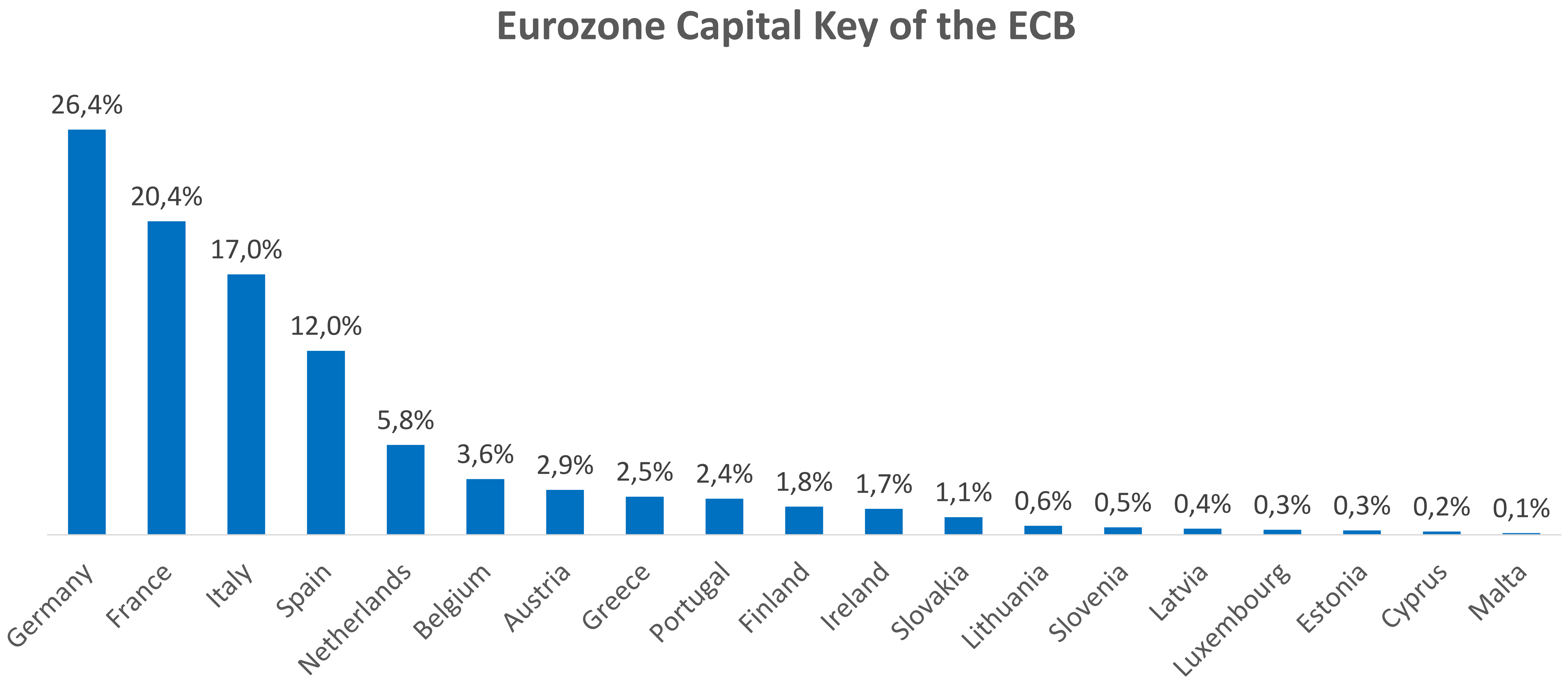
Calibration principles

- Exemption threshold for liquidity purposes
- Given 30%-50% traditional haircut in sov. default:
  - Disincentivise 100% Tier 1 ratio
  - Meaningfully discourage 200% Tier 1 ratio

Sovereign exposure relative to Tier 1	< 33%	33% - 50%	50% - 100%	100% - 200%	200% - 300%	300% - 500%	> 500%
Applicable risk weight	0%	15%	30%	50%	100%	200%	500%

Source: Véron, N. 2017, ‘Sovereign Concentration Charges: A New Regime for Bank’s Sovereign Exposures’, Bruegel, November 17.

My proposal: The Safe Portfolio Approach



The path to a European Safe Asset: four steps

1 Safe Portfolio Approach

- Define the Safe Portfolio as the ECB's Capital Key
- Concentration charges based on distance to Safe Portfolio

2 Raise as desired concentration charges

- Increase meaningfully concentration charges to lead banking sector smoothly towards diversification
- Avoid at this stage using risk-based criteria

3 easures to ensure asset market development

- Eliminate capital charges for sovereign securitizations with the "right" concentrations
- Non-neutrality principle does not apply

4 Safety in tranching

- Commitment to tranching required from step 1, with a deadline (to avoid reneging): only the asset with seniority in common portfolio has 0% risk weight. No implicit or explicit guarantee (as in SBBS Parliament position)

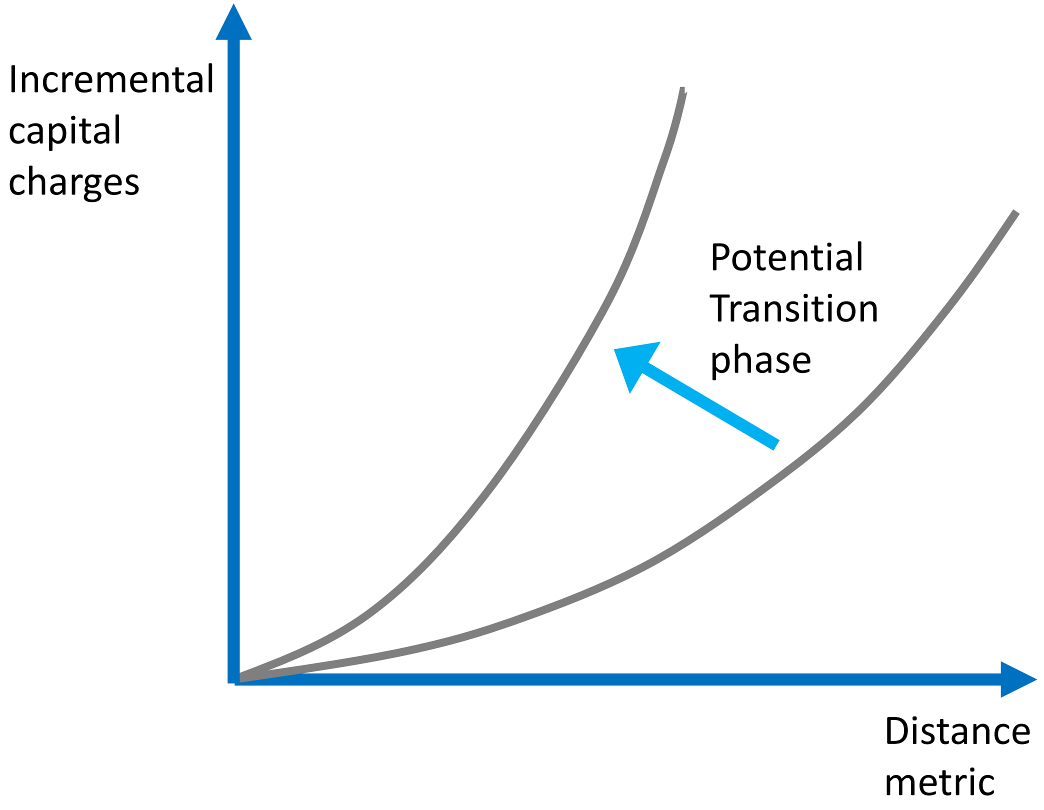
My proposal: The Safe Portfolio Approach (continued)

The distance metric

(1)
$$\begin{pmatrix} key_{DE} \\ key_{FR} \\ key_{IT} \\ key_{ES} \\ \dots \\ key_{MT} \end{pmatrix} - \begin{pmatrix} exposure_{i,DE} \\ exposure_{i,FR} \\ exposure_{i,IT} \\ exposure_{i,ES} \\ \dots \\ exposure_{i,MT} \end{pmatrix} = \begin{pmatrix} d_{i,DE} \\ d_{i,FR} \\ d_{i,IT} \\ d_{i,ES} \\ \dots \\ d_{i,MT} \end{pmatrix}$$

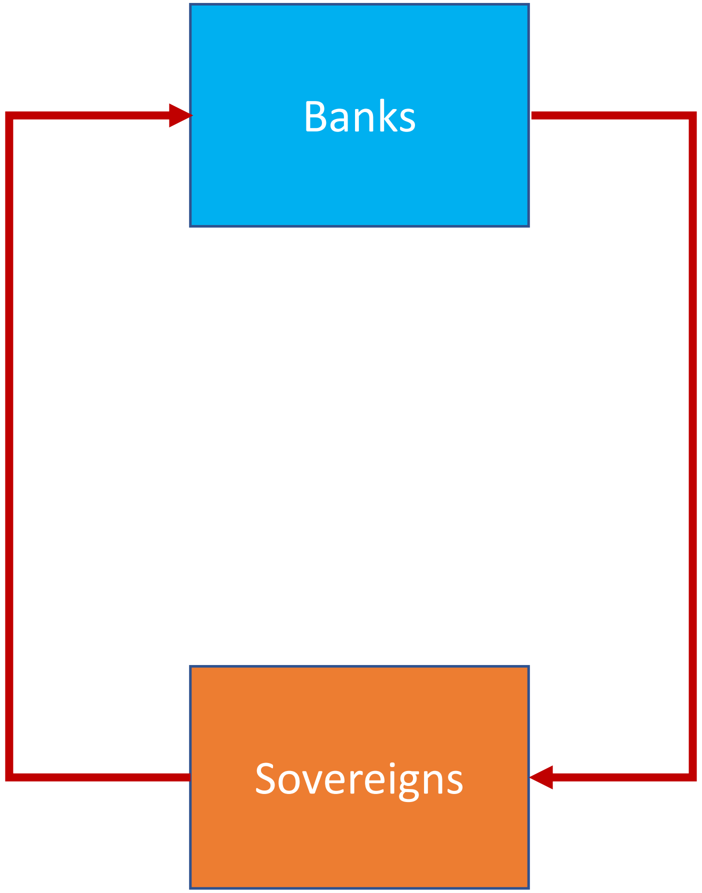
(2)
$$d = \sqrt[2]{d_{i,DE}^2 + d_{i,FR}^2 + d_{i,IT}^2 + d_{i,ES}^2 \dots}$$

Illustration



Diabolic loop in entirety must be tackled

✓ Diversified sovereign debt holdings



× National Deposit Insurance

× National resolutions

× National liquidations

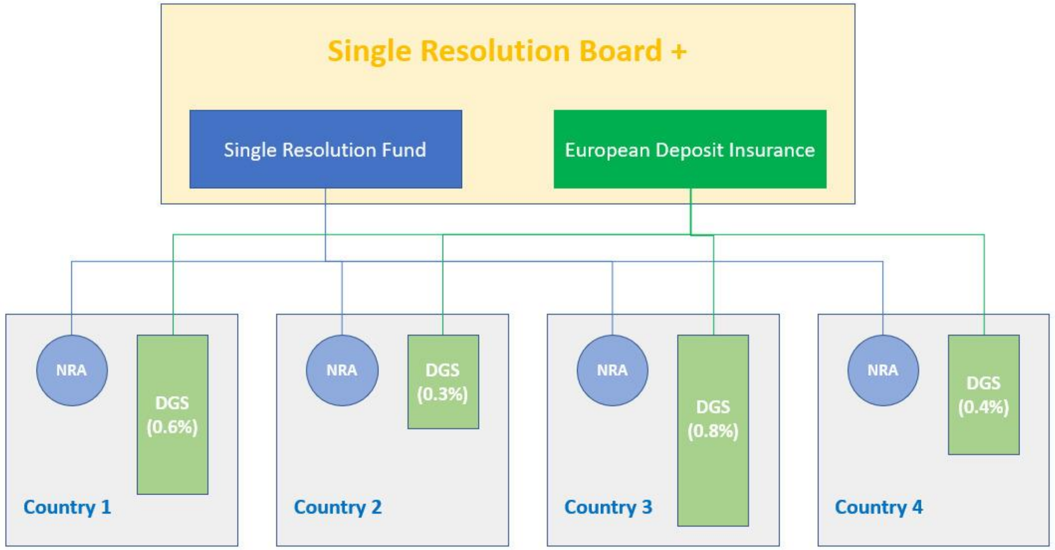
× State Aid

SRB+ as the European FDIC

1 Clarify scope	▪ Veneto (+60bn in assets) a significant precedent for the Public Interest Assessment ▪ Assessment must be clarified to ensure all banks which require substantial funds ('SSM banks') are covered by SRB+
2 Coordination Powers	▪ Transition SRB+ to outpost model for it to coordinate Deposit Guarantee Schemes (DGSs) ▪ Entrust with co-decision powers with DGSs
3 Financial Cap	▪ Depositor super-preference prevents DGSs from being used for Alternative Measures (inefficient use of resources and destruction of franchise value)
4 European Deposit Insurance	▪ Hybrid model ▪ Risk based contributions, with potential national component ▪ Variable targets of national components to avoid cross-subsidization ▪ Transition stage towards eventual full mutualization

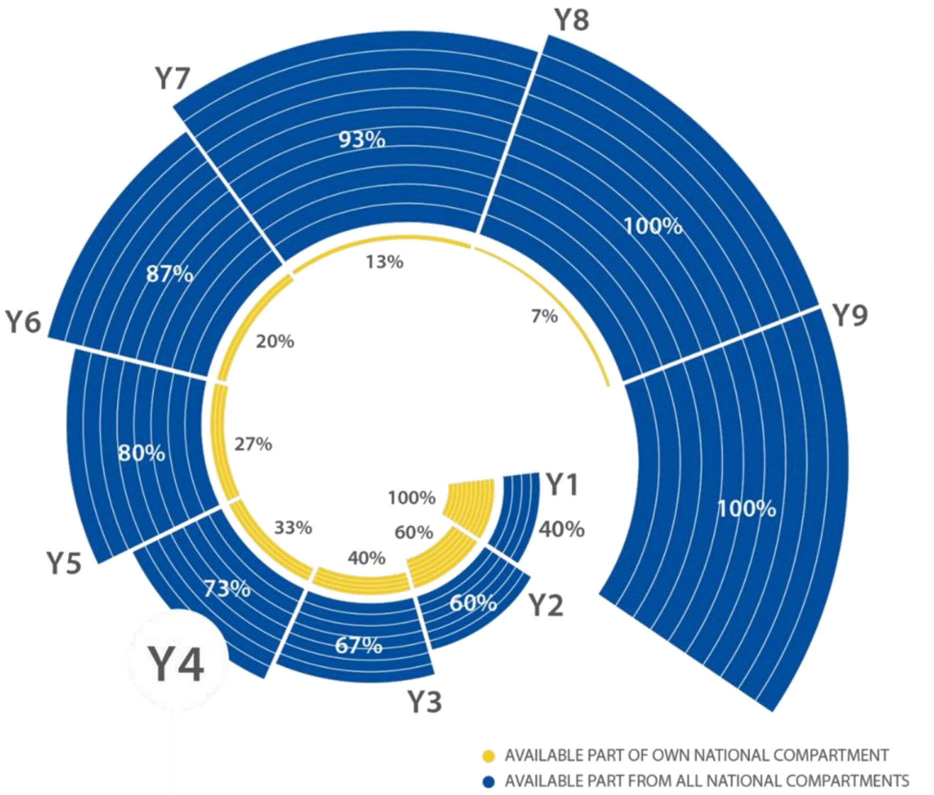
SRB+ as the European FDIC (continued)

Envisioning SRB+



SRF mutualization model

Available funds for bank resolution

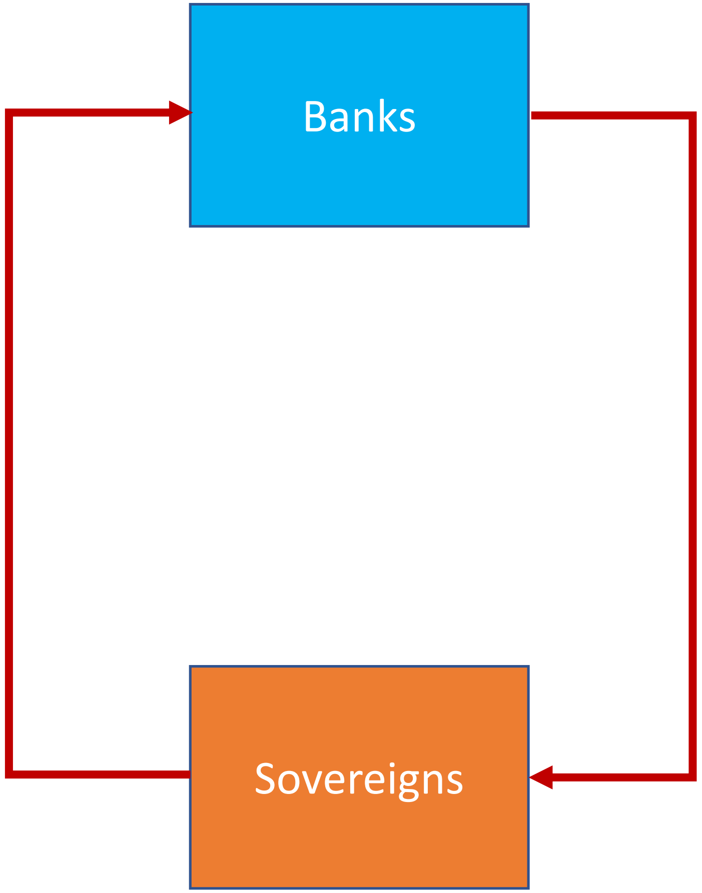


References: Council of the European Union 2019, 'Single Resolution Mechanism'. Available at: https://www.consilium.europa.eu/en/policies/banking-union/single-resolution-mechanism/.

The package to Resurrect the Banking Union

Safe Portfolio Approach

- ✓ Diversified sovereign debt holdings



SRB+

- ✓ European Deposit Insurance
- ✓ SRB leading resolutions
- ✓ Minimize potential Liquidations
- ✓ Limit potential State Aid interventions

Thank you