

Banking Union and the ECB

Hugo Rodríguez Mendizábal
IAE (CSIC), Barcelona GSE and MOVE

Banking Union and the ECB

LEGAL SIDE

1. Amtenbrink, F. and M. Markakist (2017), “Towards a meaningful prudential supervision dialogue in the Euro area? A study of the interaction between the European Parliament and the European Central Bank in the Single Supervisory Mechanism”, ADEMU WP 81
2. Monti, G. and C. Petit (2016), “The Single Supervisory Mechanism: legal fragilities and possible solutions”, ADEMU WP 16
3. Smits, R. (2017), “Competences and alignment in an emerging future. After L-Bank: how the Eurosystem and the Single Supervisory Mechanism may develop”, ADEMU WP 77
4. Yiatrou, M. (2016), “Bank resolution credibility and economic implications”, ADEMU WP 38

ECONOMIC SIDE

5. Adao, B. and A. Silva (2016), “The effect of firm cash holdings on monetary policy”, ADEMU WP 11
6. Gaballo, G. and R. Marimon (2016), “Breaking the spell with credit-easing”, ADEMU WP 01
7. Jungherr, J. (2016), “Bank opacity and financial crises”, ADEMU WP 02.
8. Rodriguez Mendizabal, H. (2016), “Narrow banking with modern depository institutions: Is there a reason to panic?”, ADEMU WP 52

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Banking Union and the ECB

ECB

Single supervisory
mechanism

Monetary stability

Financial stability

Banking Union and the ECB

ECB

Single supervisory
mechanism

Monetary stability

Financial stability

Monti and Petit (2016)

- Legal basis of EBU
- Discretion in supervisory standards
- Overlaps between ECB and EBU
- Asymmetries between euro and non-euro area countries

Banking Union and the ECB

ECB

Single supervisory
mechanism

Monetary stability

Financial stability

Monti and Petit (2016)

Amttenbrink and Markakist (2017)

- Accountability of the ECB
- Assessment of ECB performance
 - objective standard
 - information
- Consequences to ECB's conduct

Banking Union and the ECB

ECB

Single supervisory
mechanism

Monetary stability

Financial stability

Monti and Petit (2016)
Amttenbrink and Markakist (2017)
Jungherr (2016)

- Transparency as discipline
- Opacity as insurance
- Information spillovers

Banking Union and the ECB

ECB

Single supervisory
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Monetary stability

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Monti and Petit (2016)

Amttenbrink and Markakist (2017)

Jungherr (2016)

Adao and Silva (2016)

- Increase in firms' cash holdings
- Enhanced powers of stabilization
- Gradual interest rate increases

Banking Union and the ECB

ECB

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Monti and Petit (2016)

Amttenbrink and Markakist (2017)

Jungherr (2016)

Adao and Silva (2016)

Gaballo and Marimon (2016)

- SCE in competitive markets
- Credit easing (TALF) as optimal policy
- Evidence on ABS auto loan

Banking Union and the ECB

ECB

Single supervisory
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Monetary stability

Financial stability

Monti and Petit (2016)

Amttenbrink and Markakist (2017)

Jungherr (2016)

Adao and Silva (2016)

Gaballo and Marimon (2016)

Smits (2017)

- Reviewability and juridification
- Borderlines with NCAs
 - supervision (competences)
 - monetary policy (gold/foreign reserves and ELA)
- Supervisory liability

Banking Union and the ECB

EBU

Single supervisory
mechanism

Single resolution
mechanism

European deposit
insurance scheme

Banking Union and the ECB

EBU

Single supervisory
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Jungherr (2016)

Single resolution
mechanism

Yiatrou (2016)

European deposit
insurance scheme

- Insufficient resolution funds
- Implications for credibility
- Fully credible system too expensive
- Balance between risk-taking and cost

Banking Union and the ECB

EBU

Single supervisory
mechanism

Monti and Petit (2016)
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Jungherr (2016)

Single resolution
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Yiatrou (2016)

European deposit
insurance scheme

Rodríguez Mendizábal (2016)

Rodriguez Mendizabal, H. (2016), “Narrow banking with modern depository institutions: Is there a reason to panic?”, ADEMU WP 052

What would be the effects of narrow banking (100% res. req.)?

Rodriguez Mendizabal, H. (2016), “Narrow banking with modern depository institutions: Is there a reason to panic?”, ADEMU WP 052

What would be the effects of narrow banking (100% res. req.)?

*“(...) 100% reserve banking is a **dangerous** proposal that would do substantial **damage** to the economy by reducing the overall amount of liquidity. Furthermore, the proposal is likely to be **ineffective** in increasing stability since it will be impossible to control the institutions that will enter in the **vacuum** left when banks can no longer create liquidity. Fortunately, the political realities make it unlikely that this **radical and imprudent** proposal will be adopted.”*

Diamond and Dybvig, JofB 1986.

Rodríguez Mendizábal, H. (2016), “Narrow banking with modern depository institutions: Is there a reason to panic?”, ADEMU WP 052

Traditional banking model (D&D, JPE 1983)



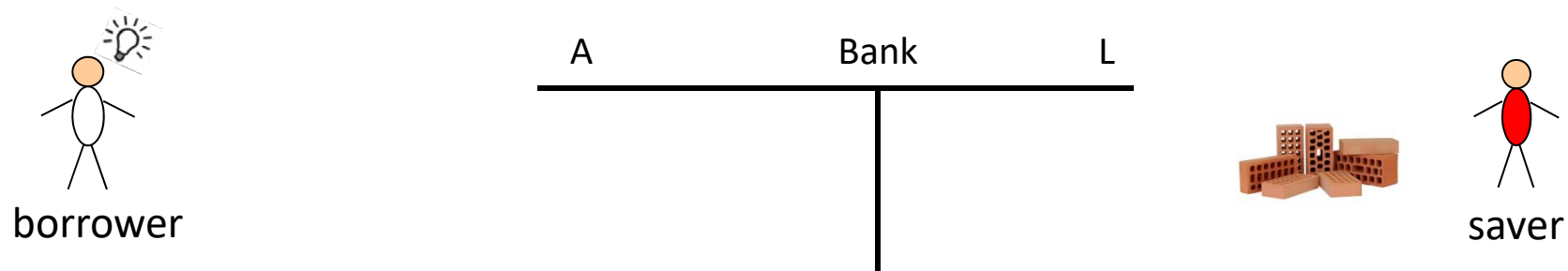
borrower



saver

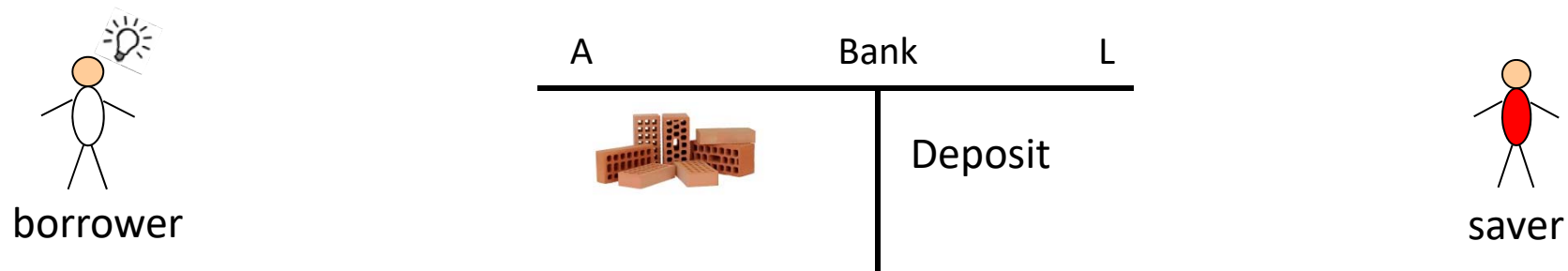
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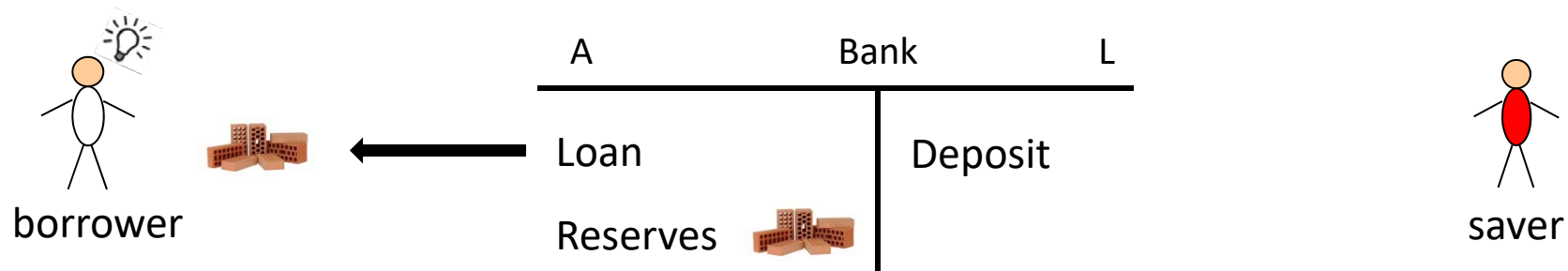
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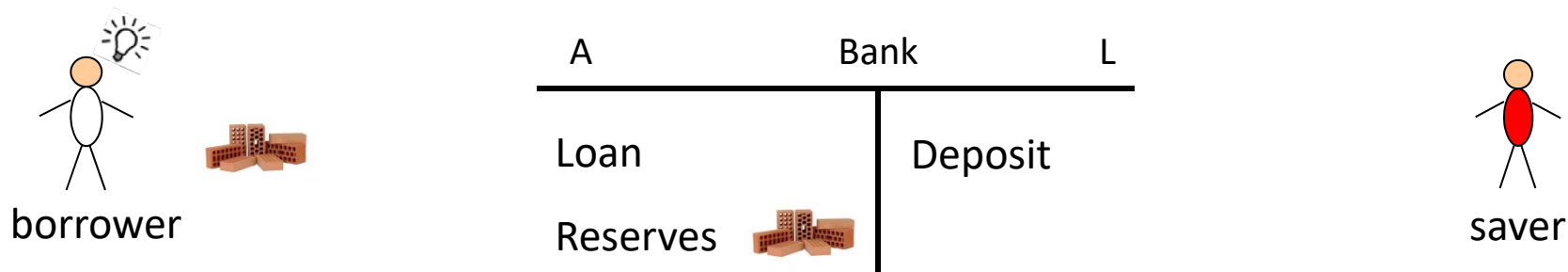
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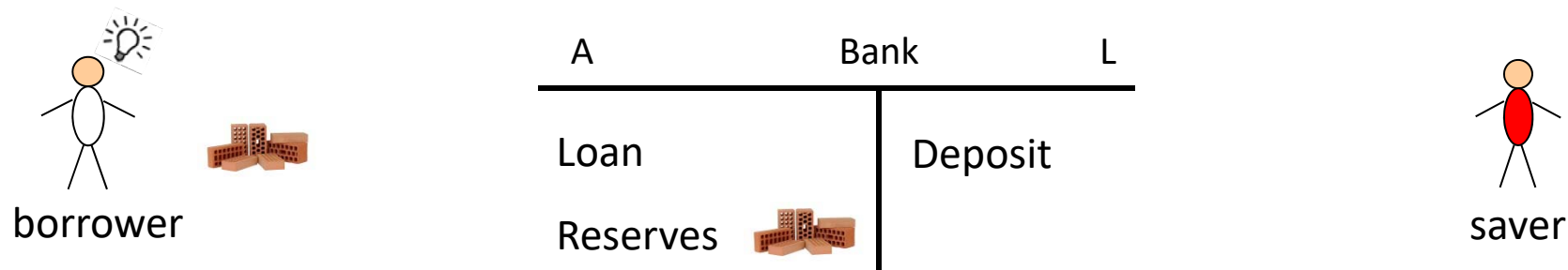
Traditional banking model (D&D, JPE 1983)



100% reserve requirements → huge efficiency costs
→ separation of financial institutions

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Traditional banking model (D&D, JPE 1983)



100% reserve requirements → huge efficiency costs
→ separation of financial institutions

cheaper alternatives to avoid bank runs

- deposit insurance
- suspension of convertibility



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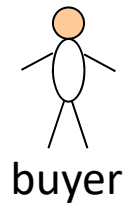


Including a realistic description of modern monetary systems radically changes the predictions of the traditional model (at least regarding narrow banking)

Rodríguez Mendizábal, H. (2016), “Narrow banking with modern depository institutions: Is there a reason to panic?”, ADEMU WP 052

- reserves are **not competing** with bank loans
- **no need to separate** financial institutions
- reserves have **indirect effect** on bank intermediation through cost of producing loans and deposits
- if central banks remunerated **required reserves** at refinancing rate (Eurosystem), then narrow banking would have **no effect** on liquidity creation and bank intermediation
- **collateral** at central bank’s OMOs? **seigniorage?**

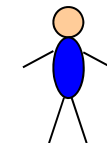
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A

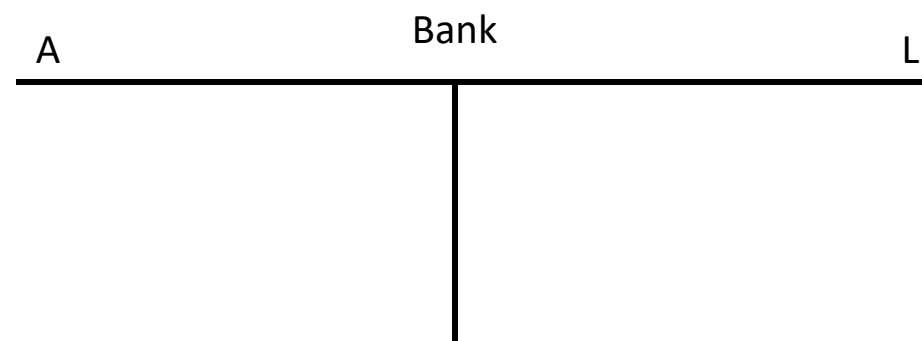
Bank

L

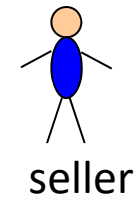
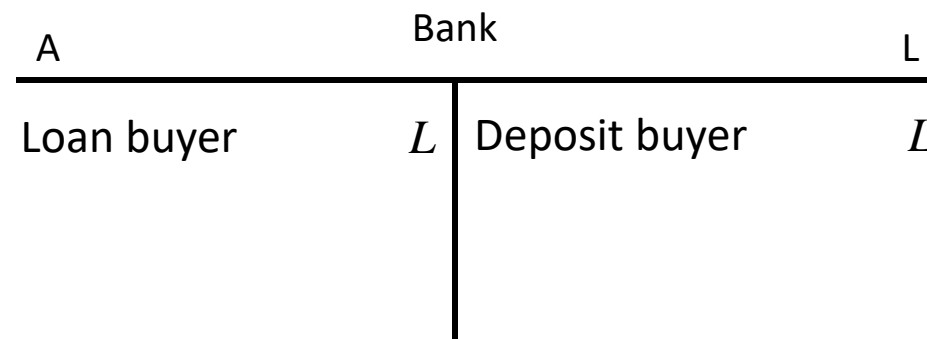
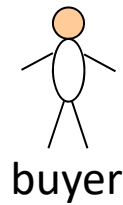


seller

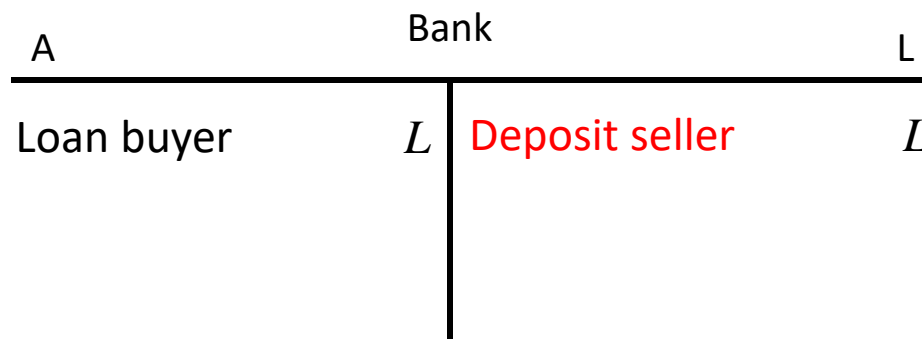
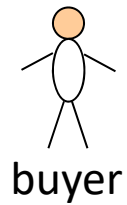
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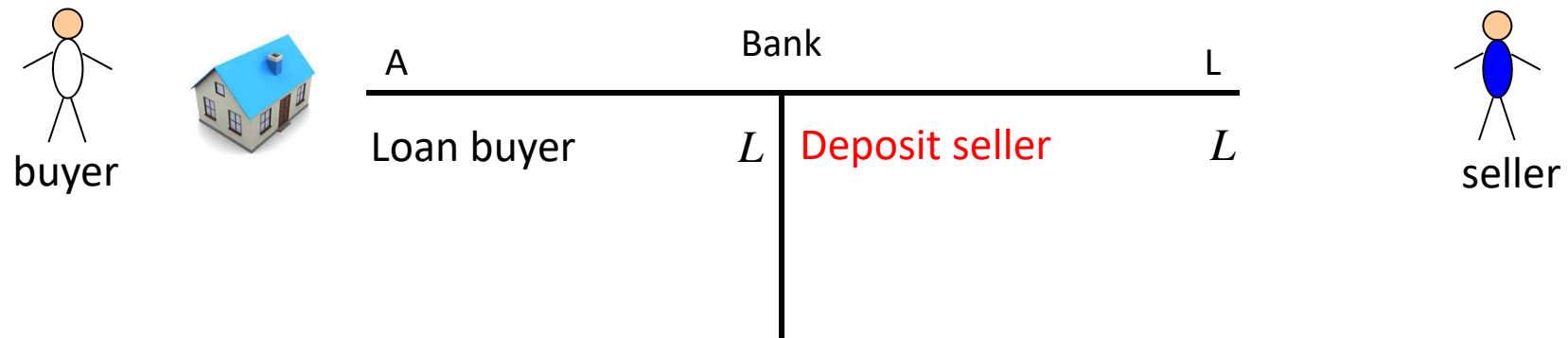
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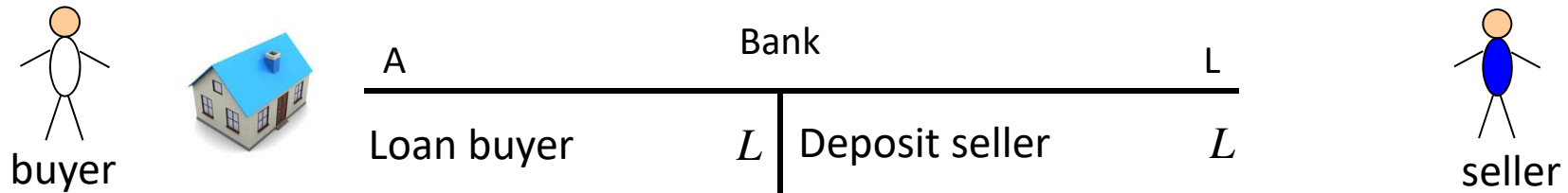
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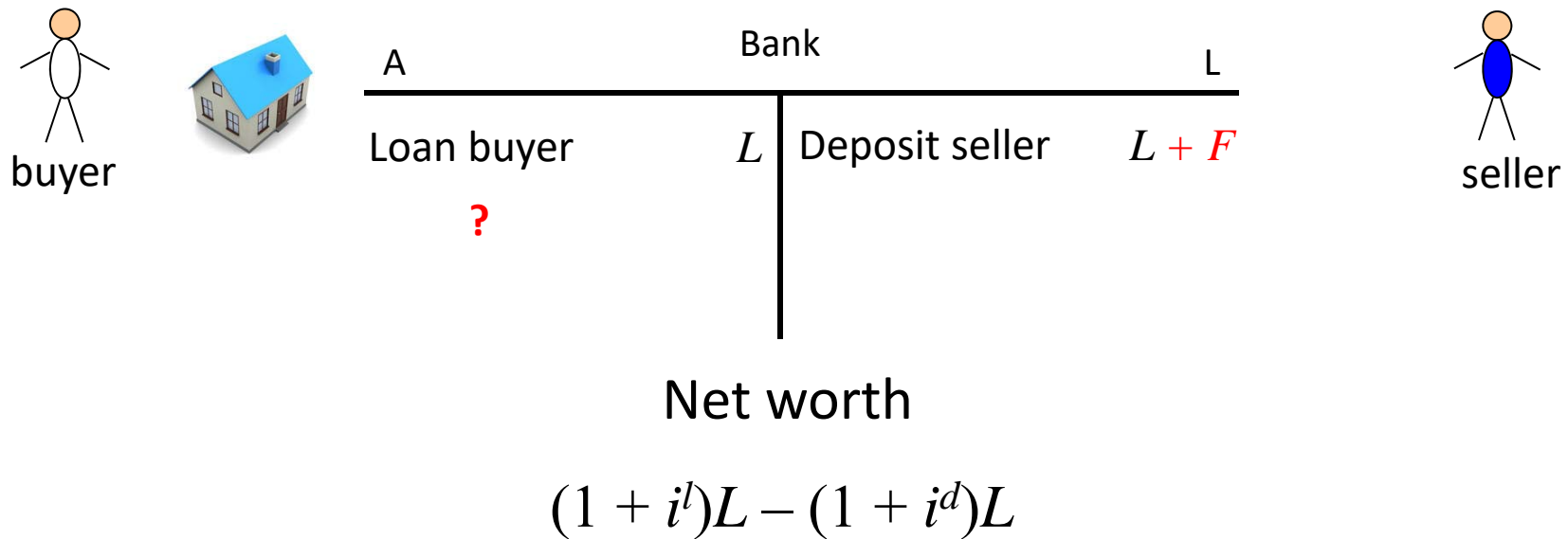


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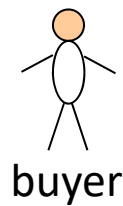


$$(1 + i^l)L - (1 + i^d)L$$

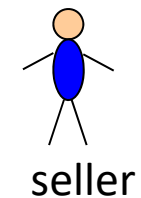
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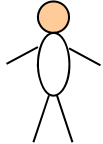

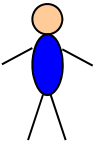
| A | Bank | | L |
|------------|----------|----------------|----------|
| Loan buyer | <i>L</i> | Deposit seller | <i>L</i> |
| Reserves | <i>M</i> | Loan from CB | <i>M</i> |



Net worth (liquidity problem)

$$(1 + i^l)L - (1 + i^d)L + M - (1 + i^o)M$$

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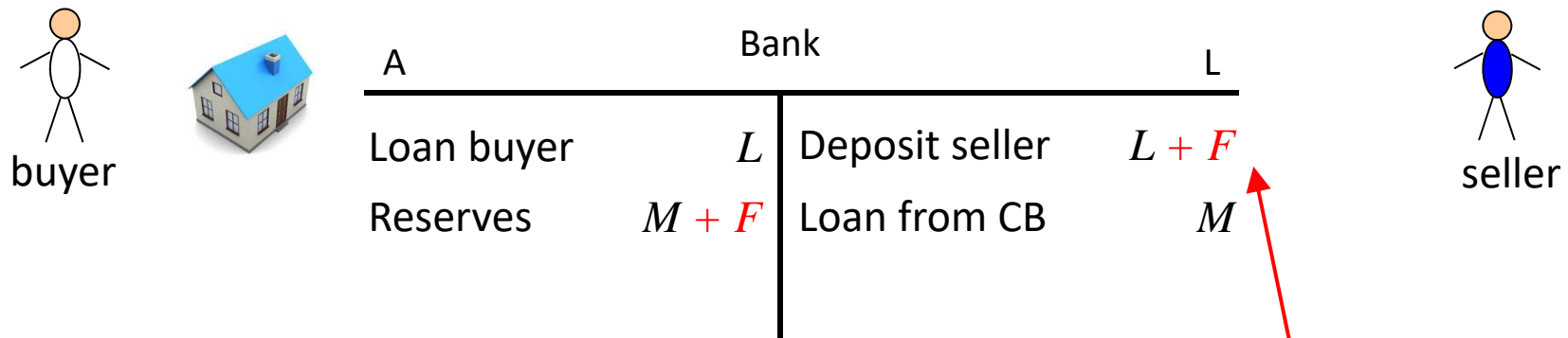
| | | | | | | |
|--------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|------------|---------|----------------|-----------------------------------------------------------------------------------------------|--|
|  buyer |  | A | Bank | L |  seller | |
| | | Loan buyer | L | Deposit seller | $L + F$ | |
| | | Reserves | $M + F$ | Loan from CB | M | |

Net worth (liquidity problem)

$$(1 + i^l)L - (1 + i^d)(L + F) + (M + F) - (1 + i^o)M$$

$$F \sim \Phi(F) \text{ i.i.d.}$$

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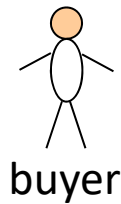
Net worth (liquidity problem)

$$(1 + i^l)L - (1 + i^d)(L + F) + (M + F) - (1 + i^o)M$$

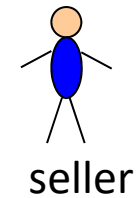
$$F \sim \Phi(F) \text{ i.i.d.}$$

Flow of funds

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| A | Bank | | L |
|------------|---------|----------------|---------|
| Loan buyer | L | Deposit seller | $L + F$ |
| Reserves | $M + F$ | Loan from CB | M |

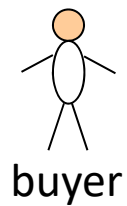


Net worth (liquidity problem)

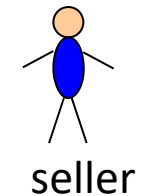
$$(1 + i^l)L - (1 + i^d)L - i^d F - i^o M$$

$$I = M + F - \rho L$$

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| | Bank | | |
|------------|---------|----------------|---------|
| A | | | L |
| Loan buyer | L | Deposit seller | $L + F$ |
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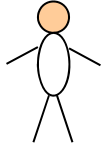

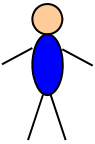
Net worth (liquidity problem)

$$(1 + i^l)L - (1 + i^d)L - i^dF - i^oM$$

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Reserve
requirement

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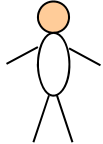

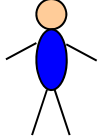
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|  buyer |  | A | Bank | L |  seller | |
| | | Loan buyer | L | Deposit seller | $L + F$ | |
| | | Reserves | $M + F - I$ | Loan from CB | M | |
| | | Interbank | I | | | |

Net worth (liquidity problem)

$$(1 + i^l)L - (1 + i^d)L - i^dF - i^oM + iI(I > 0) + (i + s)I(I < 0) + i^p\rho L$$

$$I = M + F - \rho L$$

Rodríguez Mendizábal, H. (2016), "Narrow banking with modern depository institutions: Is there a reason to panic?", ADEMU WP 052

|  buyer |  | <table border="1" style="border-collapse: collapse; width: 100%;"> <thead> <tr> <th style="width: 20%;"></th> <th style="width: 30%; text-align: center;">A</th> <th style="width: 30%; text-align: center;">Bank</th> <th style="width: 20%; text-align: center;">L</th> </tr> </thead> <tbody> <tr> <td>Loan buyer</td> <td style="text-align: center;">L</td> <td>Deposit seller</td> <td style="text-align: center;">$L + F$</td> </tr> <tr> <td>Reserves</td> <td style="text-align: center;">$M + F - I$</td> <td>Loan from CB</td> <td style="text-align: center;">M</td> </tr> <tr> <td>Interbank</td> <td style="text-align: center;">I</td> <td></td> <td></td> </tr> </tbody> </table> | | A | Bank | L | Loan buyer | L | Deposit seller | $L + F$ | Reserves | $M + F - I$ | Loan from CB | M | Interbank | I | | |  seller |
|--------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|---|------|---|------------|-----|----------------|---------|----------|-------------|--------------|-----|-----------|-----|--|--|-----------------------------------------------------------------------------------------------|
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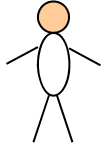

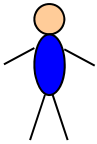
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$$I = M + F - \rho L$$

$$\Pi = \max_M - i^d E(F) - i^o M + i \int_{I > 0} I d\Phi(F) + (i + s) \int_{I < 0} I d\Phi(F) + i^p \rho L$$

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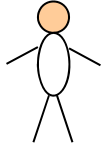

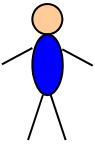
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$$I = M + F - \rho L$$

$$\Pi = \max_M - i^d E(F) - i^o M + i \int_{I > 0} I d\Phi(F) + (i + s) \int_{I < 0} I d\Phi(F) + i^p \rho L$$

$$M^* = \rho L - E(F) + \mu(i, s, i^o)L$$

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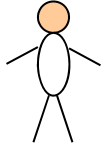

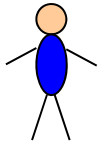
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$$I = M + F - \rho L$$

$$\Pi = \max_M - (i^d - i^o)E(F) - (i^o - i^p)\rho L + i \int_{I > 0} Id\Phi(F) + (i + s) \int_{I < 0} Id\Phi(F) - i^o \times \mu(i, s, i^o)L$$

Rodríguez Mendizábal, H. (2016), "Narrow banking with modern depository institutions: Is there a reason to panic?", ADEMU WP 052

| | | | | | | |
|--------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|------------|-------------|----------------|-----------------------------------------------------------------------------------------------|--|
|  buyer |  | A | Bank | L |  seller | |
| | | Loan buyer | L | Deposit seller | $L + F$ | |
| | | Reserves | $M + F - I$ | Loan from CB | M | |
| | | Interbank | I | | | |

Net worth (liquidity problem)

$$(1 + i^l)L - (1 + i^d)L - i^dF - i^oM + iI(I > 0) + (i + s)I(I < 0) + i^p\rho L$$

$$I = M + F - \rho L$$

$$\Pi = \max_M - (i^d - i^o)E(F) - (i^o - i^p)\rho L + i \int_{I > 0} Id\Phi(F) + (i + s) \int_{I < 0} Id\Phi(F) - i^o \times \mu(i, s, i^o)L$$

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- Role of collateral

| A | Bank | | L |
|------------|-------------|----------------|---------|
| Loan buyer | L | Deposit seller | $L + F$ |
| Reserves | $M + F - I$ | Loan from CB | M |
| Interbank | I | | |

- Banks need collateral to access OMOs
- $M < L$ (securitization)?

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- Role of collateral
- Seigniorage

| A | Central Bank | L |
|--------|--------------|----------|
| Assets | | Currency |
| OMO's | | Reserves |
| | | Required |
| | | Excess |

Banking Union and the ECB

Conclusions

- potential for improvement in EBU/ECB design to avoid
 - weaknesses in achieving objectives
 - conflicts between ECB, EBU and NCAs
- potential new policy measures
 - credit easing policies
 - narrow banking

Banking Union and the ECB

Looking ahead...

- role of EBU/ECB design in supporting polarization
- analyze dynamics of banks' balance sheets
- role of payment flows as a joint determinant of solvency and liquidity risks