

# FINANCIAL STABILITY CONFERENCE

## FOURTH JOINT CONFERENCE ON EU REGULATORY REFORMS



## REPORT 2016

HOW TO FIX THE DEFICIENCIES IN THE EU FINANCIAL SYSTEM?

BANK-STATE-NEXUS, BUSINESS MODELS AND THE MISSING LEVEL PLAYING FIELD

FINANCIAL  
RISK AND  
STABILITY

NETWORK



DIW BERLIN



3 November 2016, ESMT Berlin

JACQUES DELORS INSTITUT  
BERLIN

Dear Conference Participants, dear All,

Our joint Financial Stability Conference 2016 was a great success in regard to its aim and motivation. An excellent line-up of speakers and panellists represented an exceptional mixture of different views and perspectives, while a large audience of 200 participants actively and controversially debated the agenda topics.

The problems in the EU financial sector are not yet solved. We still have a fragile banking system, unsustainable business models, legacy issues, an unsolved bank-state nexus, problems with non-performing loans and a lack of consolidation. This hinders intermediation, credit supply to the economy and the prospects for sustainable growth in EU member states.

As we set about at the beginning of this year to decide upon agenda topics, I was not sure if the program would stay relevant. But looking at the ongoing media coverage, it became even more topical. It was only recently that a political discussion in German television was headlined "Is financial crisis coming back?" And during the past months, we have experienced a debate on state aid for big banks looming in the German media. So, timing for the two main issues on the thematic agenda was well set. First, the bank-state nexus: Politicians and regulators have not yet broken the vicious circle of banks and sovereigns or created a single European banking market. Second, the missing level playing field, for which we find many lingering obstacles outside.



This relates to the situation of the whole European banking sector: On the one hand, there is the healthier part of the banking system; on the other hand, we have the weak and troubled part: non-viable banks, banks in stress, zombie banks, as some are called. It is my impression that, on the European level, there is no clear direction and understanding of how to tackle both parts, what solutions could be found and what policy options would be adequate to create a level playing field with a safe and sound financial sector. And there is also disagreement on how to achieve a full functioning banking union in practice.

These are highly political questions, and national interests play an important role. To some extent, they make it very difficult to advance on the European scale. But that is of highest importance in order to get the financial system back in the business of supporting the real economy, jobs and growth, rather than being a threat to those priorities. One central question is therefore how we shall practice financial reforms and fix deficiencies in the regulatory and supervisory framework.

The conference deliberated upon critical questions regarding the bank-state nexus, business models, bail-in and deposit insurance. The banking union is setting a comprehensive pan-European institutional and legal framework to address crisis challenges. But critical points in the regulatory and supervisory framework remain to address underlying problems in the EU banking sector and in achieving a level playing field for financial institutions. How to tackle weak banks and how to design Edis are controversial issues in this aspect.



Finance Senator Kollatz-Ahnen pointed in his address to the question of confidence and credibility, which has not been fully restored concerning sovereign debt as well as European banks. Referring to other topics of the conference, he reminded inter alia the need of greater acceptance of bail-in politically, and regarding Basel provisions suggested not relying on internal risk models too much. Robert Jenkins in his speech criticized the Basel rules as falling short by far to ensure financial stability. He further stressed the need to restore accountability for bad behaviour by banks and called for the authorities not to be timid.

How to tackle exposure and concentration of sovereign debt in banks' balance sheets was discussed in the first panel. While having different viewpoints, the panellists showed that introducing limits on sovereign bond holdings is a sensitive topic that should be carefully considered. The discussants of the following panel emphasized the challenges for banks as regards non-performing-loans, interest rates and competition from non-banks.

In her keynote Catherine Mann presented research on the question of how much finance is adequate for different policy objectives, drawing some conclusions for policy options. Results show that too much finance can have negative implications on growth, income equality and financial stability. She then illustrated measures which can reduce financial risk. The following afternoon panels discussed the critical agenda topics of how to make the bail-in regime credible, how to achieve a level playing field and how a common EU deposit insurance scheme can be reached to complete the banking union.



I am convinced that bringing together different groups and stakeholders in an open and public discussion on the financial reform agenda is a very sensible thing to do. Generating this debate on critical issues is also necessary to continue building a more resilient financial system which fulfils its vital functions in serving the economy and society. I also believe that the financial sector should be interested in having such an open discussion format, and I would very much appreciate your feedback on this!

During the day, we had fruitful discussions, and participants gained new insights. We should move on with these debates. Financial stability is never a given condition. It is only achieved by adequate rules, good regulation and efficient supervision. In my view, regulation tends to be overly complex and backward-looking. There is still a need to improve regulation, enhance governance and redirect responsibility to those who take the risks. And we also have to ensure that underlying causes of risk build-up and vulnerabilities are effectively addressed. It would be good to be prepared, and authorities, as well as politicians, should be dedicated to taking necessary actions. But they also need to be reminded sometimes of what their job is and for whom it is.

The European Union is facing big challenges, politically, economically and socially. Looking at the developments this year – Brexit, U.S. elections, populist movements – we see that the forces that could drive the EU apart have grown in strength. To address these challenges we need a sustainable and diversified financial system which fulfils its core functions and serves real needs. The debate on this is crucial and should not be restricted to experts.

Good regulation and hence smooth functioning of the financial sector can only come from having an ongoing public debate on regulatory issues. We also need to overcome national interests and to take action in a cooperative manner at all political levels.

That is in my view what made the conference agenda relevant, to policy and society as well. At this point, I want to quote Andreas Dombret, board member of Deutsche Bundesbank. In a speech he held in October this year in London, two weeks before the conference, he said: "What we cannot do, though, is hold back on regulation simply because the sector is having a hard time. After all, taxpayers didn't have an easy ride with banks in the years that followed 2007 either. Improving regulation was and remains necessary to restore trust in the banking sector. And any costs that it might involve must be weighed against the benefits of a stable banking system."

**Martin Aehling**

## Organiser

**Martin Aehling**, Head, Financial Risk and Stability Network

## Scientific Co-Organisers

**Prof. Henrik Enderlein**, Director, Jacques Delors Institut – Berlin

**Prof. Marcel Fratzscher**, President, DIW Berlin

**Prof. Jörg Rocholl**, President, ESMT Berlin

**Dr. Guntram Wolff**, Director, Bruegel

## Motivation:



Eight years after the financial crisis the European banking sector remains in part fragile. Slow growth, zero interest rate, troubled assets, NPL, lacking consolidation and unviable business models bear risks to financial stability. In particular, the hazardous interdependency between states and banks is not solved, despite BRRD and Single Resolution Mechanism in force.

Furthermore, one crucial aim of last year's regulatory reforms has not been reached yet: To clean-up and achieve a more level playing field for financial institutions in the EU. Big banks grew even bigger, the Banking Union is still missing a testing of bail-in, and in politics national interests prevail, impairing much needed joint efforts to ensure future financial stability in the EU.

One central question is therefore how we shall practice financial reforms and fix deficiencies in the regulatory framework. We have critically questioned proposals and settings as well as supervisory practice by asking what else could be done to achieve a level playing field with a sound and diverse financial sector. In this respect, Edis is a controversial aspect on the political level.

The conference has been bringing together regulators, supervisors, scientists, policy makers, industry experts and organisations. We think that generating an open debate on critical issues is very reasonable and also necessary to keep on in building a more resilient financial system which fulfills its vital functions in serving real needs and supports sustainable growth.

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Figures:

28 speakers, panelists and moderators

280 guest registrations

220 attended participants



Participants breakdown by groups:

Regulatory authorities: 31

Banks: 24

Financial institutions and consultancy: 33

Policy and political organisations: 27

Ministries: 14

Scientists and research institutions: 38

Organisations: 7

Associations: 12

Press: 10

Others: 22



09:00

## Opening

Martin Aehling, Head, Financial Risk and Stability Network



09:15

## Address

Dr. Matthias Kollatz-Ahnen, Senator for Finance, Berlin

09:30

## Speech

**Capital, Accountability and Courage**

Robert Jenkins, Adjunct Professor of Finance, London Business School, and Senior Fellow, Better Markets

10:10

## Panel Discussion I

**Limiting Sovereign Bonds Exposure: Feasibility, Effects and Implications**

- Easier said than done: The political Dispute on "Equitising" Sovereigns
- What would be the Implications of Risk Weights and Exposure Limits?
- How to design an appropriate Regime and shape a transitional Period?
- What would be the Effects on Public Debt, Markets and Banks' Viability?



Prof. Claudia M. Buch, Vice-President, Deutsche Bundesbank

Prof. Mathias Dewatripont, Executive Director, National Bank of Belgium

Dietrich Domanski, Head of Policy Analysis, Bank for International Settlements

Dr. Roberto Gualtieri, European Parliament, ECON Chair, Member S&amp;D

Erik F. Nielsen, Group Chief Economist, Global Head of CIB Research, UniCredit

Moderation: Prof. Jörg Rocholl, President, ESMT Berlin

11:50

## Panel Discussion II

**Business Models and Banks' Stability: How to enhance Banks' Resilience?**

- State of Play: Current Risks, Legacy Issues and NPL in the EU Banking Sector
- SREP and supervisory Transparency: How to better address Weaknesses?
- Leverage Ratio: A Counter Check for the flawed Concept of Risk Weights?
- Uneasy Interdependencies: ECB Liquidity, Funding Structures and Stability



Prof. Elena Carletti, Professor of Finance, Bocconi University

Dr. Klaus Düllmann, Head of SSM Risk Analysis Division,

DG Microprudential Supervision IV, European Central Bank

Santiago Fernández de Lis, Head of Financial Systems and Regulation, BBVA Research

Piers Haben, Director Oversight, European Banking Authority

Dr. Constantin Sobiella, Partner, d-fine

Moderation: Prof. Dirk Schoenmaker, Senior Fellow, Bruegel



14:00

Keynote

**Finance: Are there Trade-offs among Growth, Stability and Inclusiveness?**

Prof. Catherine L. Mann, Chief Economist, Head of the Economics Department and G20 Finance Deputy, OECD



14:45

Panel Discussion III

**How to tackle weak and TBTF Banks? Enabling Resolvability and Bail-in**

- How to decide on whether fragile Banks should be capitalised or resolved?
- Challenges to Implementation: Policy and a ponderous Bail-in Mechanism
- Cooperation, unfeasible Living Wills and Plan Execution: How to get along?
- Bail-in of eligible Bonds: How to avoid Market Contagion for other Banks?

Andrew Gracie, Executive Director, Resolution Directorate, Bank of England

Dominique Laboureix, Board Member, Director Resolution Planning and Decisions, Single Resolution Board

Dr. Sven Schelo, Partner, Linklaters

Mark Venus, Head of Recovery and Resolution Planning, BNP Paribas

David Walker, Secretary General, International Association of Deposit Insurers

Moderation: Prof. Isabel Schnabel, Professor of Financial Economics, University of Bonn

16:30

Panel Discussion IV

**A Level Playing Field and EU-wide Deposit Insurance: Mission impossible?**

- "Good" Banks and "Bad" Banks: Why is a Cleaning-up still missing?
- How could the Banking System be changed to a fairer Level Playing Field?
- Deleveraging and Risks Depression: Preconditions for introducing Edis?
- Completing the Banking Union: Do we have to fear a redistributive Scheme?



Sylvie Goulard, European Parliament, Member ALDE

Dr. Levin Holle, Director General, Financial Markets Policy Department, German Federal Ministry of Finance

Dr. Vincenzo La Via, Director General of the Treasury, Italian Ministry of Economy and Finance

Dr. Gerhard Schick, Deutscher Bundestag, Bündnis 90/Die Grünen

Emiliano Tornese, Deputy Head, Resolution and Crisis Management Unit, European Commission

Moderation: Prof. Henrik Enderlein, Director, Jacques Delors Institut – Berlin, and Professor of Political Economy, Hertie School of Governance



17:50

Closing

Martin Aehling, Head, Financial Risk and Stability Network

18:00

Get together

## The Importance of Confidence and Trust in fiscal and financial Stability

**Dr. Matthias Kollatz-Ahnen**, Senator for Finance, Berlin

Matthias Kollatz-Ahnen opened his address by thanking the organiser on behalf of the Berlin Senate for having initiated this conference and advancing a broad and informed dialogue on financial stability issues. He observed that Berlin being the conference venue is yet another piece of evidence of the re-emergence of Berlin as an international political, but also economic centre where even high-level financial symposia take place these days.



Nowadays, fiscal stability does not constitute a major issue for Berlin anymore. Instead there is increasing evidence for a turn-around of the city.

Mr Kollatz-Ahnen pointed out that after reunification it has taken a long time for Berlin to overcome its weaknesses, which originated in the legacy of World War II and the city's division and resulted in low per capita incomes and fiscal difficulties. However, nowadays, fiscal stability does not constitute a major issue anymore. Instead there is increasing evidence for a turn-around of the city. This evidence includes a reduction of the large public debt burden by means of sustained budget surpluses over the last five years as well as the fact that Berlin ranks among the top-growth and job-creating federal states within Germany. In spite of this success, Berlin is still widely perceived to have fiscal and financial problems. The fact that the actual fiscal turn-around is largely unknown, exemplifies the general difficulty of regaining the confidence of markets and the wider public, once you are considered as being off-track. Mr Kollatz-Ahnen observed that market confidence is like chinaware: "When broken, it can be mended, but the cracks will always remain visible."

With a view to financial markets, Mr Kollatz-Ahnen indicated that the question of confidence and credibility cannot be based exclusively on mathematical models and formulas. However, the corresponding debates are helpful for providing adequate analytical tools. The dimension of trust is also relevant for the discussion about sovereign debt and removing the preferential treatment of sovereign bonds. Prior to the financial crisis, it was a universally held view that OECD countries' debt was risk-free and that, therefore, there was no need for banks to hold capital against it. Obviously, the sanctity of public debt was subsequently shattered in the financial and debt crisis, and full confidence in sovereign debt has not been restored ever since.



Consequently, it is hard to argue, in principle, against a removal of the zero risk weighting. However, the Senator admitted that Berlin was not a disinterested party in this respect: In the face of the Berlin's remaining debt burden and the potentially far-reaching consequences of a regime change for its debt service burden, the Senate is very attentive to new regulations being implemented as well as its details on, inter alia, exemption rules, transition periods and grandfathering rules.

Mr Kollatz-Ahnen further noted that European banks, too, had difficulties to restore confidence even despite the enormous progress made so far in terms of greater resilience in the banking sector. Moreover, banks are not only in search for yield, but also in search of new sustainable business models. In the banking sector great challenges remain given the overall environment of low interest rates, a high degree of regulation, intensified competition as well as new and occasionally disruptive technological developments.



At the end of the day, the probability of defaults is what counts from a risk perspective, not some abstract notion of a particular banks' business model.

Regarding the other topics of the conference, Mr Kollatz-Ahnen went on to stress that even if there was no bail-in system that functions perfectly yet, the move towards such a regime was the right approach. However, more needed to be done to gain greater acceptance of bail-ins also politically, as bail-in constitutes a new way of distributing the costs of a banking crisis. Finally, he identified a level playing field as the cornerstone of any financial regulation in an environment of global competition. Furthermore, Mr Kollatz-Ahnen considered the Basel provisions so far to excessively rely on internal risk models and put forward that new approaches ought to be found. At the same time, the Senator noted that, at the end of the day, the probability of defaults is what counts from a risk perspective, not some abstract notion of a particular business model.

Finally, Mr Kollatz-Ahnen alluded to the lively debate on deposit insurance schemes in Germany. In his view, a supranational deposit insurance scheme is an integral element of the EU's banking union. Ideally, such a system is to be implemented in a manner that prevents national systems from becoming superfluous while still contributing to the overall protection of savers.

## Capital, Accountability and Courage

**Robert Jenkins**, Adjunct Professor of Finance, London Business School, and Senior Fellow, Better Markets

Robert Jenkins began his keynote by referring to the conference's overall topic of strengthening the European banking system. Such a challenge has to be met within a highly connected global financial system and an international regulatory regime. In order to address this, he continued to recapture the current state of play of global banking reform.

Mr Jenkins acknowledged that there has been a great deal of activity as part of the regulatory response towards the financial crisis, the main challenge of which can be captured by the lemma "Too big to fail, bail and jail". However, practical results fall short of the much needed changes, given that current capital leverage remains high while accountability remains low and a lack of courage to address these issues prevails. "Capital, accountability and courage – all other issues pale in comparison."



New Basel rules on banking risk are tougher than before, but by no means tough enough or sufficient to ensure future financial stability.

Starting with the aspect of capital, Mr Jenkins identified the vast degree and magnitude of leverage as the central element that distinguishes the most recent bubble and subsequent crisis from its predecessors. Nonetheless, the issue of excessive leverage has not been properly addressed in the aftermath, even though planners and regulators showed commendable ambition in the beginning. For instance, this included the rewrite of Basel such as tightened-up rules on the definition of banking risk and placing an overall-cap on leverage. These new rules are tougher than before, but by no means tough enough or sufficient to ensure future stability.

In this regard, Mr Jenkins gave the example of collateralised debt obligations squared (CDOs squared). This instrument still features the list of risk weighted assets, the regime which determines the required amount of banks' loss-absorbing capital to support such risks. The new rules demand a capital buffer of less than 1.4 per cent, which appears ridiculously low compared to the risk conveyed by such a security that neither banker, regulator, rating agency nor investor was able to understand.

Furthermore, the new Basel rules include a backstop, such that banks are subject to a cap on the total leverage on which they operate. However, this leverage ratio is currently set to still allow for banks' balance sheets to expand disproportionately to 33 times of their loss absorbing capital. "At that degree of gearing, a 3 per cent decline in the value of a bank's assets wipes out 100 per cent of bank capital. How confidence inspiring is that?", he put the question.

Further regulatory efforts have introduced stress testing and the total loss absorbing capacity (TLAC) framework. Mr Jenkins explained that even though such steps are potentially positive, compared to capital, they present a problematic patchwork, since the efficiency of stress tests hinges on the knowledge and certainty about which risks to stress and by what degree. In this context, there is a reasonable chance of human error, limited foresight and for bankers and regulators to get it wrong, all of which points towards the importance of capital. "Capital is there not just for the risks that we think we understand. It is there for the risks that we don't!"



Large fines for the numerous misdeeds were common, but with few exceptions, they have been paid by the shareholders, and not by the perpetrators.

On TLAC, Mr Jenkins further remarked that as a potentially solid building block, it still rests on a shaky foundation due to the following aspects: Firstly, targeting the banks' loss-absorbing capital as a percentage of risk weighted assets proves to be a poor reference point. Secondly, various forms of bank debt are deemed to be loss-absorbing which presents a two-fold presumption. On the one hand that the authorities will have the guts to force losses on debt holders. On the other hand that at the first hint of financial trouble, debt and equity holders just sit and wait to see what actually happens. Will they?

Mr Jenkins critically concluded that the banking system remains and is set to remain undercapitalised, and in this regard he viewed Basel III as a 'busted flush'. "The many measures to compensate serve only to confirm this fact without adequately compensating for its failure."

Subsequently, Mr Jenkins introduced the aspect of accountability. "If capital is vital to the survival of our market system, accountability is critical to its legitimacy." By now, he mentioned, it is consensus that corporate culture was the culprit and bankers behaved badly before and during the crisis. In contrast to the presented long list of financiers' misdeeds, inter alia the mis-selling of payment protection insurance, manipulation of the swaps market benchmark index and mis-reporting, Mr Jenkins noted that little to nothing has been done to hold the responsible ones accountable for their actions. Large fines were common, but with few exceptions, they have been paid by the shareholders and not by the perpetrators.

Moreover, no bank has lost its banking license, no senior has gone to jail, no management team has been prosecuted and no board or supervising executive has been financially ruined. Instead, business as usual moderately continued with few fundamental changes. Looking forward, Mr Jenkins noted that, "Restoring accountability is vital to restoring a sense of fairness. It is also key to reducing recklessness." It is essential for the actors on the front line of financial risk-taking to internalise the difference between right and wrong and align their practices and behaviour accordingly. In contrast, "If 'wrong-doing' is left unpunished, much less rewarded, we will get what we deserve and deserve what we get."

In spite of the declarations made by various regulators, politicians and practitioners to impose justice and take action on this accountability issue, Mr Jenkins observed that respective actions have fallen short of what was both needed and possible. For instance, he considered it especially irritating that laws have been broken and yet law breaking has not touched senior management, referring for instance to the US "deferred prosecution agreements". In this regard, findings that establish such agreements and corresponding procedures are insufficiently transparent and hidden from the public. Moreover, already existing rules and tools have sat untouched in the process and aftermath of the financial crisis, such as the ability of UK authorities to oust bank management and board by striking them of the 'approved persons list', which was hardly executed in practice.

From this and further examples, Mr Jenkins concluded: "The signal sent to the public is that justice is two tiered: there is one set for citizens and another for the financial elite."



He warned about the resulting negative sentiments and anger among the electorate, which might limit the room for manoeuvre if the banking system should need taxpayer support once more. At last, authorities imposing large fines, that due to their size tend to weaken banks' balance sheets, as a way to seek settlement and to appease the public, does not compensate for truly going after the perpetrators in terms of prosecuting individual offenders and shaming failed management. For this, authorities must not be timid.

As a final remark, Mr Jenkins returned to the conference's initial theme and refined the dimensions of capital, accountability and courage as prerequisites in order to adequately strengthen the financial system in Europe. "Unless we address leverage, we cannot have confidence in the resilience of the system. Without better behaviour, we cannot have faith in the market that underpins it. Without penalising the perpetrators and their seniors, we will not get better behaviour. And without greater courage from policy makers and regulators, we will get none of the above and more of the same."

Against this backdrop, Mr Jenkins called on Europe to tackle its banking reform challenge and in doing so cannot rely on the global financial framework, as this is too soft in many regulatory aspects. He closed his speech by expressing the prospect and possibility for Europe to set an example of a profound banking regulation and financial reform system that is for others to follow.



Panel I**Limiting Sovereign Bonds Exposure:  
Feasibility, Effects and Implications**

Matthias Dewatripont advised to induce banks to invest in diverse and safe assets to stabilise the system, and perhaps later to introduce European safe bonds.

with **Prof. Claudia Buch**, Vice-President, Deutsche Bundesbank; **Prof. Mathias Dewatripont**, Executive Director, National Bank of Belgium; **Dietrich Domanski**, Head of Policy Analysis, Bank for International Settlements; **Dr. Roberto Gualtieri**, European Parliament, Member S&D; **Erik Nielsen**, Group Chief Economist, Global Head of CIB Research, UniCredit; moderated by **Prof. Jörg Rocholl**, President, ESMT Berlin

Jörg Rocholl started the panel by introducing the main topic of the bank-state-nexus and specified the question of how the transfer of risk from the sovereign to the banking sector can be reduced and what the regulatory implications for sovereign debt are.

On the issue of sovereign exposure, Dietrich Domanski criticised that the current regulatory treatment of sovereign exposure in the Basel framework is “out of line with economic reality.” In this regard, Matthias Dewatripont characterised the treatment of sovereign exposure as the original sin of Basel. In this framework, several exemption rules grant preferential treatment of sovereign exposure resulting in a zero or close to zero risk weight of these bonds. In this regard, Claudia Buch emphasised the importance of acknowledging the fact that, however, government debt is not risk-free and particularly different from risk in the private sector. According to Mr Domanski neglecting this riskiness of sovereign exposures and granting preferential treatment has the negative implication of introducing distortions in risk management and in the portfolio allocation as well as contributing to systemic risk, since banks are too exposed to sovereign risk.



Erik Nielsen warned about the ex ante mechanisms of risk weights, since such an ascription of risk would undermine society's belief in the government.

On the other hand, the panel concluded possible trade-offs regarding sovereign exposures, since they could also serve as liquidity buffers or as investment substitutes when there is a lack of other assets. Also governments may want banks to act as shock absorbers during recessions and as contrarian investors in sovereign bonds. However, Mr Domanski clarified that such considerations are important but not a justification to preserve the status quo of preferential treatment for sovereign bonds.

In this regard, Ms Buch pointed towards the central question of how to handle sovereign risk in current banking regulation while noting that so far neither quantity limits nor risk weighting for sovereign exposure have been applied, both of which constitute two central regulatory measures. Generally, it was noted that as the Banking Union provides better surveillance of sovereign risk, it also contributes to effectively lowering the bank-state nexus.

Furthermore, there are economic reasons for dealing with sovereign risk, which are based on empirical evidence and point towards misaligned incentives such as reduced lending to the private sector on behalf of the sovereign sector, which is particularly true for weaker banks. Erik Nielsen highlighted the crucial link between the private and sovereign sector. He called for precaution when restructuring government debt, since “the private and sovereign sectors are mirror effects of the same.”



Roberto Gualtieri stressed the necessity of a profound cost and benefit analysis of policy intervention on sovereign debt and called for a long transition period.

Therefore, in terms of diversification, he also called for banks to diversify their real business, which is lending to the private sector.

Generally, the panel agreed upon the need to limit sovereign exposures. In this regard, Mr Nielsen warned about the ex ante mechanisms of risk weights for sovereign bonds, since such an ascription of risk would undermine society's belief in the government which could be potentially dangerous. Moreover, he considers such limits on the holdings of sovereign debt as a dangerous pro-cyclical instrument and recommends that instead sovereign exposure should be limited to a share of national GDP, equity, capital or a comparable measure.

Furthermore, the panel concurred that diversification of sovereign exposures across European banks is a key issue in financial regulation in order to guarantee financial stability. The main challenge is to set the appropriate incentives to induce greater diversification so that cross-border investments in sovereign bonds are increased. So far, as Mr Domanski pointed out, there is a strong home bias for sovereign debt in the Euro zone for reasons of regulation, responses to the crisis, as well as market structures.

On this point, Mr Dewatripont added that concentration of sovereign debt as "high quality liquid assets" in times of crisis or recession also constitutes a normal market phenomenon that has the perks of granting market access to sovereigns. In economically better times, a higher degree of diversification usually prevails. However, it is advisable to induce banks to invest in diverse and safe assets to stabilise the system, and maybe later it might be a good idea to introduce European safe bonds (ESB). In addition to diversification, however, Mr Domanski stressed that the fiscal soundness of the sovereign itself matters and that regulation cannot substitute for respective efforts.



Policy makers would have to thread the fine line to get the incentives right ex ante and to retain the capacity to deal with bad outcomes, said Dietrich Domanski.

In conclusion, long transition periods, complementary measures as well as greater diversification regarding sovereign exposure can be distinguished as necessary steps for the future regulatory treatment. In terms of regulatory intervention, Roberto Gualtieri raised the question of the appropriate timing of measures from a policy making perspective. Particularly, he stressed the necessity of a profound cost and benefit analysis of policy intervention. Mr Gualtieri suggested that one potential aspect of isolating banks from sovereign risk might be to put additional stress on the sovereign bonds market, which currently may not be a good idea. Instead of activism, a long transition period is needed. Moreover, Mr Domanski added that policy makers would have to "thread the fine line to get the incentives right ex ante and to retain the capacity to deal with bad outcomes."

On market discipline on the issue of sovereign debt, Mr Nielsen commented, "the market is not the right policemen for fiscal discipline that is needed in the currency union." In the end, markets do tend to panic and credit agencies tend to overreact irrationally.

One question from the audience regarded the issue of how to deal with subsidiaries in third countries assuming that sovereign exposure is a European issue. Mr Dewatripont responded that there is no clear policy idea on the table yet. However, for dealing with third countries and advancing diversification of not only sovereign but also country risk, it might be a good idea to look at the group instead of subsidiary level.



Claudia Buch noted that the discussion on exposure limits is not about prohibiting sovereign bonds as risk-free altogether, but about acknowledging related risks.

This could possibly induce cross-border banking especially beyond the Euro-area, since risk remains the major hurdle so far. Mr Domanski added that in many cases, cross-border and subsidiary issues are more of a supervisory nature, since regulatory frameworks already provide sufficient flexibility to address the specific ways in which international banks operate.

One remark from the audience addressed that without a European 'super-bond', the targeted diversification might be problematic, since small banks hold domestic sovereign bonds for liquidity reasons and are often unable to diversify to other foreign bonds. As with any regulation, Ms Buch replied that one has to account for endogenous market adjustments taking place regarding banks' investment behaviour. Also, it is not about prohibiting sovereign bonds as risk-free altogether, but about acknowledging related risks. On the debate between small vis-à-vis large banks, Mr Gualtieri reiterated the importance of a careful cost-benefit assessment. For a complete Banking Union it remains fundamental to promote risk sharing and the Capital Markets Union. However, echoing Mr Domanski, Mr Gualtieri noted that home bias can be influenced but not radically changed by regulation. The issue of small banks will therefore persevere.

A final comment from the audience addressed the contradiction of introducing European safe bonds as an alternative to removing preferential treatment of sovereign debt, since ESB would require certain privileges as well. Mr Dewatripont responded that Basel sets merely the minimum in terms of risk weights. Therefore, soft limits regarding concentration instead of credit risk weights could be introduced as well as ESB-specific exemptions from this. On this, Mr Gualtieri pointed to consider the level playing field also on a global stage and hence a careful divergence from Basel rules.

Panel II**Business Models and Banks' Stability:  
How to enhance Banks' Resilience?**

with **Prof. Elena Carletti**, Professor of Finance, Bocconi University; **Dr. Klaus Düllmann**, Head of SSM Risk Analysis Division, DG Microprudential Supervision IV, European Central Bank; **Santiago Fernández de Lis**, Head of Financial Systems and Regulation, BBVA Research; **Piers Haben**, Director Oversight, European Banking Authority; **Dr. Constantin Sobiella**, Partner, d-fine; moderated by **Prof. Dirk Schoenmaker**, Senior Fellow, Bruegel



Klaus Düllmann said that the forces and interactive effects of low growth, low interest rates, fiscal imbalances and high levels of NPLs are of major concern.

Dirk Schoenmaker appreciated the distinguished panel and clarified that the subject of banks' business models covers many different aspects, which will make for a less homogenous debate compared to the previous panel. He refined the three main dimensions of the debate by non-performing loans (NPLs), low interest rates as well as fin-tech and related challenges.

First off, Klaus Düllmann explained that the challenges of NPLs are of high priority for financial stability, but currently they do not constitute the only key risk in Europe. Moreover, the driving forces of low economic growth, low interest rates, fiscal imbalances together with high levels of NPLs and the respective interactive effects are of major concern. To this, Santiago Fernández de Lis added that European banks also face problems related to market perceptions of insufficient transparency, institutional changes in the EU regulation and supervision as well as regulatory uncertainty and problems of fragmentation. On the latter, Mr Düllmann noted that the issue of fragmentation is closely linked, since NPLs are not distributed homogeneously across the euro-area, but differ widely between different banks in different countries.



In Spain, government interventions, reforms, changes in the insolvency law and economic recovery have been main factors for overcoming the NPL problem.

The panel agreed on the enormous scale of the NPL problem and that it constitutes a major obstacle for the recovery of the European banking sector and the economy. As Piers Haben put it: "Whilst there are big differences between banks and between countries, it is a problem for the system as a whole." Recapturing the NPL crisis in Spain, Mr de Lis identified the strong government interventions and reforms in the context of the ESM program, changes in the insolvency law and more importantly economic recovery as main factors for overcoming the problem. In turn, economic recovery can be seen as partly endogenous to a banking system once it has regained its lending capacity.

Generally, the panel conceived that European banks remain under a lot of pressure especially in terms of their profitability prospects and current business models given the interactive effects of low interest rates in the present economic environment. In this regard, Elena Carletti presented some summarised facts from a taskforce report of the European Systemic Risk Board, focusing on the nature and implications of the prevailing low interest rates. Against a time horizon of ten years, the report concluded that interest rates are likely to remain low in line with the low growth projections due to structural factors such as ageing. Three major risks from low interest rates include pressure on the stability of banks' business models, a resulting broad based risk taking and changes in the structure of the financial system.



Elena Carletti said that major risks of low interest rates are pressure on business models, resulting risk taking and changes in the structure of the financial system.



Piers Haben said that the areas of peer-to-peer lending, payments and cross-selling advice present additional competitive pressures for existing banks.



Constantin Sobiella said that apart from competitive effects, new partnerships between fin-tech and banks can be evaluated as positive market dynamics.

Even though low interest rates contribute to the reduction of lending costs for banks, the environment of low economic growth counteracts this positive effect. Moreover, in the existing business models of banks, the major part of total operating income is generated by net interest income, which, however, is negatively affected by the given interest rates. Therefore, banks have to adjust their business models regarding their search for yield and find new ways to boost profitability. Present coping and solution strategies of banks include a relaxation of credit standards on new loans and lending to riskier borrowers. Finally, Ms Carletti remarked that additional competition and pressure for banks also originates from non-banks such as peer-to-peer lending. In this context, Mr Düllmann added that despite of low interest rates depressing net interest margins, they also yield the positive aspects of reducing debt-servicing costs, which could facilitate growth even in a low growth economy.

Moreover, the emergence of fin-tech and related new technologies constitute a major source of intensified competition in the European banking sector. As elaborated upon by Constantin Sobiella, besides the rather negative competitive effects, new coalitions and partnerships between fin-tech businesses and existing banks already take place and can be evaluated as positive dynamics in the market. Therefore, new technologies can enable banks to better implement new regulations while allowing for new sources of income, market access and a way to change the cost base of their services.

In line with these technology-based positive prospects, Mr de Lis noted the opportunities for efficiency gains and for restoring the profitability of banks. Nonetheless, Mr Haben mentioned that the areas of peer-to-peer lending, payments and cross-selling advice present additional competitive pressures for existing banks and suggested that "Fin-tech is not coming overnight, but it will come, so firms should not ignore it. There is time, but also not too much time."

On the question from the audience on whether loan-to-value (LTV) limits help to avoid NPLs, Mr Haben responded that those limits would not help with existing NPL-levels, but they could present a useful macroprudential tool on a forward-looking basis to address rising problems of bubbles. Furthermore, Ms Carletti agreed on the potential trend of banks turning into asset managers as they are advised to retreat from business models based on interest rates. If then peer-to-peer lending or fin-tech steps in to fill the gap, regulatory challenges arise. Respective policy conclusions entail rather activity-based besides equity-based regulation.

Also mentioned in the audience was the gap between modelling and the reality of banks' balance sheets due to the methods employed in risk assessment. To this, Mr Düllmann replied that indeed a higher degree of harmonisation is needed across Europe in terms of how collateral is valued and whether market or mortgage values are applied. Mr Haben added that in real estate there have been many problems with risk management and yet the European Banking Authority continues to work on improving the transparency, comparability and consistency of respective risk-based models.

A further question related to cross-border banking in the EU as a necessary step towards the Banking Union. Mr Düllmann concluded that the introduction of a common supervisory approach with the Single Supervisory Mechanism has been a huge step for facilitating cross-border banking and mergers already.



Despite of this common supervision, challenges due to different legal systems and national laws persist even while banks in the Euro-area are supervised by the European Central Bank.

On this, Mr de Lis viewed the term 'cross-border' in the context of the Euro zone as redundant, since it is to become a single jurisdiction. The ultimate idea behind the Banking Union is to have Euro-zone instead of national borders. But regarding this transition, challenges such as national resolution authorities or national legislation still remain, even with the Single Supervisory Mechanism and the Single Resolution Mechanism in force and the existing common Euro area. Moreover, if the Banking Union agenda is not finished, Europe might loose out on the international level.



## Finance: Are there Trade-offs among Growth, Stability and Inclusiveness?

**Prof. Catherine Mann**, Chief Economist and G20 Finance Deputy, OECD

Catherine Mann opened her keynote by seeking to address the actors involved in the regulatory environment as well as putting forward the issue of finance to be located at a questionable core of economic activity. She refined the main question of her speech as: "Are there trade-offs among the objectives of growth, stability and inclusiveness when we look through the lens of finance?" In doing so, she emphasised that for each of the dimensions of growth, risk and inclusiveness there are pros and cons about the role of finance to be considered.



Finance can have negative implications for growth through excessive financial deregulation, TBTF guarantees, too much bank lending, too much household credit.

First off, she stated that financial deepening is often thought of in a positive sense as boosting economic growth through the channels of reducing the need for self-financing, more efficient capital allocation and more professionally monitored investments, facilitating international trade, smoothing cash-flow shocks and facilitating monetary policy transmission. On the other hand, with a too excessive financial expansion, Ms Mann said that negative effects can emerge such as misallocating capital as was for instance the case in Spain, magnifying the cost of implicit guarantees in terms of too-big-too-fail banks, distorting allocation of labour, generating boom-bust cycles and increasing the risk of regulatory capture.

Ms Mann went on to present empirical results for financial deepening to be negatively associated with gross domestic product per capita growth in OECD countries where there already exists a respectively well developed financial sector in terms of credit. After a threshold of 60 per cent credit to GDP, deterioration in growth rates of GDP becomes notable in the face of additional credit deepening. Hence, finance can have negative implications for growth through the four channels of excessive financial deregulation, TBTF guarantees, bank lending outpacing bond financing and household credit outpacing business credit. One of the major insights is that treating banks as too-big-too-fail tends to exacerbate the negative relationship between credit deepening and GDP per capita growth. From this, one can conclude the importance of implicit guarantees for the overall functioning of the financial system.

Furthermore, extending bank credit to households is negatively correlated with GDP growth per capita to a much greater extent than business credit, since the latter is extended against an economic activity and can repay the undertaken obligation. In contrast to increased credit expansion, further deepening in equity markets appears to boost GDP per capita growth, which constitutes a further argument in favour of completing the European Capital Markets Union in terms of developing equity markets.

Then, Ms Mann continued by addressing a broader set of policies and its implications for growth and risk. The considered structural and financial policies include, inter alia, product market regulations, tax settings, capital account openness, exchange rate regimes, financial liberalisation and trade openness. For all of these policies the joint effects on growth and crisis risk were to be considered.

In order to derive the respective analytical results, the OECD research agenda entailed both of the following questions of “To what extent do policies increase vulnerabilities or reduce probabilities of severe recessions?” and the commonly less analysed question of “To what extent do risk-mitigating policies reduce mean growth?” This set-up represents the important trade-off of structural policies in terms of mean growth and crisis risk, Ms Mann explained.

As for the presented results, policy reforms outside the financial sector do not present growth-fragility trade-offs. For example, high quality of institutions tends to increase growth and reduce risk, whereas improvements in product markets tend to be unrelated to crisis risk while increasing mean growth. Moreover, labour market reforms appear to have a notable albeit small beneficial effect on both growth and the reduction of crisis risk. “These are the kinds of policies that create an environment in which a financial system operates either well or not well.”



Debt-to-income caps, countercyclical capital buffers and capital surcharges on SIFIs represent policies that do not harm growth but clearly reduce financial risk.

Subsequently, Ms Mann presented a set of questions regarding financial policy options, given that the policies above were in effect. On the one hand, financial markets policies promoting capital account openness and financial markets openness represent a trade-off in terms of contributing to growth and financial fragility at the same time. “The approach that you take, can give you a very different view on whether or not a policy of financial liberalisation is going to lead to more or less growth without the cost of financial fragility.”

On the other hand, there are macroprudential policies that support growth to an albeit small degree whereas significantly lowering financial fragility, including debt-to-income caps, countercyclical capital buffers and capital surcharges on systemically important banks. “Those are the policies where we do not have a trade off in the sense that they do not harm growth, but we have gained a lot in terms of reducing financial risk.”

When choosing a package of macroprudential tools, the trade-offs between growth and risk have to be carefully considered, Ms Mann indicated. While capital account openness in terms of market openness overall, foreign direct investments and portfolio equity contributes to financial fragility to some degree, the respective costs are off-set by gains in growth. On the contrary, costs of fragility from portfolio debt inflows are not compensated by such gains in growth. Portfolio debt is therefore dangerous in a domestic environment in terms of mean growth as well as in an external environment.

Ms Mann concluded that in a global world of finance and with international capital markets, policy makers always have to take into account that their policy choices not only affect their own country, but other neighbouring countries as well.

On the last topic of inclusiveness, Ms Mann pointed out that, on the one hand, finance could contribute to income equality if it relaxes consumption constraints on low-income households or encourages work in the formal sector. On the other hand however, it can also contribute to income inequality if capital is allocated to those already better off or if financial firms pay particularly dispersed wages. Empirical findings include that credit by banks and stock market expansions are linked to increased income inequality.

Ms Mann elaborates the reason for this as follows: "Financial means flow disproportionately to those who have finance or higher income already and benefit more those who already have wealth in equity." Furthermore, the financial sector adds to inequality due to the nature of compensation in terms of paid wages. As Ms Mann pointed out: "On average, financial firms pay disproportionately more than other non-financial firms." Therefore, a concentration of financial firms in an economy or in a region within an economy results in a disproportional income inequality generated by such financial wage premia. In turn, these premia are linked to TBTF banks as they are not closed even in bankruptcy and therefore transfer a share of their rents towards wages.



Financial reforms should take place against a backdrop of broad structural policies to create resilience in the overall economy and to address income equality.

As a closing remark, Ms Mann put forward different policy reforms best suited to simultaneously obtaining the three objectives of growth, stability and equality. Firstly, this is the promotion of a more balanced financial system in terms of equity, bond and bank credit. Secondly, this entails a reduction in debt subsidies especially in the areas of TBTF and housing policy. Thirdly, this would include the implementation of selected macroprudential instruments such as the debt-service-to-income ratio and counter-cyclical capital buffers, which represent the most efficient trade-off between growth and risk.

Lastly, financial reforms should take place against a backdrop of broad structural policies to create resilience in the economy overall and to address income equality. As a key take-away from the presented points and results, Ms Mann emphasised and urged policy makers to carefully take into account "jointly the reduction of crisis risk and avoidance of reducing mean growth." Neither one of these two policy-specific aspects should establish a form of collateral damage, but rather a conscious decision.

Panel III**How to tackle weak and TBTF Banks?  
Enabling Resolvability and Bail-in**

with **Andrew Gracie**, Executive Director, Resolution Directorate, Bank of England; **Dominique Laboureix**, Board Member and Director Resolution Planning and Decisions, Single Resolution Board; **Dr. Sven Schelo**, Partner, Linklaters; **Mark Venus**, Head of Recovery and Resolution Planning, BNP Paribas; **David Walker**, Secretary General, International Association of Deposit Insurers; moderated by **Prof. Isabel Schnabel**, Professor of Financial Economics, University of Bonn



According to Andrew Gracie, the bail-in regime will only be credible when it is abundantly clear to bank debt investors that they will be on the hook.

At the beginning of the discussion Isabel Schnabel pointed towards the changes that have been made so far in the regulatory framework as to the Single Resolution Mechanism (SRM), the Bank Recovery and Resolution Directive (BRRD) as well as the new regulations on Minimum Requirements for Eligible Liabilities (MREL) and Total Loss Absorbency Capacity (TLAC) which are to come. Given the remaining doubts about the credibility and feasibility, the bail-in and resolution regime has partly been perceived as rather destabilising in times of crisis and as putting banks under even more strain. Therefore, the central question refers to how the bail-in regime can be made more credible.

Setting the scene for the bail-in regime, Andrew Gracie remarked that during the financial crisis the responsible investors in bank debt were bailed-out, and it was a painful truth for authorities to acknowledge the lack of tools to actually impose losses on those investors. Hence, the current bail-in regime "will only be credible and move from a world of bail-out to a world of bail-in when it is abundantly clear to bank debt investors, that they will be on the hook." By now, authorities have engaged in resolution planning and are clear about the subordinated bail-in debt, such that debt holders have to be unambiguously aware of their potential losses.



Mark Venus argued to spread the bail-in risk widely and to limit any exemptions for MREL and TLAC holdings. Resolution should affect all relevant stakeholders.

Furthermore, Mr Gracie posed the critical question of who is supposed to hold the bail-in-able debt and clarified that ultimately this cannot be pensioners as in the previous crisis. On this, Mark Venus responded that bail-in and resolution is an intelligent form of insolvency for banks, which generally hurts but should affect all relevant stakeholders. He argued to spread the related risk widely and to limit any exemptions for MREL and TLAC holdings since these would yield the adverse effect of concentrating risk among a small group of actors, who later might not be held responsible.

Drawing a distinction between depositors using banking simply for payment and depositors who invest, Mr Venus noted: "Depositors as a category deserve no more protection than any other debt holder category once they have gone beyond the retail deposit amount of 100.000 Euro. Above this amount it is an investment decision." Generally, the panel remained vague on pinpointing the precise group of actors to be held responsible for bail-in-able debt.

Dominique Laboureix then elaborated that the resolution authorities in charge have to find solutions to avoid any risk related to the potential contagion effects between banks.

For instance, some supervisory rules already impose limits on the exposures from one bank to another. In this regard, Mr Gracie identified the important measure of setting up appropriate liability structures such that in case of bank failure and losses imposed on debt investors, the rest of the market is not impeded from functioning. He warned about a domino effect after bailing-in one bank, as this would jeopardise the credibility of the resolution regime.



For Sven Schelo, an environment of high confidentiality and trust between people involved is important to openly speak and without creating a self-fulfilling prophecy.

However, while the TLAC scheme relies on subordinate debt instruments, it is more difficult to define a good MREL regime due to the large scale of instruments and the large scope of banks involved, as pointed out by Mr Laboureix. Therefore, MREL requirements have to be designed carefully in order to prevent further destabilising effects.

On the differences between the TLAC and MREL schemes, Mr Gracie suggested that "TLAC is just a nest within the broader concept of MREL rather than being something radically different." While Sven Schelo argued that TLAC and MREL start from different points conceptually. A higher degree of discretion on MREL requirements was conceived as reasonable, since MREL deals with up to 6000 European banks of many different types with a diversity of balance sheets and business models.

Specifically, it was mentioned that a large number of European banks might not end up with MREL capital requirements and that the BRRD provides the scope to have different MREL requirements for different resolution strategies. In contrast, the TLAC system deals with merely about 28 global systemically important banks (GSIBs), and for the respective bail-in banks subordination was seen as appropriate. For GSIBs there should be sufficient subordinate debt instruments in order to refill banks' capital in full in case of failure.



David Walker emphasised that resolution planning is as important as the resulting resolution plan itself due to the valuable insights gained on structures and actors.

In contrast to the reservations of some panellists, Mr Gracie addressed resolution planning for banks as an essential regulatory element. "It is an ex ante internalisation of the externalities around failure. It is going to cost proportionate to the externalities the banks bring to the system." He also noted that this transition towards becoming a resolvable entity constitutes a progressive process over the period of at least two to three years. From personal experiences with resolution planning, David Walker echoed Mr Gracie in emphasising that the actual planning process is as important as the resulting resolution plan due to the valuable insights gained. This includes the level of invaluable knowledge from this resolution procedure on the relevant structures and actors.

In contrast, Mr Schelo indicated a possible paradox of resolution planning if not executed carefully in terms of a self-fulfilling prophecy. Once a resolution plan is drawn up and out of the box, it might be discussed bank-internally or with stakeholders and authorities, which can develop its own dynamics. On this he noted: "It is important to develop an environment of high confidentiality and trust between people involved to openly speak about plans and without creating a self-fulfilling prophecy, because otherwise the plans will not be implementable."

In response to the audience, Mr Venus concluded that the resolution and recovery mechanisms of the BRRD were not pushed on too quickly on the banking sector.



Dominique Laboureix said that resolution authorities have to find solutions to avoid any risk related to the potential contagion effects between banks.

However, banks do need to change their liability structures to be better suited to resolution purposes. In this regard, authorities need to give banks the time and the tools to achieve this objective, since it cannot be achieved overnight.

On the question of mis-selling bail-in eligible debt, Mr Gracie responded that one would not want the observation of mis-selling to be misinterpreted. Retail investors have to play the hand they are given in terms of the bank's liability structure, so they potentially might have to suffer losses in the way that the credit hierarchy demands it. Therefore, it is important to get a liability stack that is fully credible. Moreover, there is a resemblance to inflation targeting around resolution, because in order to get market discipline out of resolution measures, people on the receiving end need to understand and internalise what is going to happen in case of bank failure and resolution.

On resolution decisions, Mr Laboureix added that the Single Resolution Board has been established as an independent authority and is about cutting the link between the state and failing banks. Therefore, not deciding to organise a resolution is already a decision, and it has to be clear that without a resolution planning the bank would go through a normal insolvency proceeding.



Panel IV**A Level Playing Field and EU-wide Deposit Insurance:  
Mission impossible?**

Vincenzo La Via called for soon adopting Edis and a common backstop to complete the Banking Union. Many risk reducing efforts have already been accomplished.



Emiliano Tornese said that discussions on Edis with stakeholders are still necessary and part of a broader debate on how to align risk sharing and risk reduction.



Gerhard Schick supported the approach of a re-insurance mechanism for the Edis design as well as a fiscal backstop in order to make the system more credible.

with **Sylvie Goulard**, European Parliament, Member ALDE; **Dr. Levin Holle**, Director General, Financial Markets Policy Department, Federal Ministry of Finance; **Dr. Vincenzo La Via**, Director General of the Treasury, Italian Ministry of Economy and Finance; **Dr. Gerhard Schick**, Deutscher Bundestag, Bündnis 90/Die Grünen; **Emiliano Tornese**, Deputy Head, Resolution and Crisis Management Unit, European Commission; moderated by **Prof. Henrik Enderlein**, Director, Jacques Delors Institut – Berlin

Henrik Enderlein opened the debate by touching on the controversial topic of the European Deposit Insurance Scheme (Edis) and introducing the panel, which he viewed as well-selected given the diversity of expertise.

Emiliano Tornese appreciated that great progress on Edis has been made already. However, political discussions with stakeholders are still necessary and part of a broader debate on how to align risk sharing and risk reduction and on how to restore confidence in the European banking sector. Adding to this, Levin Holle argued that prior to Edis, other elements of a comprehensive stability package have to be addressed. "This is a question of priorities." Firstly, this includes a profound risk reduction in the European banking system by means of higher capital ratios and a workable bail-in regime, which requires concrete rules on bail-in-able buffers and a harmonised subordination regime to be proposed by the Commission as soon as possible. Secondly, this relates to overcoming the risk contagion from the sovereign to the banking sector.

In contrast, Vincenzo La Via was in favour of speeding up the completion of the Banking Union by promptly adopting EDIS and a common backstop as the last remaining elements. "Many risk reducing efforts on the European level have already been accomplished." In this regard he suggested that more integration within the European banking system and the single market was needed as well as the implementation of the Capital Markets Union in order to restore the crucial confidence in the banking sector.

With respect to sovereign risk and potential solutions, Sylvie Goulard proposed that banks should be encouraged to diversify and to "adopt a European instead of a national passport", which was well received on the panel. Regarding the measure of risk weights for sovereign bond holdings, however, Mr La Via raised the objection that unnecessary and country-specific advantages interfered with a level playing field, and that there is no single European solution, as this is inconsistent with global discussions.

On the regulatory architecture for financial stability Gerhard Schick argued that "to respect and include existing structures could help bring Edis forward and not to force too much of a change where it is not necessary." He supported the approach of a re-insurance mechanism for the Edis design as well as a fiscal backstop, which is currently lacking, in order to make the system more credible than it is today. He also criticised that, in the concept of the bail-in regime, authorities often regard consumer protection as a side issue when really it is at the core of financial stability.



An inclusive European perspective and joint efforts for financial stability are needed instead of concentrating on single national interests blocking the project.

This refers to the question of who carries the risk that banks sell to their clients, and how smaller savers and private households can be protected.

Overall, the panel concurred that the transition period of the regulatory system had to be acknowledged, especially when moving from a bail-out to a bail-in regime. Ms Goulard noted: "It is a complex issue and it takes time to constitute the precise rules for member states to actually implement. We have to ensure, that what we produce can function." Moreover, an inclusive European perspective and joint efforts on the issue of financial stability are needed instead of concentrating on single national interests blocking the project. In Ms Goulard's view, a lack of mutual trust among the member states constitutes one reason for the Banking Union to be in the middle of formation with respect to deposit guarantee schemes and Edis. In terms of Europe's economic prospects, Mr Holle echoed the necessity of a regulatory environment which promotes cross-border investments in future-oriented projects, since currently there is rather a problem of finding investable and future-oriented project instead of liquidity issues or funding.

In addition, different panelists agreed that the Euro area is overbanked and contains a vast number of unprofitable banks. A further rationalisation of the system via banking consolidation and mergers could provide more efficiency and credibility for the system. In order to make the European financial system more resilient towards future turbulences, the panel summarised the need for a clear commitment to implementation dates, the single currency as a starting point, a less politicised commission as well as a comprehensive stability package including clear rules and harmonisation across the Euro zone.



The 8 per cent in the BRRD constitutes an important threshold. Without, any bank could mutualise its own mismanagement, which would constitute a terrible state.

In response to questions from the audience on why the European Commission is pushing so hard for Edis, Mr Tornese summarised that Edis was a declared aim in order to complete the Banking Union as well as to create confidence and the respective infrastructure for financial stability. Regarding the level playing field and an overbanked Europe another question referred to whether a concrete blueprint is needed on how the EU banking sector should look like. Ms Goulard responded that such a pre-definition is not in line with a free and liberal market functioning, which might indeed entail the co-existence of small vis-à-vis large banks. On this, Mr Holle agreed that rather diversity in the banking sector and cross-border mergers are needed.

On the issue of the appropriate level regarding risk reduction in the banking sector, Mr Holle clarified that the requirements on capital levels as the first safety buffer are set by the Basel rules, while the bail-in-able buffers in terms of the TLAC standard go beyond the double of that bound in order to guarantee a bank's recapitalisation. Then, resolution authorities can still set higher buffers if a bank appears to be more dangerous than others. In terms of sovereign debt there is a concentration risk in the balance sheets of some individual banks, a problem which has to be addressed. He further pointed out, that when a bank is running into difficulties, the bank itself, its owners and creditors have to bear a certain percentage of the bank's liabilities as losses. In the BRRD 8 per cent was set in a political process. The precise amount is disputable, said Mr Holle, nonetheless it constitutes an important threshold, after which banks can use the resolution fund. Without such a threshold, any bank could mutualise the problems of its own mismanagement with the remaining banks in the sector, which would constitute a terrible state.

It was our pleasure to host the fourth Financial Stability Conference at ESMT Berlin this year. I would like to extend our appreciation to Martin Aehling and the other scientific co-organisers, Bruegel, DIW Berlin, and Jacques Delors Institut, for the ongoing cooperation. As in the past, the conference brought together a wide array of top national and international expert speakers from politics, policymaking, academia, and industry. The speakers and participants shared a diverse variety of insights, and the ongoing discussions were high in quality and forward-looking, making this conference a valued platform for the important debate of regulatory issues in the financial system. As this yearly conference becomes a trademark event, ESMT Berlin looks forward to partnering as a scientific co-organiser and host.

**Prof. Jörg Rocholl**, President, ESMT Berlin

I greatly enjoyed my panel, but maybe more importantly, I thought the entire day provided an outstanding opportunity to hear - and discuss - the most important issues around financial stability with a big group of the key people involved in the topic. Combined with the flawless organisation, it was one of the best conferences I have participated in for a long time.

**Erik Nielsen**, Group Chief Economist, Global Head of CIB Research, UniCredit

The 2016 Financial Stability Conference has been an outstanding opportunity to get deep and valuable insights from regulators, practitioners, politicians and scholars and to foster intriguing new perspectives. Excellent keynote speakers inspired the debate and high-level participants of carefully composed panels lead to open, controversial and thus invaluable discussions. I am very much looking forward to next year's conference.

**Prof. Stefan Janßen**, Banking and Finance, Jade University of Applied Sciences

I would like to thank you for the wonderful conference you put together and your invitation. I look forward to meeting you again in the future.

**Prof. Dimitrios Tsomocos**, Professor of Financial Economics, Saïd Business School, University of Oxford

Let me send you an email to thank you for the well-organised conference in Berlin. I have received very positive feedback. The conference has really become a great flagship event.

**Dr. Guntram Wolff**, Director, Bruegel

Firstly, I wanted to write to say many thanks for your organisation of yet another excellent conference. It was my second year attending and I was again impressed at the quality of the speeches and discussions, which mark the conference as „a must attend“.

**Eoin Dorgan**, Principal Officer, Department of Finance, Government of Ireland

## How to fix the Deficiencies in the EU Financial System? Bank-State-Nexus, Business Models and the missing Level Playing Field

Conference, 3 November 2016, ESMT Berlin

The Financial Risk and Stability Network is an independent initiative focusing on regulation and financial sector reforms in the EU. The mission is to offer a frame for open discussion and views exchange, to stimulate debates and to contribute to information on these issues from a public interest point of view. One main activity is the Financial Stability Conference in Berlin.

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