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The European Banking Union

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The decade of the economic crisis has highlighted in a most visible way the need for reforms in the original design of the monetary union. The consolidation of the national banking sectors is at the centre of this effort, as the discussions for the much-needed changes in Europe have been revived, especially after the results of the recent European elections on May 2019. In this context, the Banking Union is one of Europe's most ambitious and important projects.

The banking union first appeared in the public debate at the end of 2011 and became widely discussed among European officials in 2012 when Euro-area countries pledged to consider more concrete steps towards a more integrated financial architecture. Although not yet completed, the banking union is based on a framework whereby the banking sector's policy is managed at the European level including regulation, supervision, resolution and deposit insurance. The 19 euro-area member states participate automatically while the non-euro member states of the EU have the ability to join under the status of close cooperation, with the ECB as the main supervisor. Until today the only official request to join has been made by Bulgaria in July 2018.

The main goal of the European banking union is to disconnect the banking sector from public finances in order to break the so-called "doom loop"[1] that proved to be a source of instability. The traditionally large presence of European governments on the balance sheets of financial institutions meant that fears about the solvency of the sovereigns were translated into fears about the solvency of the banks. The absence of sufficient supervision, regulation and discrimination rules in the sovereign bond market, which remained mainly entrusted to the national authorities, allowed the European banks to hold large amounts of national debt, mostly from their own governments, which in certain cases even exceeded their own capital. In addition, governments have to deal with the constant danger of having to rescue their domestic banks using public money, resulting in fiscal crisis. The cases of Ireland, Greece and Spain, states that had to recapitalize their banks either with the use of public funds or by requiring external financial assistance, highlight the strong interdependence of banks and sovereigns and the crises that can occur because of it.

[1] See among others Gerlach, Schulz and Wolff (2010), Pisani-Ferry (2013), Gomez-Puig, Sosvilla-Rivero and Singh (2015) and Farhi and Tirole (2017).

The structure of the European Banking Union

The European Banking Union is based upon three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS). However, the cornerstone of this structure is the Single Rulebook. Created in 2009 by the European Banking Authority (EBA), its role is to provide a common and harmonized framework of prudential rules to be followed and respected by all financial institutions across the EU in order to limit the regulatory loopholes that distort competition and prevent markets from operating within the Single Market. It therefore consists of legal acts that regulate, among other things, capital requirements for banks, depositors' protection and the management and prevention of bank failures (EBA 2019).

The main function of the SSM is to supervise the credit institutions and make sure they comply with the prudential requirements set by the relevant European legislation, to detect weaknesses at an early stage and to ensure that proper corrective action is being taken to prevent them from threatening financial stability. A wide range of tools is used, including stress tests, that allow the monitoring and evaluation of the risk exposure of the supervised institutions and the risk posed to the financial system as a whole.

The SSM is based at the European Central Bank (ECB), which is responsible for the overall function of the supervisory structure and the national supervisory authorities of the euro area member states. The allocation of tasks between the ECB and the national authorities depends on the significance of the supervised entities. The ECB directly supervises all banks and financial institutions that have assets of more than €30 billion or which account for at least 20% of their home country's GDP. Around 120 such banks in the euro area, that represent almost 85% of the total euro area banking assets, are currently supervised by the Eurozone's central bank which is accountable to the Council of the EU and the European Parliament (European Council 2018). National authorities are responsible for overseeing the functioning of smaller, less significant banks in accordance with the SSM's common framework and operations and under the overall oversight of the ECB.

Although the choice of the ECB as supervisor is consistent with the existing European legal framework[2] and the ECB already possesses the relevant knowledge and technical infrastructure, there are concerns about a possible conflict of interest between its role as a central bank and that of a supervisor. In such cases a tradeoff between inflation-targeting monetary policy and prudential supervision could be jeopardizing financial stability (Goldmann 2017).

Up until now the ECB has kept its interest rates at historically low levels and continues to do so in order to safeguard the European economy during the crisis and offer additional stimulus to the anemic economic activity. Still, once the inflation target is reached and the economy grows stronger, a rise in interest rates should be expected, especially if one considers the experience of asset bubbles prior to the crisis in the countries of the periphery where the ECB's interest rate proved to be "too low" and fed the excessive borrowing activity. More generally, the very fact that the ECB has as

[2] Art. 127(6) TFEU

its main tool the interest rate instrument, in order to maintain both price level stability and financial stability creates a problematic situation. As Borio (2014) notes, long periods of low interest rates lead to imbalances and asset bubbles due to cheap borrowing. This was the case not only in Europe but also in the U.S. with its pre-crisis housing bubble. On the other hand, a higher interest rate may contain this tendency but at the cost of a lower inflation level making thus the ECB to diverge from its inflation targeting mandate (Bordo 2017). So far, the ECB has been consistently undershooting its target of inflation "below but close to 2%". As a result, an institution with such a dual mandate may not be able to deliver socially optimum results, which can severely harm the ECB's reputation both as central bank and supervisor. Therefore, clear separation of powers between the monetary and supervisory tasks is necessary alongside with the political independence of the institution.

The Council has considered these cross-effect risks and strived for a clear separation between the two functions by assigning the planning and execution of the supervisory tasks to the SSM's Board in the relevant Regulation[3]. However, this independence is still questionable as the Board's decisions cannot be adopted if the ECB's Governing Council objects. Although it cannot modify the decisions proposed, the Governing Council is required by primary law to take any decision on behalf of the ECB[4], something that raises concerns about the extent of independence of the SSM's final decisions.

The effectiveness of the SSM in breaking the "doom loop" between banks and sovereign is also doubted in view of the revival of banks' practice of purchasing domestic public debt after the crisis. Despite a decline in the stock of government debt securities held by banks after mid-2015, since late 2018, banks have started stocking up on national government debt again (Graph 1), triggering fears of new economic problems (Allen 2019). Such "home bias" is especially so in the case of Italy, where the government does not seem to comply with EU fiscal rules, sustaining market unease about the intertwined solvency of government and the banks.

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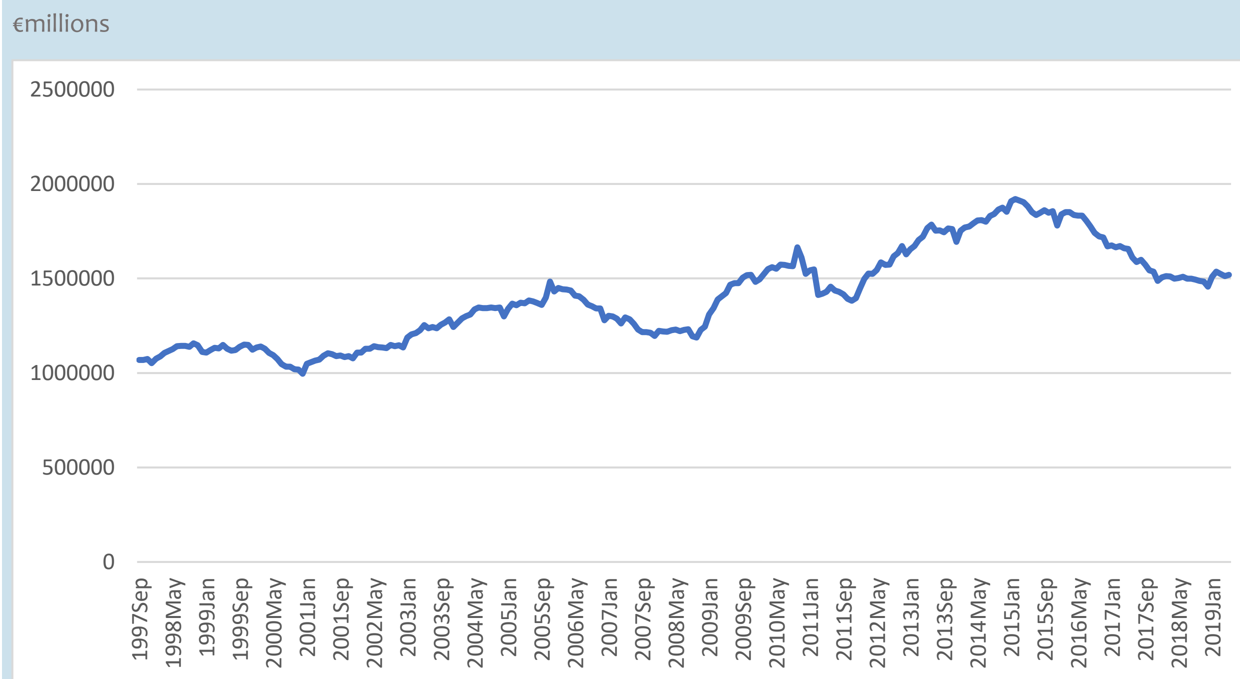
[3] Council Regulation (EU) No 1024/2013

[4] Art. 129 and 282(2) TFEU, Art. 12.1, Protocol (No 4) on the statute of the European System of Central Banks and of the European Central Bank.

Graph 1. Domestic government debt securities held by Euro area monetary financial institutions excluding ESCB[5]

€millions



Source: ECB

The second pillar, the SRM, was established on 1st January 2016. Its main objective is to strengthen confidence in the banking sector by minimizing dependence of banks on national budgets for support in times of financial difficulties, which could result in bank runs and contagion as well as fiscal crises. A single European resolution authority was necessary as a receiver of failed banks that can offer a single approach for their resolution, irrespective of whether they operate only in a home European country or have activities in other European countries. Such a central mechanism does not allow the resolution process to affect neither the host nor the home country's banking systems.

The mechanism consists of an EU-level resolution authority- the Single Resolution Board (SRB)- and a common resolution fund which is financed by the banking sector- the Single Resolution Fund (SRF). SRF is designed to be built up over an 8-year period beginning in 2016, and it will replace the national resolution funds of all member states participating in the SSM and the SRM. It is financed by ex-ante annual contributions from credit institutions and certain investment firms in the 19 participating member states of the banking union. The Fund is an essential supranational tool for financing the restructuring of failing credit institutions, which is activated and used as last resort in order to guarantee the application of the resolution tools but only after a bail-in process has taken place where at least 8% of the losses are absorbed by shareholders (Single Resolution Board 2019). Additionally, the Fund's contribution does not exceed 5% of the total liabilities, including own funds, of the institution under resolution (Single Resolution Board 2019). The bail-in process

[5] European System of Central Banks.

steers the weight of a bank failure to shareholders and creditors and away from taxpayers. The recent experience during the financial crisis where public funds were used in order to bail-out "too-big-to-fail" banks revealed serious shortcomings in the existing resolution tools available and made clear that government intervention is not a sustainable solution.

Despite its solid design and clear scope, the SRM has been criticized for not being adequately equipped to fulfill its mandate, especially in its early years. Consequently, it has been questioned whether the precautionary recapitalizations, with the use of public funds of three Italian banks in the period 2016-2017, was inevitable or became necessary due to the unpreparedness of the SRM and the inability of ECB's supervision to assess the risks properly. However, the recent resolution decisions on four European banks[6] that were determined as failing or likely to fail, demonstrate that although there is a lot of ground still to be covered, the mechanism moves in line with its initial objective of financial stability.

Finally, a common deposit insurance scheme is considered critical for the completion of the European Banking Union as it can provide a greater sense of security to depositors in the weaker economies of the Eurozone, and disengage banks' financing costs from the finances of their host states. Although the relevant proposal was adopted by the European Commission in 2015, EDIS is still the missing piece of a complete banking union, given the reluctance of mostly Northern euro member states.

EDIS is designed to be completed in three stages with a time horizon of up to 2024. The final stage will consist of full risk mutualization where the losses and liquidity needs of the participating deposit guarantee schemes would be fully covered by a European Deposit Fund (EDIF). However, since such mutualization incorporates potential moral hazard, the Commission has proposed the possible disqualification of a national guarantee scheme in case it does not comply with the foreseen obligations. EDIS will be based on banks' risk-based contributions. As expected, the possibility of a mechanism that comprises such wide risk sharing has triggered vivid debates in the European public speech. As a result, the European Commission counter proposed a more gradual approach towards EDIS in an effort to address the diverging views and reach consensus on key aspects of the proposal which is still under discussion.

[6] Banco Popular Español S.A. (June 2017), Banca Popolare di Vicenza (June 2017), Veneto Banca (June 2017), ABLV Bank (February 2018).

The way forward

Although not much has been achieved in the progress of EDIS it is crucial for the completion of the banking union and the further safeguarding of EMU stability. Today, the national deposit insurance authorities still have a strong role as banks backstop and the "doom loop" still exists affecting bank supervision. As a result, the risks and the performance of banks as well as their funding costs depend mainly on national policies. If the markets doubt a country's fiscal capacity or political willingness to support its banking system, deposit flight is inevitable as it happened in the cases on Portugal, Spain, Ireland, Greece and Italy.

Keeping the national authorities involved and not moving from the beginning towards a fully supranational deposit guarantee mechanism can balance out the lack of political willingness for such a scheme but only temporarily as its effectiveness will be constantly under question. Apart from promoting the supranational nature of EDIS, significant risk sharing must come hand in hand with risk minimization. Moral hazard is the main concern that has to be addressed primarily by limiting the concentration of sovereign bond holding on banks' balance sheets. In this way the potential market questioning of the solvency of banks will not be able to significantly affect a country's fiscal situation and vice versa. The "cleaning" of banks should also be intensified with the continuation of the NPLs reduction process before banks can be full members of the EDIS mechanism (Schoenmaker, 2018).

The regime change attempted has not yet been achieved but many steps towards this direction have been taken. The newly established structures of the banking union can only be fully tested under conditions of a new potential banking crisis and once the three pillars are in place and fully functional.

So far, the building of a more resilient European banking sector has stumbled upon the lack of political willingness and compromise to proceed on a scheme which entails risk mutualisation. The political landscape that emerged following the recent European elections of May 2019 would make one assume that the time is ripe now to promote further reforms as the Euroscepticism wave seems to have lost its momentum. Yet, the high degree of political fragmentation makes political consensus a challenging task. The upcoming end of term of the current ECB president, Mario Draghi, on October 2019 has also been a source of concern since he has played a vital role in shaping the monetary policy that kept the eurozone from collapsing. However, his replacement by the IMF managing director, and former French Minister of the Economy, Finance and Industry, Christine Lagarde, has prompted many discussions on how this choice will impact the course of reforms in the Eurozone. Since the main obstacles that hold behind the reform agenda are of political nature and given the fact that Mario Draghi has already laid out the monetary policy to be followed after his withdrawal, Lagarde can use this "space" to make a shift on economic policy and pursue the consent on the completion of the banking union.

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