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TOWARDS THE EUROPEAN BANKING UNION

Literature review

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Abstract

The financial crisis has made the need for a more integrated regulatory and supervisory framework for the financial services sector evident. An important step towards this aim is the establishment of the Single Supervisory Mechanism. European leaders have committed to moving toward a banking union, in which bank regulation and supervision, deposit guarantees, and the handling of troubled banks will be integrated across at least the euro area and possibly across the wider European Union. This paper provides an overview of research on this topic. We also identify important future research questions that emerge from both the literature and the current debate.

1. THE NATURE AND SIGNIFICANCE OF BANKING UNION

The concept of a banking union is an analogy to the monetary union that already exists in the euro area and the political union toward which many members strive.
Douglas (2012) considers that in generally the banking union refers to a structure under which nations coordinate their banking systems in at least three ways:

- Common regulation and supervision of the banking system. This means applying the same rules to banks in different countries and supervising compliance with these rules in a common manner, overseen by a single ultimate authority. National supervisors may retain substantial powers, delegated from the ultimate authority and subject to its intervention. The common approach may be limited to the dominant banks, with smaller banks remaining subject solely to national authority, at least in the ordinary course of activity.
- Common management of the "resolution" process for troubled banks. When a bank is in danger of insolvency, the problem may be resolved through a restructuring process that includes liquidity assistance, capital injections, or other forms of aid. A restructuring into a "good bank" and a "bad bank" will often be part of the solution. In the event of actual insolvency, decisions need to be made about how any losses are divided between investors, creditors, trading counterparties, taxpayers, deposit guarantee funds and other parties. Authorities may also step in to manage the bankruptcy or similar insolvency proceedings, if necessary to preserve the functioning of the financial system. Resolution processes in Europe remain essentially at the national level, with some cross-border cooperation for international banks. In a banking union, there would need to be a common process, most likely managed by a single resolution authority.
- A common deposit guarantee fund or a fund that backstops national guarantee funds. Currently, deposit guarantee funds are purely national. In addition, the rules about how protection is provided, to whom, and at what levels differ considerably across countries. Virtually all observers believe that a banking union would be incomplete without either a common guarantee fund or at least a fund that would guarantee the guarantors, so that depositors would no longer need to be concerned about whether their national guarantee systems would remain solvent.

At the European Council on 28/29 June 2012, European Union leaders agreed to deepen economic and monetary union as one of the remedies of the current crisis. At that meeting, the leaders discussed the report entitled 'Towards a Genuine Economic and Monetary Union, prepared by the President of the European Council in close collaboration with the President of the European Commission, the Chair of the Eurogroup and the President of the European Central Bank.

Van Rompuy (2012) set out the main building blocks towards deeper economic and monetary integration, including banking union:

- An integrated financial framework to ensure financial stability in particular in the euro area and minimize the cost of bank failures to European citizens. Such a framework elevates responsibility for supervision to the European level, and provides for common mechanisms to resolve banks and guarantee customer deposits.
- An integrated budgetary framework to ensure sound fiscal policy making at the national and European levels, encompassing coordination, joint decision-making, greater enforcement and commensurate steps towards common debt issuance. This framework could include also different forms of fiscal solidarity.
- An integrated economic policy framework which has sufficient mechanisms to ensure that national and European policies are in place that promote sustainable growth, employment and competitiveness, and are compatible with the smooth functioning of EMU.
- Ensuring the necessary democratic legitimacy and accountability of decision-making within the EMU, based on the joint exercise of sovereignty for common policies and solidarity.

James (2012) noticed that in the early 1990s, there was already the strong conviction that a single system of banking supervision was a key element in the construction of monetary union.

Constâncio's (2013) opinion is that the conviction was based on the relatively logical observation that the single currency would deepen financial interdependence in Europe and so require an integrated system of supervision. It was also in line with the prevailing model at the time of banking supervision being entrusted to the central bank. And although in the end a different approach prevailed, the force of this conviction explains why the EU Treaty left open the possibility – through Article 127(6) – to give supervisory powers to the ECB based on a unanimous decision of the Member States

Padoa-Schioppa (1999) wrote: "*I am convinced that in the future the needs will change and the multilateral mode will have to deepen substantially. Over time such a mode will have to be structured to the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the euro area to be as prompt and effective as it is within a single nation*".

That said, those like Padoa-Schioppa could not have complete foresight about how monetary union would evolve. The crisis fulfilled new issues, from which the authorities learned. The events of recent years have revealed a variety of weaknesses in the governance of the financial sector that were not foreseen before 1999 – and that also need to be addressed through common solutions.

Constâncio (2013) believes that the Banking Union we are aiming for today goes beyond purely banking supervision and should comprise the next five elements:

- First, a single rulebook for banks.
- Second, a single framework for banking supervision.
- Third, a single mechanism for resolving banks, funded by levies on the sector itself.
- Fourth, a common backstop in case temporary fiscal support is needed.
- Fifth, a common system for deposit protection.

2. WHY A BANKING UNION?

Sapir (2012) underlines that currently, bank supervision, resolution and deposit insurance arrangements in the European Union are still essentially national matters. The joint sovereign debt and banking sector crisis that has affected the euro area for several years has shown that this state of affairs is unsustainable.

Douglas (2012) shows that there are at least five main reasons why Europe is committing itself to a banking union. For the most part the implications of these various rationales are consistent, but there are also tensions between them. Key structural choices about the banking union will often hinge on the prioritization of these various objectives:

- Dealing with existing bank weaknesses that contribute to the euro crisis.
- Reducing the risk that banking will contribute to later stages of the euro crisis.
- Restoring the effectiveness of the monetary policy of the ECB.
- Reintegrating the European banking system.
- Fixing long-standing problems with the "single market" in banking in the EU.

Mersch (2013) focuses on three specific reasons for the establishment of an European Banking Union: first, delinking sovereigns and banks and fostering the reintegration of financial markets, second, avoiding national bias in supervision, and third, restoring the proper transmission of monetary policy.

Mersch (2013) believes that the establishment of a Banking Union would help to break this negative feedback loop between sovereigns and banks.

A single supervisor with a truly European focus could rebuild depositor and investor confidence. A central supervisor will not be suspected of allowing banks to hide bad assets in some countries. Neither would a European supervisor insist on national asset and liability matching, which increases fragmentation.

A Single Resolution Mechanism (SRM) – the necessary complement of the Single Supervisory Mechanism (SSM) – would avoid rising funding costs amid the risk of bank bail-outs by national governments, because it would become more common to resolve banks rather than save them. Hence, the private sector would bear the cost rather than the taxpayer. Any residual fiscal burden on sovereigns would be contained through a federal fiscal backstop.

The shift of supervision from the domestic to the European level, at which supranational interests are pursued, should also eliminate national bias and the associated supervisory forbearance that the financial crisis has brought to the fore. With hindsight, in the past supervisors were often lenient towards "national champions", constrained either by their mandates or by other national pressures, or perhaps both. Supervisors should be free from local pressures and interests; they should be able to independently assess the situation of individual banks in a systemic context.

From a monetary policy perspective, the Banking Union can relieve monetary policy of some of the tasks undertaken during this crisis, notably that of repairing and bypassing a clogged transmission channel. Early supervisory action limits the necessity to access central banks' financing, including non-standard measures.

Asmussen (2013) underlines the reasons for the establishing of the banking union:

- First, it will break the vicious feedback between weak banks and weak sovereigns;
- Second, it will help restore the proper transmission of monetary policy;
- Third, it will improve the incentives for proper supervision and limit the susceptibility to any prospective regulatory capture.

According to the Council of the European Union, a European banking union should therefore be set up and underpinned a true single rulebook for financial services for the Single Market as a whole. In view of the close links and interactions between Member States participating in the common currency, the banking union should apply at least to all Euro area Member States. With a view to maintaining and deepening the internal market, and to the extent that this is institutionally possible, the banking union should also be open to the participation of other Member States.

The financial stability objective could possibly be pursued with national financial policies and supervision but only at the expense of further integration. The resulting fragmentation of the single market is however clearly at odds with the EMU framework and the requirements of the single monetary policy. Similarly, financial stability cannot be safeguarded as financial integration progresses (with an ever greater degree of interconnectedness between financial institutions and markets) and financial sector policies remain a strict national competence.

Pursuing financial stability and integration as joint objectives requires true European level policies. This is particularly illustrated in a ECB working paper by Holthausen and Ronde (2004) showing that with increasing financial integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare, while not taking into account externalities of their supervisory practices on other countries. This leads to an under-provision of financial stability as a public good.

From a different perspective, Goodhart and Schoenmaker (2009) show, both in a model and using European data, that a coordination failure emerges when ex-post coordination among different national supervisors leads to an underprovision recapitalization of cross-border banks after a banking problem.

3. THE SINGLE SUPERVISORY MECHANISM, ONE OF THE PILLARS OF THE BANKING UNION

Van Rompuy (2012) considers that the establishment of the SSM constitutes the first step towards the creation of a banking union, aimed at creating an integrated framework for the financial sector as set out in the report "*Towards a genuine Economic and Monetary Union*" which was prepared by the Presidents of the Council, the European Commission, the Eurogroup and the European Central Bank.

Asmussen (2013) underlines that the agreement on the Single Supervisory Mechanism was reached between the European Parliament, the Council and the European Commission in March. Some technical details still need to be clarified.

The SSM will be a mechanism composed of the ECB and national competent authorities of euro area countries, with the national competent authorities of non-euro area Member States being able to participate through the establishment of close cooperation with the ECB, whereby the responsibility for specific supervisory tasks will be conferred to the ECB.

The ECB will be responsible for the effective and consistent functioning of the SSM.

Mario Draghi, The European Central Bank believes that the establishment of the SSM should contribute to restoring confidence in the banking sector and to reviving interbank lending and cross-border credit flows through independent integrated supervision for all participating Member States, on the basis of a system that involves the ECB and national supervisors.

Gros (2013) punctuate that the Single Supervisory Mechanism should correct the tendency of national supervisors to overlook problems at home. Although the European Central Bank (ECB) will directly supervise only a limited number of large banks, it will also exercise a '*droit de regard*' over the rest of the banking system. This should make it much more likely that bubbles and other threats to the systemic stability of the banking system will be recognized earlier.

Mersch (2013) submits that the proposed SSM Regulation confers on the ECB certain key supervisory tasks necessary for the supervision of credit institutions, notably all key tasks related to the prudential supervision of credit institutions, while all tasks not specified in the Regulation would remain within the competence of national competent authorities. Over the years, the ECB has built up a unique expertise in analyzing financial institutions and markets. In other words, the ECB has the means and, in conjunction with the national authorities, in most cases coinciding with the national central banks, the technical capability to carry out this complex task. Moreover, most of the national central banks already have prudential competence.

According to Constâncio (2013) there are three main reasons for the establishment of the SSM:

- A single supervisory mechanism is necessary because of the increasing interconnectedness between financial institutions and markets across the euro area over the past decade, be it through internationally active banking groups, bilateral trading exposures, or presence in the same market segments. The recent financial crisis demonstrated how quickly and powerfully problems in the financial sector of one country can spread to another).
- A second reason that justifies the banking union project regards the requirements for a smooth functioning of the single monetary policy. Its transmission mechanism across all member countries of the euro area requires an appropriate level of financial integration that ensures well performing cross border money markets. After a spectacular integration of money and financial in the first 10 years of monetary union that could have observed increasing fragmentation that only recently, after the creation of OMT program, started to abate. This fragmentation has impaired the transmission mechanism of monetary policy. It has, of course, several different causes but could have been mitigated in the first place if some elements of a banking union had been in place. This would have contributed to a stronger separation between sovereign and banks by creating enhanced confidence in the national banking sectors´ solvency and liquidity situations. This would happen not only as a result of an effective overall supervision but also would stem from the elimination of ring-fencing practices condoned or even incentivized by some national regulators.
- The third reason that justifies the banking union project has to do with the development of large financial imbalances within the euro area in both public and private sectors. In particular, the development of macro and external imbalances was significantly driven by private sector indebtedness, proving that the fiscal brake was not enough to guarantee macro stability and excessive heterogeneity among member states. This provided the rationale for the recent creation of a formal Macroeconomic Imbalances Procedure to monitor and promote timely policy measures to avoid the building up of macroeconomic instability in member states.

Goyal (2013) emphasizes on other potential advantages of SSM. First of all, it would facilitate a more systemic approach to tracking the buildup of risk concentrations, and contribute to achieving a comprehensive macro-prudential oversight of the euro area. Then, It would coordinate supervisory actions across countries, and ensure consistent application of prudential norms. In the same time, it would foster convergence of best practices across members, partly alleviate concerns of regulatory capture at the local level, and promote integration of the single market for financial services. In concrete terms, higher standards of supervision in place before the crisis might have meant a swifter identification of unsustainable build-up of risk in countries like Ireland or Spain and a more timely and effective intervention to diffuse such risk by applying higher capital buffers or restricting excessive concentrations.

4. HOW WOULD BANKING UNION HAVE HELPED DURING THE CRISIS?

Vítor Constâncio, Vice-President of the ECB speaks, at the conference entitled “Banking and Supervision under Transformation” (2013), that, in the recent financial crisis, how quickly and powerfully problems in the financial sector of one country can spread to another. This is especially the case in a monetary union. As a result, the problems in the banking sector might originate at the national level, but are more and more likely to affect other countries of the euro area as well, and may quickly threaten the stability of the entire euro area banking system. Such developments and the underlying financial structures can be best assessed by a central authority rather than through cooperation between national ones.

Also, Vítor Constâncio speaks at the conference entitled “Financial Regulation: Towards a global regulatory framework? (2013) about the fact that a banking union is important in case of a crisis.

To illustrate why the need of such a financial structure, it is helpful to think through how a genuine Banking Union in Europe could have helped both prevent and mitigate the crisis.

4.1.1. PREVENTING THE CRISIS

Turning first to prevention, one of the key causes of the crisis was the unacknowledged build-up of large private financial imbalances in the period from 1999 to 2008. They were unacknowledged because the governance framework that existed in Europe was focused exclusively on fiscal policies via the Stability and Growth Pact. This reflected the prevailing belief at the time that the private sector was composed of fully rational agents and was essentially stable and self-correcting – hence only the public sector could create instability.

This was of course a fiction: the private sector was where some of the largest imbalances were concentrated. Between 1999 and 2007, the ratio of the *public sector* debt to GDP in EMU declined on average by around 6 percentage points – while the ratio of the *private sector* debt to GDP increased by almost 27 percentage points. To give just one example, in Spain the ratio of private sector debt to GDP increased by around 75 per cent, while the ratio of public debt to GDP fell by around 35 per cent.

The key point for this discussion was that all of these private flows were being intermediated by the banking sector, which had become much more integrated as a result of monetary union. Hence the official bodies best placed to identify these growing risks, and act to prevent them, were national bank supervisors both in lending and borrowing countries. However, they lacked both the cross-border perspective and also the instruments to do so. After all, their mandates were national and did not extend to systemic risks building up for the euro area as a whole. In this context, Schoenmaker (2011) shed light the concept of trilemma. In his vision, he adapts the famous ’monetary trilemma’, which explains the impossibility of simultaneously achieving of the following three objectives: a fixed exchange rate, capital mobility and national monetary policy.

Goyal(2013) argues that a banking union would not have halted the sovereign debt crisis in some countries, but that a well-functioning banking union could have substantially weakened, if not broken, the adverse sovereign-bank-growth spirals, maintained depositor confidence, and attenuated the liquidity and funding freezes that followed.

The main reasons for the existence of a banking union prior to the crisis are:

- ➢ The rate cuts of the ECB would more likely have fed through to lower borrowing costs for the private sector.
- ➢ A strong banking union would also have limited the exposures of banks to

certain risks. For example, euro-area-wide supervisors would arguably not have allowed size, structure and concentration risks to grow as they did in countries such as Spain, Ireland, or Cyprus, or for general banking weaknesses to have accumulated in some other places.

- United States and other recent experiences suggest that supervision would have had to strive to be of a high standard. Merely reorganizing supervisory structures would not of itself have addressed the buildup of systemic risk or the too-big-to-fail problem.

4.2. HOW WOULD BANKING UNION HAVE HELPED?

Constâncio (2013) is sure that the crisis could have been prevented very easy by moving supervision and other national financial policies to the European level, and that is the only way the problem can be solved.

Supervisors can take a euro area wide view of the financial developments, identify the early build-up of the systemic risks, and use appropriate macro-prudential tools to counteract them. Had a single European supervisor existed prior to the crisis, it could have spotted the unsustainable growth in private sector debt and the excessive leveraging of banks' balance sheets associated with it – and hopefully taken early preventative measures.

4.2.1. MITIGATING THE CRISIS

Constâncio (2013) speaks about the role of the Banking Union in mitigating the crisis and emphasizes two key ways in which it would have been instrumental.

Firstly, it would have lessened the so-called "bank-sovereign loop" that drags down the fiscal sustainability of sovereigns. This loop is driven by bank bailouts or just by the expectation that sovereigns will have to bail-out struggling banks, which then increases borrowing costs for sovereigns and further drives up funding costs for banks. A Single Resolution Mechanism would avoid this by resolving banks rather than saving them and by making the private sector rather than the taxpayer pick up the bill. Moreover, any residual fiscal burden on sovereigns would be distributed across the euro area through the common fiscal backstop, the safety procedure put in place by a government or loan guarantee program which insures the debt of a company or its credit line.

Secondly, a Banking Union would have reduced the fragmentation in financial markets that holds back bank lending and economic growth. At present, market fragmentation is severely disrupting the transmission of the ECB's monetary policy. In some countries, changes in our main interest rate are being passed on fully by banks; in others, because bank funding is tight, interest rate changes are being passed on hardly at all. This is making credit very hard to come by or unduly expensive in some parts of the euro area.

Banking Union would limit financial fragmentation in a number of ways:

- An impartial supervisor conducting credible stress tests would lessen fears that banks are hiding bad assets in some countries.
- Depositors' confidence would be mitigated by harmonising deposit guarantee schemes.
- A supervisor with a truly European focus would never undertake actions that can encourage fragmentation.

5. HOW WOULD A BANKING UNION AFFECT MONETARY AND MACROPRUDENTIAL POLICIES

Elliott (2012) explains that the monetary policy could be quite significantly affected by a banking union, at least while the euro crisis remains an active problem. As noted, monetary policy achieves its principal effects by changing the availability and price of credit. Therefore, central banks rely on financial institutions to transmit moves on interest rate policy into the broader economy. Under normal conditions, the direct impact of central bank moves is very considerably amplified by the reactions of the banks. In the current crisis, it appears that a number of banks are hoarding any liquidity they can find, in order to have greater capacity to deal with potential runoffs of their deposits and bonds and to deter such runoff by showing that they can do so.

If European banks were perceived as safer due to the advent of a banking union, then they would be more prepared to redeploy the reserves they hold at the central bank by lending them out. Thus, the monetary transmission channels would be unclogged and monetary policy would work in more predictable and effective ways again.

In recent years, a consensus has developed that there has been a gap in regulation of the financial system, falling between monetary policy and other macroeconomic policies that operate at the level of the economy as a whole, and traditional prudential (or “safety and soundness”) regulation of individual financial institutions. New “macro-prudential” policies are being developed that operate at the level of the financial system as a whole, with the intent of reducing the frequency and level of damage to the wider economy from financial crises. (Traditional prudential regulation of individual institutions has been renamed “micro-prudential” policy to distinguish it.) Such policies would include system wide increases or decreases in capital or liquidity requirements for banks or the tightening or relaxation of credit standards for mortgages or other debt, such as by altering the maximum loan to value ratio5.

Creating a banking union would have pros and cons with regard to macro-prudential policy. It would make it distinctly easier to deal with credit bubbles or crunches that were broader than in a single country, but might make it somewhat more difficult for national authorities to tackle homegrown problems, if too little flexibility is provided for national responses. In addition, choices about the structure of the banking union would also tend to strengthen or weaken the role of various institutions in setting macro-prudential policy, with the ECB potentially the biggest winner from this change, simply because its role in overseeing the banks will almost certainly expand greatly.

Future decisions in this area could be quite important, as they have the potential to lower the risk of damaging bubbles in housing or other areas in the future. Avoiding such bubbles, and their very painful bursting, would make it substantially easier to operate a monetary union going forward.

Millar (2012) expresses some concern that the role of macro-prudential policy has not been given enough consideration in the design of the European supervisory mechanism, pointing out that there is no detailed discussion, for example, of the interaction of the existing European macro-prudential authority, the European Systemic Risk Board, and the ECB in its new supervisory role.

6. CONCLUSIONS

We can say that the role of a banking union was well evidenced in the present paper. The existence of a true banking union would have made a big difference both before and during the current financial crisis. But for further researches, there can be put certain questions, namely, if the banking union would have been already functional, what would have happened in practice? It is really effective a banking union? Supervision at European level will be functional or it will remain unchanged and will continue to work at a national scale?

We believe that the most important pillar of the banking union is the Single Supervisory Mechanism, and his establishment must be seen in a broader perspective. SSM, the key element of the European Banking Union which is itself embedded in the process of further European integration. Among the achievements on the path towards a fiscal and economic union in Europe, we should reap the benefits from the recent dynamics of institutional reforms by building the Banking Union.

The corresponding tightening of economic links will ultimately require institutional adjustments with a view to democratic accountability regarding the transfer of sovereignty; this concerns the European Parliament and the European Commission and will require treaty adjustments. This is the price for a well-functioning Monetary Union, in which the ECB focuses on price stability while ensuring that financial stability does not stand in the way of its primary objective.

For the ECB, and for the more seasoned authorities that carry out supervision in the Member States, the new supervision mechanism will represent a sea-change, a "new frontier", comparable in many ways with that of creating a new currency and a new central bank.

The ECB is keenly aware of this and consequently puts an enormous focus on the careful, yet efficient, execution of the preparatory work, drawing on all available sources of expertise, both internal and external.

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