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Article

Banking Union: Meaning and implications for the future of banking[☆]

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This article aims at providing an overview on the latest developments regarding the European Banking Union – in particular, what the meaning is of the achievements so far and what the implications are for the future of banking and the financial system in the Eurozone.

We start with briefly looking back at the rationale for Banking Union. This has been recently addressed in several speeches.[1] Keeping supervision at the national level in both creditor and debtor countries contributed to the large imbalances that built up before the crisis.[2] Contrary to the "it was mostly fiscal" view of the crisis, private financial sector developments, intermediated by banks, were at the heart of developments in peripheral countries. This is why Banking Union is the necessary institutional response.

Indeed, the current account deficits in most peripheral countries were, in fact, led by very large capital inflows coming from core countries with capital account surpluses. The exposures of banks from core to peripheral countries more than quintupled between 1999 and 2008. Competitiveness losses in the periphery were simply the mechanism that connected the capital account surplus and the current account deficit – that is, an appreciation of the real exchange rate caused by economic over-heating. As John Williamson explained, it is impossible to have "an immaculate transfer" from capital inflows to current account deficits.[3]

Without unified supervision, national supervisors found it impossible to contain these developments. They had to respect the single market rules and lacked the macro-prudential tools to offset the effects of large capital inflows. But, by introducing supervision at the European level, the Banking Union offers a possibility to better pre-empt such developments in the future – and therefore to better protect the real economy and financial stability in the whole area.

The article will concentrate on two more practical and immediate goals of the Banking Union: (i) to eliminate the bank-sovereign loop and thereby reduce financial fragmentation; (ii) to repair banks' balance sheets, unclog the impaired credit channel and consolidate the on-going mild economic recovery. Lastly, the article will also reflect on some implications of the Banking Union for the future of the financial system and for the role of macro-prudential policies.

1. The bank-sovereign feed-back loop

What makes the link between sovereigns and banks important is the fact that, during the crisis, weak banks weakened the sovereign

☆ Speech published previously in Constâncio V. Banking Union: meaning and implications for the future of banking. Master in Banking and Financial Regulation, Navarra University, Madrid, 24 April 2014 [consulted 01/26/2015]. Available at: http://www.ecb.europa.eu/press/key/date/2014/html/sp140424_1.en.html and reprinted in this publication with the author's permission.

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[1] **Banking union and the future of banking,** *speech by Vítor Constâncio, Vice-President of the ECB, at the IIEA Conference on "The Future of Banking in Europe", Dublin, 2 December 2013;* **Towards the Banking Union,** *speech by Vítor Constâncio, Vice-President of the ECB, at the 2nd FIN-FSA Conference on EU Regulation and Supervision "Banking and Supervision under Transformation" organised by the Financial Supervisory Authority, Helsinki, 12 February 2013;* **Towards a European Banking Union,** *speech by Vítor Constâncio, Vice-President of the ECB, Lecture held at the start of the academic year of the Duisenberg School of Finance, Amsterdam, 7 September 2012 (ECB website).*

[2] See **"The European Crisis and the role of the financial system",** *speech by Vítor Constâncio, Vice-President of the ECB, at the Bank of Greece conference on "The crisis in the euro area" Athens, 23 May 2013 (ECB website).*

[3] See Williamson, J., "Comment", in Bergsten, F. (ed), International Adjustment and Financing: The Lessons of 1985–1991, Institute for International Economics, 1991, p. 243.

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and vice-versa. Some governments had to support their national banks with negative consequences for their own debt. In other cases, it was the weakness of the sovereigns, which had low ratings and difficulty in accessing the financial markets, that enfeebled domestic banks, who saw their ratings tumble and their funding become more difficult. At the same time, as the sovereign debt crisis in 2010 deepened and triggered contagion effects across countries, banks' holdings of domestic government debt rose, thereby increasing their dependence of the sovereign's fortunes.

These different forms of dependence created a negative feedback loop that induced financial fragmentation among members of the euro area. It contributed to impairing the credit channel and the transmission of monetary policy. Monetary policy interest rates were not properly transmitted and deposit and credit rates became too divergent among countries. It was as though interest rates were not related to the same currency and that banks were not operating in a monetary union.

The ECB did its utmost to repair the transmission of monetary policy and restore the credit channel. The OMT initiative proved effective in reducing fragmentation. More recently, world market developments, combined with the perception that the tail risk of euro redenomination has been overcome, have contributed to an inflow of capital into European periphery assets, further mitigating fragmentation of financial markets in the euro area.

Severing this bank-sovereign nexus and reducing fragmentation was also the initial trigger for establishing the Banking Union. The idea of launching the Single Supervisory Mechanism (SSM) was born during the June 2012 European Council meeting. It was a consequence of the decision that the ESM could directly recapitalise weak banks, thus taking some fiscal pressure off sovereigns. But if at a European level were to assume liability for European banks, it also had to assume control: hence the need for a European supervisor. It was only later, through the Van Rompuy Report, that the concept of a fully-fledged Banking Union appeared, which would contain a Single Resolution Mechanism (SRM) and a future possible Deposit Guarantee Scheme as well. Thus, out of a desire to sever the bank-sovereign nexus, we achieved what can be seen as the biggest institutional reform since the inception of the euro, with implications that go well beyond the problem of the bank-sovereign loop.

Somewhat ironically, however, this widening of the focus caused the initial objective to become obscured. The question of European direct recapitalisation – for which a framework has still not yet been decided – ceased to be the main focus of attention. In the view of many commentators, the SRM became the expected instrument to achieve the separation between banks and sovereigns. But this is a somewhat misleading view.

Both components of the Banking Union, the SSM and the SRM, contribute to reducing the negative feed-back loop between banks and sovereigns. The SSM is the first building block. One important objective of the SSM Regulation is to improve the quality of supervision and to ensure homogenous supervisory standards across the euro area. The SSM, from its operational start in November, will base its supervisory work on the best supervisory practices. The general principles, processes and methodology for supervision will be described in the SSM Supervisory Manual. A comprehensive public version is being prepared.

The SSM will lead to a convergence of rules and standards and a harmonised supervisory culture. For example, by imposing common principles about methods and parameters that improve the reliability of banks' internal models, it will address the problems created by differences in the way that banks calculate risk-weighted assets. Importantly, the SSM will ensure that the same risks are given similar weights – recognising, of course, that the same types of risk can have different manifestations in different markets, reflecting the local economic situation. There will also be a harmonised treatment of non-performing exposures and provisioning rules, which at present varies between jurisdictions and are not directly comparable for investors. More generally, the substantial compliance costs, from having to observe different sets of rules and different sets of reporting requirements, as well as having to interact with several different authorities, will be reduced.

Under the SSM, direct supervision of significant banking groups will be undertaken by joint supervisory teams. These will comprise supervisors from both the ECB/SSM and National Competent Authorities, enabling a fully integrated approach to the supervision of cross-border banks. Compared with supervision at national level, this integrated approach will enable the SSM to detect excessive risk-taking and the cross-border externalities associated with it, and therefore to be proactive if local financial situations develop into threats to broader financial stability.

These changes in the supervisory framework should contribute to reducing fragmentation, by creating a level playing field for financial institutions and spreading best practices across borders, thus removing the barriers that existed in the past. An important consequence of those changes, which is essential for de-linking banks from sovereigns, is the trust that, for banks both directly and indirectly supervised by the SSM, a genuinely European financial system is being developed. This can help normalise interbank markets and overcome financial fragmentation.

That said, high standard banking supervision does not focus on preventing bank failures at any cost. In fact, to effectively perform its tasks, a supervisor must also be able to let failing banks exit the market. This is the reason why the SSM has also been given the competence to withdraw the authorisation to operate from credit institutions. However, given the role of banks in the financial system and in order to safeguard financial stability, the supervisor has to feel confident that the resolution of banks can be conducted in an orderly fashion. This brings me to the second pillar of the Banking Union, the SRM.

The establishment of the SRM is the second crucial step towards addressing financial fragmentation and breaking the bank-sovereign nexus. This is because the orderly resolution of banks, even large ones, helps avoid costly rescues by sovereigns that may endanger their own finances.

The SRM creates a single authority responsible for the resolution of banks in the euro area and participating Member States. This will enable swift and unbiased resolution decisions, which will address notably cross-border resolution cases in an effective manner. In this respect, the SRM should be viewed as a necessary – and logical – complement to the SSM. It would indeed be ill-advised to elevate the responsibility for supervision to the European level, while keeping resolution at the national level. This would create a mismatch of responsibilities, undermine the credibility of the SSM as supervisor, and delay the resolution of banks – a task that has to be done swiftly.

An important element of the SRM is the Single Resolution Fund, which will be financed via levies on the banking sector and gradually mutualised. Starting with national compartments, it will become a truly single European Fund in the course of eight years. By mutualising the cost of bank resolution, this approach will loosen the link between domestic banks and their sovereigns and further level the playing field. A shortcoming of the SRM, however, is the absence of a clear common financing arrangement that would provide additional temporary resources when needed.

In practice, however, the SSM and SRM may not be sufficient to completely sever the ties between sovereigns and their domestic banks. The effect of SSM and harmonised supervision on trust among banks may be more limited than expected, while, more