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Article

A banking union for Europe: Making a virtue out of necessity

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ABSTRACT

Banking union is the most ambitious European project undertaken since the introduction of the single currency. It was launched in the summer of 2012, in order to send the markets a strong signal of unity against a looming financial fragmentation problem that was putting the euro on the ropes. The main goal of banking union is to resume progress towards the single market for financial services and, more broadly, to preserve the single market by restoring the proper functioning of monetary policy in the eurozone through restoring confidence in the European banking sector. This will be achieved through new harmonised banking rules and stronger systems for both banking supervision and resolution that will be managed at the European level. The EU leaders and co-legislators have been working against the clock to put in place a credible and effective set-up in record time, amid intense negotiations (with final deals often closed at the last minute) and very significant concessions by all parties involved (most of which would have been simply unthinkable just a few years ago). Despite the fact that the final set-up does not provide for the optimal banking union, we still hold to its extraordinary political value and see its huge potential. By putting Europe back on the right integration path, banking union will restore the momentum towards a genuine economic and monetary union. Nevertheless, in order to put an end to the sovereign/banking loop, further progress in integration is needed including key fiscal, economic and political elements.

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1. Introduction

The outbreak of the financial crisis in early 2007 showed that the European institutional architecture was weak to properly address the new structural risks. The lack of predictable and harmonised rules to handle the banking crisis together with defensive ring fencing supervisory practices resulted in an increasing financial market fragmentation whereby the bank's funding cost became highly dependent on the strength of their sovereign, thus reinforcing a feedback loop between banks and sovereigns. A widely used way to explain this process was that banks were "European in life but national in death".

Deficiencies in the European governance are not new. There is vast literature stating that the European Monetary Union was flawed. Perhaps, it would have rather been qualified as a union of banknotes. The euro is the mean to ensure that we can pay with the same currency all over the 19 Member States of the monetary union. However, this crisis has revealed that there are differences between the "euros" of each Member State. The lack of perfect money's fungibility reflects financial fragmentation. Those differences appear because two assets which should be completely fungible and interchangeable within the monetary union are not perceived as of the same quality. Instead of assessing the asset quality by taking into account individual entity's risk considerations, a purely country risk prevails and this is in essence contrary to the spirit of integration. Therefore, until the money is truly fungible, we will not be indifferent having deposits in one country or another, and we will not live in a true monetary union.

Abbreviations: AQR, Asset Quality Review; BRRD, Bank Recovery and Resolution Directive; CET, Common Equity Tier; COREPER, Committee of Permanent Representatives to the Council of the European Union; CRD IV, Capital Requirements Directive IV; CRR, Capital Requirements Regulation; DG, Directorate General; DGS, Deposit Guarantee Scheme; DGSD, Deposit Guarantee Schemes Directive; EBA, European Bank Authority; EC, European Commission; ECB, European Central Bank; ECOFIN, Economic and Financial Affairs Council; ECON, Economic and Monetary Affairs Committee of the European Parliament; EIOPA, European Insurance and Occupational Pensions Authority; EMU, Economic and Monetary Union; ESA, European Supervisory Authority; ESFS, European System of Financial Supervisors; ESM, European Stability Mechanism; ESMA, European Securities and Markets Authority; ESRB, European Systemic Risk Board; EU, European Union; JST, Joint Supervisory Team; MoU, Memorandum of Understanding; NRAs, National Resolution Authorities; NSAs, National Supervision Authorities; NST, National Supervisory Team; RAS, Risk Assessment System; SRB, Single Resolution Board; SREP, Supervisory Review and Evaluation Process; SRF, Single Resolution Fund; SRM, Single Resolution Mechanism; SSM, Single Supervisory Mechanism; TFEU, Treaty on the Functioning of the European Union.

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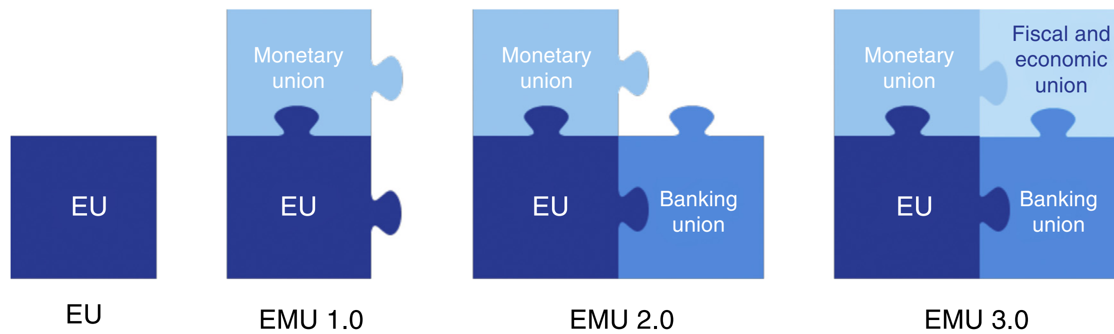

Fig. 1. Building-up a genuine economic and monetary union.

Source: BBVA Research.

Against this background, banking union emerges as another step forward towards financial integration and towards the perfection of the euro construction. It can be qualified as a major milestone as it implies moving well beyond the harmonisation of rules, which already applies to the European Union of 28 Member States. Indeed, it involves a significant transfer of sovereignty from countries sharing a common currency to new supranational authorities, thus enhancing the Economic and Monetary Union (EMU) governance. All with a big component of private-sector solidarity, never before seen in Europe. It is worth noting that this project is forward looking, designed to solve not the problems of the past but rather to prevent and address those that may arise in the future.

In this paper we explain why banking union emerged as the definitive solution to the European crisis conundrum, what type of banking union was finally politically possible and how it was built up in record time. Even if not fully fledged and complete, the agreed banking union 1.0 is fit for purpose at this stage and will deliver significant benefits already in the short-term, by helping mitigate the two biggest threats to the EMU at this moment: financial fragmentation, which still remains at unacceptably high levels (European Central Bank, 2014) and the vicious circle between sovereigns and their banks. Born out of necessity, the banking union 1.0 that the leaders have recently agreed upon had been politically unfeasible for many years and would had been simply a dream for many EMU fathers. Even if it will not suffice to fully solve these two problems, and will therefore require further development (a banking union 2.0 with a common safety net) and some other complementary measures (Sicilia et al., 2013) it still represents the biggest cession of national sovereignty since the creation of the euro, and thereby stands as a true breakthrough in the quest towards a fully integrated Europe.

2. Preamble: the necessity and the virtue

The creation of the European Monetary Union (EMU) and the introduction of its single currency in 1999 symbolised a crowning of the Single Market project and marked the starting point for the most impressive financial integration process ever undertaken in Europe (Padoa-Schioppa, 2002). In the first nine years of the euro, integration indicators showed an extraordinary improvement, especially in the wholesale domain, assisted by enhanced pan-European market infrastructures and a significant regulatory convergence promoted under the Financial Services Action Plan (2001–05). Between 2000 and 2008 total intra-EU foreign exposures grew over 200%, and by 2007 40% of the euro area's interbank claims stood against non-domestic EU banks. Although a genuine integration process remained elusive for the retail market (mainly due to regulatory, fiscal and institutional barriers across Member States), the strong convergence registered in banks' funding costs translated into reduced spreads in deposit and loan rates across the euro area. There was probably an overshooting in the convergence of sovereign spreads that prevented market discipline from working properly during the boom years and exacerbated the subsequent correction (as shown by the case of Greece), but overall the convergence process was healthy and consistent with a single currency in a single, integrated, financial market (Fig. 1).

But a significant part of the integration achieved between 2000 and 2008 was lost in a flash with the outbreak of the crisis. By the time it had fully spread over to Europe, spurring a deep sovereign debt crisis in 2011, integration levels were back to those seen before the introduction of the euro, putting at risk its achievements as well as those of the internal market. Between 2007 and 2011, the average exposure of core European Union banks to periphery banks dropped by 55% and the percentage of cross-border collateral used for Eurosystem credit operations dropped by one third (returning to 2003 levels). It is important to note that part of this fragmentation was the result of supervisory actions tending to ring fence the core banking systems and protect them from potential contagion from the periphery. These actions, although rational from a purely domestic financial stability mandate, validated market concerns at that moment and put at risk the euro itself. They created a financial stability problem far larger than the one they intended to avoid. These supervisory measures even triggered a query by the Commission on possible (and illegal) limits to capital follows.

In the summer of 2012 the situation was so critical for certain sovereigns that only the European Central Bank (ECB) strong determination and supporting action eased the rumours of a break-up of the euro. This was instrumental in stopping financial fragmentation, together with the announcement of a common strategy towards a genuine economic and monetary union, which included as the key first step the creation of a banking union (Abascal et al., 2013).

By September 2012 the European Commission (the Commission) had already tabled its proposal for the first master pillar of banking union: a Single Supervisory Mechanism. As for the other master pillar, a Single Resolution Mechanism, the proposal would be tabled at a later stage, in July 2013. These two pillars have already been passed by legislators, with a speed of action which constitutes an absolute record by any EU legislative standards. The single supervisor became fully operational in November 2014 after the identification of the legacy assets of the European banking industry, a key precondition for a safe and credible banking union. Moreover, the ECB gains not only microprudential powers but also some macroprudential tools to address any financial stability concern at the eurozone level, which would contribute to address financial fragmentation problems. The Single Resolution Board was set up in January 2015 but it will not undertake any resolution action until January 2016, when a single fund will also be constituted.

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