FINANCIAL REGULATION

Completing banking union

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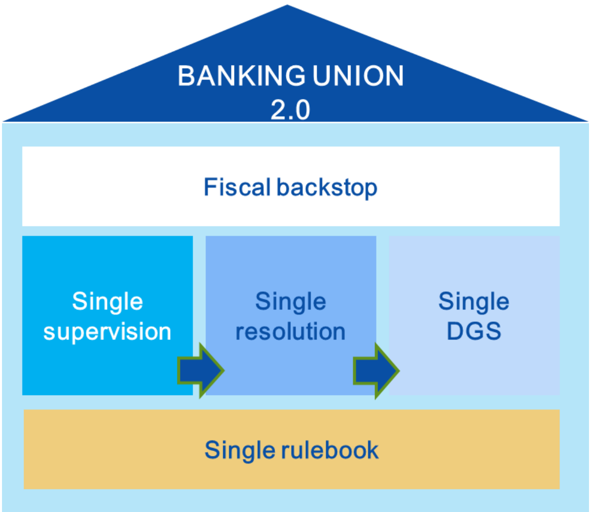
Background

The banking union project was launched by European leaders in June 2012, as a response to the increasing lack of confidence in the viability of the euro. The immediate aim was to send a signal of unity to the markets and of support for the ECB in its strategy of doing “whatever it takes” to preserve the integrity of the single currency. Together with the ECB’s unconventional policies, banking union provided the appropriate medium-term vehicle for putting a stop to financial fragmentation and breaking the vicious circle of sovereign-banking in the eurozone. In order to achieve this, responsibility for supervision and the management of a possible banking crisis had to be transferred to European institutions, so as to preclude narrow national interests from again prevailing over the eurozone as a whole in the future[1]. Thus banking union is the opportunity to remedy a deficiency in the institutional architecture of the euro which could not be put in place when it was created due to lack of consensus.

What makes up an optimal banking union?

We need to distinguish between an optimal banking union (one under which financial integration can be restored and the vicious circle broken once and for all) and the form of banking union it has actually been possible to achieve and implement in the initial phase, which we will call banking union 1.0.

Figure 1
MAIN ELEMENTS OF THE OPTIMAL BANKING UNION 2.0



Source: BBVA Research

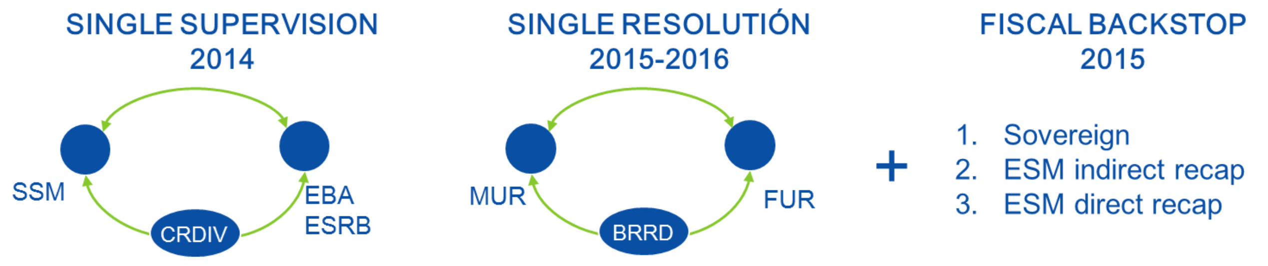
1: Schoenmaker (2011) coined the term “financial trilemma” to illustrate how it is impossible to ensure financial stability and financial integration unless centralised mechanisms exist to supervise and manage a crisis.

The roadmap towards an optimal banking union is shown in the so-called Four Presidents report (June 2012). This report lays out a strategy to achieve banking, fiscal and economic union in ten years. The first step in this roadmap is the (optimal) banking union, which rests on three basic pillars: single supervision, single resolution and single deposit guarantee. These three pillars depend on a solid regulatory foundation (the single rulebook) which provides shared, standardised rules in three areas: banking solvency (CRDIV-CRR), crisis management and banking resolution (BRRD) and deposit cover (Deposit Guarantee Fund Directive).

What stage is banking union at now?

After the first announcement of banking union, the European co-legislators, Parliament and the Council of the EU, worked against the clock to put together a credible proposal that would convince the markets. The positions at the outset of some key players were such that it was thought that it would be impossible to reach the necessary agreements. Finally, however, pragmatism prevailed in the search for the common good, and a reasonable framework for supervision and banking resolution, centralised throughout Europe was agreed upon.[2] Within this framework (banking union 1.0), the member states of the banking union[3] now have a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM) to supervise their banks and manage any eventual banking crisis.

Figure 2
ELEMENTS OF THE CURRENT BANKING UNION (BANKING UNION 1.0)



Source: BBVA Research

From this perspective, banking union 1.0 represents a huge leap forward in the history of Europe: the greatest cession of national sovereignty since the creation of the euro. The SSM, fully operative since November 2014, is made up of the ECB (which has the final word) and national supervisors. The ECB will directly supervise the 123 most significant banks in the eurozone, while the rest will be supervised by their national authorities, although the ECB can take over direct supervision of any of them if it considers this necessary. When it comes to the SRM, which has been operating since January 2015, its governance and organisational structure to a large extent replicate those of the SSM, with the new Resolution Board in charge of resolving the most important banks and those which are less important but whose resolution requires the involvement of the new Single Resolution Fund (see below).

2: For more information about how banking uni0n 1.0 came about, and its main components, see the BBVA Research working paper "A banking union for Europe: making a virtue out of a necessity" (2014).
3: The eurozone countries are required to take part. The remaining EU countries may choose to join if they wish.

Was banking union created to manage the toxic assets left over from the crisis?

No, banking union is a forward-looking project. It is not the vehicle which is expected to manage the problems inherited from the recent crisis. This legacy issue is currently being dealt with, and should be solved ahead of 2016. That is why the ECB carried out an exhaustive examination of the banking sector before taking on its full role as a single supervisor in order to quantify the legacy problem (i.,e the capital needs).

Figure 3
ADRESSING THE LEGACY ISSUE BEFORE THE SRM GETS STARTED

Source: BBVA Research

The banks which showed a capital shortfall in the AQR and/or the stress test (in which the EBA took part as well) will have to cover these deficiencies in the first half of 2015. If they do not manage to raise the necessary capital on the markets, they will have to apply a bail-in on their shareholders and subordinate creditors before they can have recourse to their national resolution fund, and if this is still not enough, before they can request money from their national treasury. If the sovereign state cannot meet the amount of help requested because it does not have access to the markets, it can request a loan from the European Stability Mechanism (ESM), as the Spanish government did in 2012 (the so-called indirect recaptialization). If the sovereign state has serious fiscal difficulties and cannot pay for a loan from the ESM, then, as a last resort, it can ask the latter to inject capital directly into the bank which is in dire straits, subject to an initial franchise and strict conditions, such as the prior application of a minimum 8% bail-in over liabilities, including all the institutional creditors (senior, uncovered deposits) and even the Deposit Guarantee Fund (inasmuch as it bears subsidiary liability for covered deposits).

How will future crises be managed under Banking Union 1.0?

The new authority, the Single Resolution Board, started to carry out its preventive role in January 2015, but it will not acquire its full resolution powers until January 2016, when the institutions affected by legacy problems should already be properly recapitalised (or liquidated if resolution is not viable). From that moment on, the total bail-in tool in the Resolution Directive (the BRRD) also comes into force, according to which, before having recourse to the private resolution fund, or, naturally, to any kind of public aid, shareholders and debt holders (subordinated and junior) will have to assume a cost of up to at least and 8% of the liabilities. After the bail-in, the Single Resolution Fund can be tapped, up to a limit of 5% of the bank's liabilities as well. This Single Resolution Fund will be 100% European and will have a total ex ante capacity of EUR55bn by 2023, but not before then (see the next question). As of 2023, if there are still costs to cover from the resolution process, help can be sought from a public European mechanism which has yet to be defined (the fiscal backstop) and which is unlikely to involve the ESM, since the latter was created to rescue member states in difficulties, rather than banks. Along the transition, between 2016 and 2023, given that a shared fiscal backstop will not yet exist, bridging finance will be available from national sources, and as a last resort, the ESM might directly recapitalise distressed banks if all the previous loss-absorption mechanisms (bail-in, resolution fund) are not sufficient, and if the sovereign state is not in a position to cover the remaining costs of the resolution process nor to ask the ESM for assistance through an indirect recapitalization.

Why is the current state of banking union not ideal and what does it need to make it so?

The ultimate purpose of banking union is to break the vicious circle of sovereign-banking and achieve financial integration. Once the transition towards full provision and mutualisation by the Single Resolution Fund is complete, by 2023, banking union 1.0 could achieve these aims if the certainty exists that all future banking crises will be of a “reasonable” size, However, for larger crises we cannot rule out that the multiple mechanisms put in place for the private absorption of losses (bail-in, single fund) may not be enough to cover the costs of banking resolutions. In this scenario, it is crucial to have a robust fiscal backstop that will protect financial stability and prevent the vicious circle. Similarly, in a context of severe crisis, we need a powerful shared deposit guarantee fund to prevent banking runs, and, once again, the vicious circle.

In order to be wholly credible and stable in the medium and the long term, banking union 1.0 needs to be supported by standardised fiscal containment and a shared deposit guarantee fund. Both of these require aspects of fiscal solidarity for which there is as yet no consensus in Europe, which is why they were not included in the initial framework. In some ways, full banking union goes hand in hand with fiscal union, and for this reason it is no coincidence that the next step in the route map of the Four Presidents' report is precisely that: fiscal union. However, although we need to make progress in this direction without delay, it has to be said that neither completing banking union 1.0, nor making progress towards fiscal and economic union, seems to be a priority on the current European agenda. At the moment, all attention is focused on the European Commission’s new star project, the capital markets union which, although potentially a support for banking union in achieving a real single financial market, can in no way take the place of complete banking union in providing the euro with the right institutional architecture to deal successfully with future crises.

We should bear in mind that some of the agreements reached in the framework of banking union 1.0, specifically in the area of provisioning and use of the single fund, have had to be passed by means of an intergovernmental agreement, since they are incompatible with the Treaty. The definitive architecture of an optimal banking union would require a reform in the Treaty, allowing the deposit guarantee funds to merge and giving their component parts more legal representation. The final destination of banking union will be a genuinely integrated financial services market, not only in the wholesale segment, but also in retail. The steps that have been taken in the area of supervision and banking resolution are decisive, but they will need to be rounded out in the future with a more comprehensive, yet more compact, framework.

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