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Banking Union: integrating components and complementary measures

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Abstract

The crisis has led to increased financial fragmentation and revealed the link between sovereign and national banking risks, whose persistence over time would be incompatible with the euro. The solution to these problems must be the banking union, which should be constructed at the same time as the current crisis is being resolved. The process will be eventually complemented by the creation of cross-border banks. The process of the banking union does not have an optimal design, it will be long and will generate tensions during the transition period, but it is politically feasible. In the end, we will have a Europe that is much more integrated from the monetary, banking, fiscal and political points of view.

Key words: banking union, Europe, supervision, fragmentation.

JEL: F330, F340, F360, G180, G210

1. Why is the banking union necessary?

Five years after the start of the international financial crisis, while the Eurozone countries continue to debate the best way of making progress in a union where they support each other in a more or less orderly fashion and are working broadly in the same direction, the financial markets have separated. Examples of the financial fragmentation in Europe today include an interbank market where transactions are practically at a standstill, and where there is still a preference for domestic investment and collateral and a high rate of dispersion between the interest rates of new retail loans. Although the extreme financial tensions of the spring of 2012 have eased, the persistence over time of these differences - financial fragmentation - is quite simply **incompatible with the existence of the monetary union**; and in the future it could even lead to its break-up if they are not dealt with correctly.

That is why the banking union is urgently necessary. It is the next stage of the process of European construction that has been managed through cautious steps forward for more than six decades. Its announcement in June 2012, and subsequent support by the ECB with the announcement of the conditional sovereign bond purchase program under the rescue plan, were fundamental in boosting the markets and anchoring expectations of a solution to the sovereign crisis. And it has been a success. It is no small matter that since the summer of 2012 there has been a significant improvement in financial tensions, and that events that at other times would have triggered a new crisis in Europe, such as the disorderly banking resolution in Cyprus, did not lead to contagion to other countries.

What is the origin of financial fragmentation? In any crisis a certain degree of fragmentation is normal as risk aversion increases and more importance is given to asymmetric information between creditors and debtors. In a framework in which the economic starting point of the different countries varied, with some more affected by domestic bubbles (as in the case of the real estate sector in Spain and Ireland) than others, it is normal that sovereign risk spreads widen. It is also to be expected that given the uncertainty regarding cyclical expectations and doubts regarding exposure to international contagion by toxic subprime products in financial institutions, this situation leads to tension on the interbank market and increases issuance costs in the private sector.

But in the Eurozone the situation was aggravated for other reasons. First, due to its institutional deficiencies. There is a major contradiction between European institutions designed for the European Union (EU) and the urgent need for more integration (economic, fiscal, banking and finally political) between countries sharing the euro. The Eurozone countries and European institutions have to be aware that it is not possible to make progress with the constant obstacle of this institutional misalignment. The reform of the Treaty on the European Union (unavoidable in the medium term, although now inopportune) must clearly tackle the reality of an inclusive Europe (possibly multi-speed), without taylor-made agreements affecting the optimal design of the system as a whole.

Second, the reaction of authorities to the crisis was not ideal, as market fragmentation was exacerbated by the introduction of regulatory barriers to capital flows, which arose as a result of the difficult resolutions of international banking crises (Lehman Brothers, Fortis, the Irish banks, etc.). This regulation did not in general take the traditional form of capital controls, but rather forms of macroprudential regulation or more restrictive regulations on the operation of foreign banks. Some well-known examples are (1) the limits imposed by Austrian supervisors on the loan-to-deposit ratio in subsidiaries or branches of its banks in countries in Eastern Europe; (2) various regulations adopted in the United Kingdom that restrict the capacity of action by foreign banks; and (3) restrictions imposed by Germany on HypoVereinsbank channeling its liquidity to its parent, the Italian UniCredit.

This situation is not exclusive to Europe. There are also examples outside Europe, such as the Federal Reserve's new regulation on foreign banks operating in the United States, which imposes stricter liquidity requirements on subsidiaries and branches. However, it is particularly contrary to the spirit of the European Union that this has taken place between countries with free movement of capital. It is no doubt an example of the national tensions that still exist and highlights the supporting institutional structure, given the target function of a national supervisor. In fact, recently the European Commission opened an investigation on the existence of these practices in the Member States.

In reality, rather than through regulations in the strict sense, the banking authorities in the Eurozone have acted through moral suasion, so it is difficult to document the use of these measures. Perhaps the use of moral suasion is due to the possible interpretation of these measures as capital controls, which are incompatible with the single European market.

Also not positive was the action of the rating agencies, which with the fall in sovereign and financial institutions' ratings in the peripheral countries mid-way through the crisis confirmed market expectations and exacerbated the problem.

At the same time, this list of reasons explaining the greater financial fragmentation cannot be ended without mentioning that until the crisis there had been an excess of complacency with respect to the economic situation in Europe. Clearly, market discipline did not function as an incentive for adjustment in the boom years in many European countries that accumulated bubbles, confirming the opinions of those who thought that such discipline only kicks in at times of crisis.

The clearest proof that monetary union had not managed to integrate its markets sufficiently is that there is not a significant number of cross-border financial entities in countries that share the banking union, particularly in retail banking. Integration of wholesale markets has progressed at a faster pace, but has proven to be insufficient during the crisis.

Perhaps if there had been cross-border entities, the reversal of capital flows that we have experienced in recent years toward national borders would have been more limited, either because the measures taken against greater integration would have had less effect, or because there would have been a framework of incentives that were less likely to produce fragmentation.

Box 1. Differences between decentralized subsidiaries and branches

The significant differences in retail banking in emerging markets depending on the model of banking business chosen have often been taken as an example to understand the mechanics of nationalization of banking flows during the crisis. It is interesting in this sense to compare what happened in the latest crisis in foreign banks in Eastern Europe and Latin America. These are, after all, the two emerging regions with the biggest market penetration of foreign banks, but based on very different models: an integrated group approach in the case of Eastern Europe and a model of financially independent subsidiaries in Latin America.

The example of banking penetration that showed its weakness after the crisis is that of **Eastern Europe**, where there were mainly subsidiaries or branches of foreign banks dependent on their parents in terms of liquidity (centralized liquidity). The currencies of countries such as Poland, the Czech Republic, Hungary and Romania depreciated strongly starting in 2008 as a result of the crisis. As many of the loans (above all mortgages) granted in these countries were denominated in foreign currency, particularly euros (and to a lesser extent in dollars, yens and Swiss francs), their repayment became very expensive. The model for these banks was based on substantial intragroup financing, in which they depended on the support of the parent. When the interbank markets collapsed in the summer of 2007, these banks began to have liquidity problems that got worse with the liquidity difficulties in the Eurozone because of their high level of dependence on funding from the parents. Finally, in January 2009 the banks affected, under the coordination of the IMF, signed an agreement (the Vienna Initiative) by which they undertook to maintain their exposure to the debt in the zone through a voluntary extension of the maturities of the credit facilities. The move limited the spread of the crisis, although by then various countries in the region had had to go to the IMF in search of funding. Thus the model for expanding banking in this region demonstrated its vulnerability during the crisis. The existence of a fragmented European market (before the banking union) had a particularly negative effect on the decentralized branches.

Experience in **Latin America** has been more positive. The entry of foreign banks has boosted banking penetration and the development of the countries in the region. As a result, the share of lending by new entrants has grown in a sustained fashion. In this case, the model has been mainly a system of decentralized subsidiaries, which has led to significant advantages. First, because this model makes risk management easier, given that capital and liquidity are handled at local level, providing for a greater degree of self-management for local banks. Second, it has shown itself to be more resilient during the crisis. This is because it is geared toward the long term, sacrificing higher short-term profits for greater stability. In addition, the model of subsidiaries limits contagion of systemic risks and allows for the orderly management of local banks problems. However, these advantages will be less clear within a banking union, where there is a common framework of competition.

The boundaries between different types of institutions have tended to become blurred in recent years, so that the legal form (subsidiary or branch) is no longer the only criterion to take into account when it comes to establishing the responsibility of authorities at origin or destination. U.S. banks, for example, have entered numerous countries using a branch model, but ring-fenced the liability of the parent. Some banks have expanded in Eastern Europe using the legal status of subsidiaries, but with a very close dependence on funding by the parents, which have funded a significant part of the credit expansion processes in the destination countries from the country of origin. This type of connection between the parent and subsidiaries (affiliates or branches) has tended to depend less on the legal status than on the business model of each banking group. The differences between subsidiaries and branches have tended to become blurred as a result of the crisis as well, to the extent that the supervisors at the destination country have exercised greater control over the entities that operate within their territory, even those that operate as branches.

Looking at recent historical experience, the model of decentralized subsidiaries presents significant advantages compared with centralized groups from the point of view of international financial stability. It is coherent with retail banking, which is based on local-currency deposits, with little intragroup support and supervision by the destination country; while the model of centralized branches is more coherent with wholesale banking, wholesale funding and intragroup support, supervised by the country of origin. But this is part of Europe's history, and will not be applicable in the future, once markets are integrated.

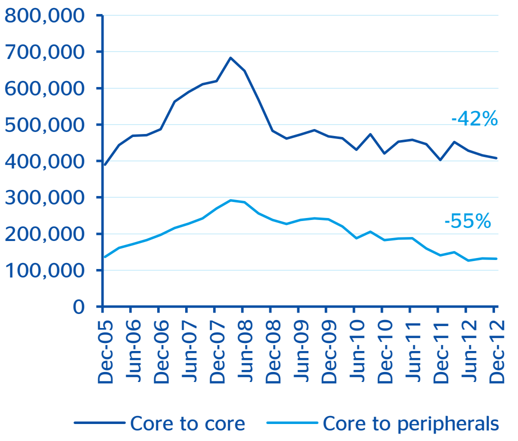
What lessons can be learned from these models for the banking union of the future? Internally, few. In a full banking union it has to be remembered that the banks will have a framework of comparable to the current national one, but with a more European and broader concept of "nation". The fundamental goal has to be the financial stability of the area as a whole, and the authorities must ensure that there is a harmonized framework of competence that guarantees a single market within the monetary union. Eventually, a system of single bank licensing should ensure the provision of financial services without obstacles from any country in the monetary union. In short, the advantages of the decentralized model cannot be extended to a Eurozone that is strengthened with the banking union.

Externally, there are more lessons to be learned: as a way of contributing to financial stability, the decentralized model appears to be the most efficient for those non-European banks operating in Europe; and for those banks in the Eurozone that operate in other geographical areas as well, although this has to be qualified in accordance with future new regulation, particularly in the area of banking resolution.

The consequences of financial fragmentation can be clearly seen in the European markets. Data show a retrenchment of financial systems back into national borders and a reinforcement of the "domestic bias" of main economies: internal savings tend to finance domestic investment. For example, cross-border interbank lending (both between core countries in the Eurozone and between core countries and those on the periphery), which had increased steadily since the adoption of the euro, began to backpedal starting in 2007 (Chart 1). The decline of these flows has been more serious for countries with a high and persistent current-account deficit. In these countries, banks have faced higher liquidity costs.

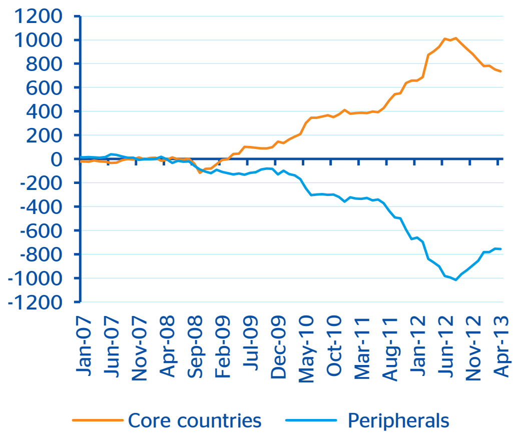
The use of ECB liquidity increased substantially since then and unconventional measures were introduced for liquidity provision, in part to replace the interbank lending market (Charts 2 and 3). The aim was to avoid a collapse of finance in the financial systems of the peripheral Eurozone countries, and had an initial impact on demand for sovereign bonds by the financial system. This trend generated unease in some sectors of public opinion in core countries, above all in Germany, where people saw their "creditor position[1]" grow. Risk aversion has also led to a replacement of the private unsecured market by the secured market and over-the-counter (OCT) derivatives. The result has tended to be more damaging for those banks using as collateral sovereign debt that has been downgraded, such as the peripheral countries. The liquidity of the ECB was also fragmented, in terms of the nationality of the collateral provided (Chart 4).

Chart 1
Average exposure to European countries (USD million)



Source: BBVA Research based on BIS

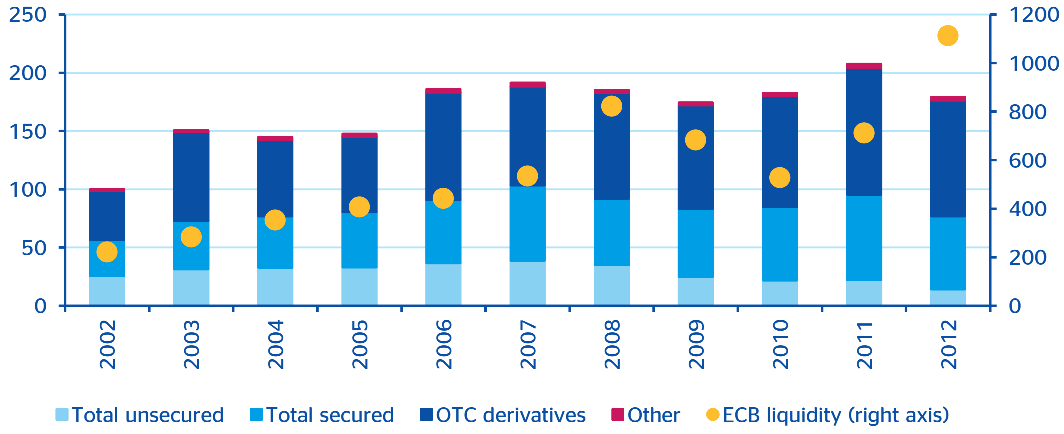
Chart 2
Net balance with the euro system (EUR billion)



Source: BBVA Research based on Bloomberg

1: Although what has been produced is a replacement of the creditor position of the private sector in core countries with that of their national central banks (protected by collateral).

Chart 3
European interbank market and ECB liquidity
(average daily interbank trading, 2002=100; ECB in EUR billion)



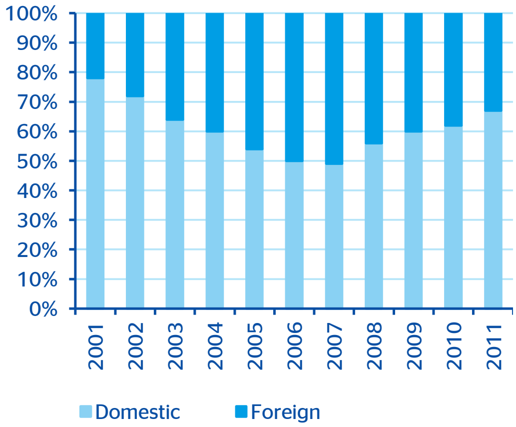
Source: ECB

In short, access to liquidity has become more difficult and the cost has been higher for financial institutions located in peripheral countries, due to their geographical location and because their collateral is anchored to their sovereign debt.

One of the most pernicious consequences of this crisis has been the collapse of the ECB monetary policy transmission mechanism. This is also particularly worrying because the countries that are making major fiscal efforts and structural reforms cannot benefit fully from the low interest rates that the ECB considers are necessary in the Eurozone's current economic situation.

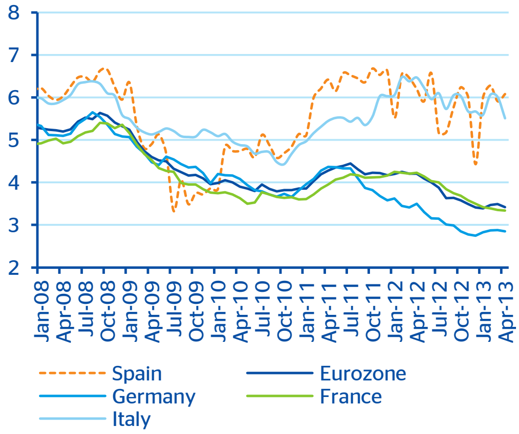
Since December 2010 interest rates of loans to households and businesses have increased in countries in the Eurozone periphery, while they have fallen in the core. This situation is incompatible with a level playing field in the single market. Specifically, Chart 5 shows the changes in the price of loans of up to a million euros, which is the series that tends to be used to refer to loans to small and medium enterprises (SMEs), for which there is no specific statistical source. These are the companies that have been hit hardest by the current situation, given that they tend to be dependent on bank finance as they do not have access to debt issuance. Although part of the divergence could be justified by the greater credit risk of investment in the peripheral countries, the difference between the two prices is too significant to be caused only by this factor. In addition, it can be seen that the interest rates in peripheral countries are more volatile, which represents an additional difficulty. These divergences can be seen as a proof that the banking union is important for the real economy, and not only for the financial institutions.

Chart 4
Collateral used in credit transactions in the euro system (%)



Source: ECB

Chart 5
Interest rate of new credit transactions for companies (%, up to €1 million, over 5 years)

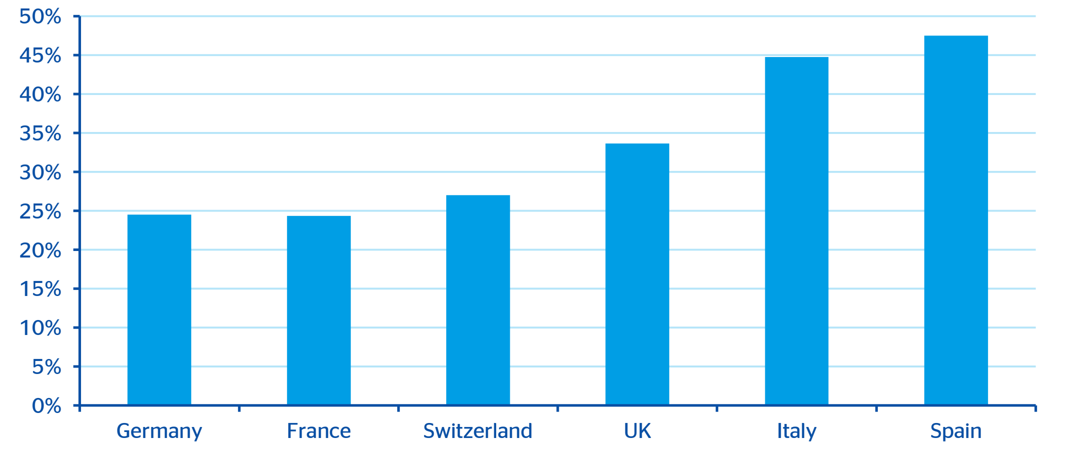


Source: ECB

If we had to create a ranking, it would be clear that the countries most affected have been those whose credit ratings (sovereign, corporate and financial) have fallen more, or those that were more dependent on external finance, whether from public or private agents. These countries are the peripherals, and include Greece, Portugal, Ireland, Spain and Italy.

This financial fragmentation has also been reinforced by doubts about national supervision and the quality of the bank balance sheets in some countries; in addition there is a lack of harmonization in regulation and banking supervision, which is no small matter. A clear example of these concerns is provided by the calculation of risk weighted assets (RWA), which make up the denominator of the capital ratio. Their weight as a proportion of total assets varies greatly depending on the country, depending not only on the asset type that each financial institution has, but also on how they are calculated. This diversity also depends on the supervisor. Another source of diversity lies in the accounting treatment of some balance sheet items.

Chart 6
Risk-weighted assets as % of assets (average, March 13)



Banks: BARCL, BBVA, BNPP, CASA, CMZ, CS, DB, ISP, HSBC, LBG, RBS, SAN, SG, UCI and UBS.
Source: BBVA, based on annual accounts

Another result of fragmentation that was not on the radar for the authorities or markets was the strong link between banking risk and sovereign risk, which feeds back in both directions.

Most banking crises were resolved at national level, and involved a huge cost for taxpayers in some countries. In the case of Ireland, the bailout of its financial system was on the verge of collapsing national public accounts, due to the high level of capital injections needed, amounting to 43% of GDP. In countries such as Greece, the banking sector was not particularly weak, but the fact that it held Greek government debt on its balance sheets, together with the economic situation, has generated a cocktail that has required a recapitalization of the country's financial system. These were some of the ingredients that reinforced the existence of a vicious circle between banking and sovereign risk.

In a world where it has been made clear that banks may have to be liquidated or resolved or saved, the risk associated to a bank is that of its own capacity to manage risk and the credit rating of the agents that can put money into this resolution. In a financial crisis, where there is asymmetrical information, this latter risk becomes the dominant one.

This is a cause for concern because any impact on the sovereign debt is transferred directly to households and businesses, given the significant role of financial institutions as suppliers of credit to the private sector in European countries.

All this has generated a significant weakness in European financial markets and even an appreciable risk of a break-up in the euro at some points during the crisis.

The **main goal** of the banking union is to stop this process of fragmentation, which is a major threat for the single currency. The aim is also to correct a serious problem of design: the banking union is the other side of the coin of the monetary union, particularly in a zone where the financial transmission channel is mainly via banks.

Before seeing why this is so and analyzing what it can resolve and how, it is worth analyzing what a banking union is not.

What is not a banking union? Without doubt, it is not the solution to all the problems of the financial system in the Eurozone. Its conception means the banking union has a long-term and profound goal, so that limiting its use only to short-term and partial problems would be a mistake.

The banking union cannot be an instrument for saving the banks of the peripheral countries. In the short term, while legacy problems persist, it is the national authorities that must guarantee the solvency of their banks, resolving the problem of legacy assets and restoring confidence. The complexity of European procedures makes it impossible a complete banking union, including a common resolution mechanism, to be in operation in the short term. At the same time, the resolution of current problems cannot be delayed until there is a banking union. It is very difficult to make progress toward mechanisms that mean sharing the results of banking crises if the balance sheets of the banks are not cleaned up first. Spain has already made a considerable effort of transparency and restructuring, in part using a credit line from the European Stability Mechanism (ESM); and it is on the way to restoring the soundness of the damaged banks. Other countries with problems, or doubts, should make a similar effort of transparency, provisioning and recapitalization, as provided for in the Balance Sheet Assessment which the ECB will presumably carry out in the first half of 2014, under guidelines from the European Banking Authority (EBA).

The banking union is neither the way of achieving direct European recapitalization for banks that now have state-owned capital, or that need such capital. Part of the confusion comes from the fact that the debate on the banking union was launched when Spain was particularly hard-hit by the banking and sovereign risk spiral, and at that time a link was made to the possibility of direct recapitalization by the ESM of Spanish and Irish banks with a capital deficit (in the case of Spain mostly savings banks). Although it was approved by the European Council in June 2012, direct recapitalization of banks by the ESM has run into numerous practical difficulties that have only begun to clear up recently; and there has been notable resistance on the part of creditor countries. Such resistance is in part due to the mistaken idea that the role of the banking union is to "Europeanize" the cost of past national crises. Without ruling out this option as a future possibility for some countries that may not achieve a reasonable growth path, such as Ireland, it is not a priority in the short term, nor is it crucial for separating banking risk from sovereign risk today. It is a necessary ingredient in the long term within the framework of a banking union that includes a resolution fund that is more European than national, and thus aspires to create a structural separation between sovereign and banking risk.

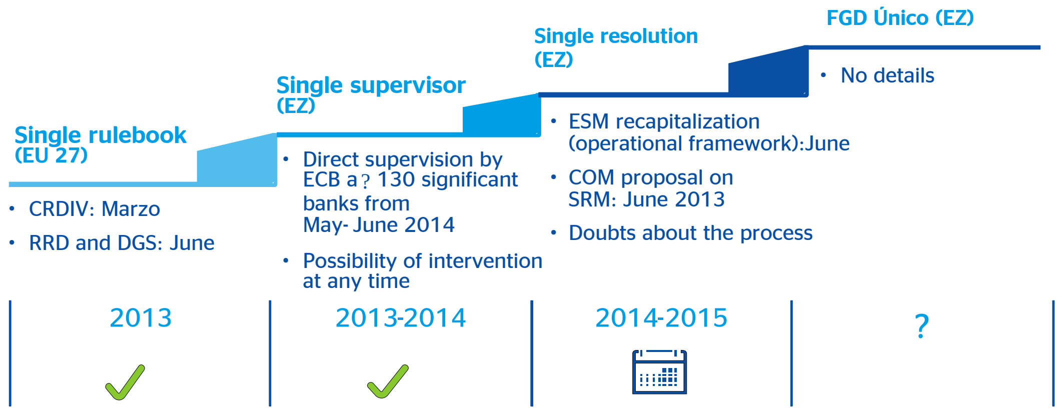
Thus, the banking union is also not a way of establishing transfers between European countries, so that German depositors pay to bail out peripheral banks. Bank bailouts must be decided today at national level. They must be paid for by the bank's creditors and, if necessary, by the banking sector as a whole, through the resolution funds that have received funds from the industry, with the backing of the national public sector if these resources are insufficient. In the future, in a framework of greater confidence and single regulation and supervision, it makes sense to have a European safety net for resolving banking crises with funds provided by European banks, once the corresponding private creditors have assumed their losses.

Finally, the banking union is not a minor change that is carried out to "get by". For example, in the area of supervision, it will be necessary to establish teams of supervisors with genuinely cross-border powers, based where necessary, of course, on the accumulated experience of national supervisors. In the field of regulation, rules and their application will have to be harmonized. Therefore, it is a comprehensive change in supervision and regulation that will profoundly alter the operation and incentives in the banking system.

What parts must a banking union be made up of?

What is understood in international debates as a banking union is structured into four pillars:

Chart 7
The pillars of the banking union



Source: BBVA Research

1. Single rulebook

The use by all the banks of the same rules of the game to compete in the European market is a precondition for integration. Specifically, various pan-European pieces of regulation represent the core of the new common rulebook. It is important to stress that these regulations affect the EU-28, but their framework may be considered essentially sufficient for the Eurozone. In other words, the more complete integration of the Eurozone derives from the other pillars of the banking union, and not so much from regulation.

The fourth edition of the Capital Requirements Directive (CRD IV) was approved in April this year by the European authorities in line with international recommendations for harmonization, agreed at the Basel Committee. As well as the minimum regulatory capital ratios, the regulation tries to encourage loans to small and medium enterprises (SMEs) by reducing the capital requirements for them. It also obliges banks to report to the European Commission profits, taxes and subsidies starting in 2014 and to make them public starting in 2015. Finally, it includes rules on the maximum bonuses that can be received by employees of regulated financial institutions.

The Recovery and Resolution Directive (RRD) and the Deposit Guarantee Schemes Directive (DGSD) were submitted to the European Parliament in June 2013. Their approval is expected by the end of the year, with a substantial delay when compared to the June target. Today the RRD is expected to enter into force in 2015, but the bail-in tool will only be operational starting in 2018.

2. Single supervision

Having a single supervisor is crucial for re-establishing confidence and assuring the taxpayers that their funds are being properly managed.

Direct supervision by the European Central Bank (ECB) of around 130 major banks (those with a volume of assets of over 30 billion euros) is expected to be implemented, initially starting in the third quarter of 2014. With this limitation by size, a significant number of banks such as the German savings banks, will remain outside its scope of influence, but this problem will be tackled in future stages of the banking union. It is possible that the entry into force will be delayed until the end of 2014, given that the agreement on accountability that has to serve as a basis for negotiation by the ECB and the Parliament is still being debated.

The choice of the ECB as a single supervisor was the most appropriate. Although there may be certain risks in the excessive accumulation of power in a single institution, as well as a possible conflict of objectives between price stability and financial stability, the advantages of the ECB being the supervisor far outweigh the disadvantages: it is an established institution in the Eurozone; it is independent and credible; and its work as a supervisor helps its task as lender of last resort, and provides a natural connection with the central banks that are already supervisors in the euro system. All the central banks in the Eurozone have supervisory powers to some extent, although in some cases these are limited to macroprudential supervision.

In any event, other alternatives have more disadvantages. One of them would be the European Banking Association (EBA), whose scope of action extends in principle to the EU-28, not the Eurozone. At the same time, creating an authority from scratch would have been too complicated and expensive.

The single supervision is one of the pillars of the banking union which is most on target, but it has not been completed yet. However, there are important challenges in the transition process. First, clarity is required in the division of tasks between the ECB and the local supervisor, with a single supervisory manual based on best practice. Second, an orderly transfer of powers is required, in what has been called a model of "intrusive delegation", based on constant cooperation between supervisors. Finally, clarity in the division of responsibilities with national supervisors is basic, as key decisions and the final responsibility, must correspond to the ECB, which for this needs adequate powers and resources.

3. The Single Resolution Mechanism (SRM)

The current crisis has demonstrated how important it is to have a pre-agreed system, so that in case of a bank's resolution, the link between banking risk and sovereign link can be broken and the impact on the taxpayer can be limited.

According to the Recovery and Resolution Directive, the proposal to absorb losses by the bank's creditors (bail-in) does not affect some liabilities, such as covered deposits. The ranking for absorbing losses would be (1) shares; (2) hybrid instruments; (3) junior debt; (4) senior debt and non-covered corporate deposits; (5) non-covered deposits of SMEs and households and liabilities of the European Investment Bank; and (6) the deposit guarantee scheme (liable for covered deposits). National authorities may exclude certain liabilities. No minimum of bail-inable liabilities has been determined, but the bail-in must amount to 8% of the liabilities for the national authorities to decide to exclude more liabilities and to use the resolution fund to absorb losses or recapitalize the bank (initially, to 5% of liabilities). In this case, the resolution fund may obtain ESM funds via its sovereign debt, without direct recapitalization. In exceptional circumstances, this 5% may be exceeded once all the non-preference or guaranteed liabilities (except for deposits) have absorbed the losses. The resolution authority may then look for sources of additional funding, possibly via a direct recapitalization by the ESM.

This proposal has the virtue of minimizing the use of public funds, and harmonizing European procedures. However, it may have a negative effect if the market reacts by increasing the cost of senior debt or transferring funds from senior debt to deposits. In any event, regulation may change and important details will be clarified in the negotiation that is beginning now between the Commission, the Parliament and the Council, before it becomes a Community Directive.

The Eurogroup meeting of 27-28 June 2013 left open the choice between a single or various resolution agencies. Currently two positions are being debated:

- A Franco-German proposal, which is founded on a network of national resolution authorities.
- A proposal by the European Commission to create a Single Resolution Authority, in theory under the remit of the Commission itself. There could be other possible options, but some would require changes in the Treaty in certain circumstances.

The second proposal could be more appropriate for ensuring a firm resolution framework, although its detractors doubt whether the Commission can adequately combine its present role with new resolution functions. If the Franco-German solution wins out, it is important to ensure sufficient guarantees of a backstop in case of problems. This requires a relevant role for the European Stabilization Mechanism. In any event, if a decentralized resolution mechanism is finally chosen, it must guarantee a harmonized application of the resolution rules.

Having a single supervisor operating at the same time as 17 national resolution authorities involves high risk. The Commission is working on guidelines that will be in place during the transition period of the new Resolution Directive, which will not enter into force until 2018 (in theory), with the aim of guiding public aid and the restructuring of banks.

Before a single resolution mechanism is imposed, each country must tackle the problem of its legacy assets, as Spain has already done. This will ensure that the depositors in healthy banks will not have to absorb losses accumulated by banks with problems. The Balance Sheet Assessment to be carried out by the ECB in the first half of 2014 (if there are no changes in the plan), will be a significant boost in this respect.

If there is need for a change in the European Treaty to implement a single resolution mechanism, a temporary solution will have to be found to send a clear signal that the banking union is making progress, to ensure the markets maintain a positive vision of Europe, and to reduce risks during the transition.

4. The common deposit guarantee scheme

The last pillar of the banking union must consist of the creation of a common deposit guarantee scheme, which prevents banks from depending in the last resort on the strength of their sovereign. There is still no timetable for this pillar, which must be the last step of the banking union.

This temporary separation between what is in force now and the future framework may cause difficulties in the transition period. The biggest risk will be that the banking union project will begin with a European supervisor that will have to coexist with national mechanisms for resolving bank crises for an indeterminate period of time. As a result, it may find difficulties in breaking the bank-sovereign link, particularly within the framework of the Resolution Directive that leaves some discretion to the national resolution funds. That is why a careful design of the road map is required, and the transition period has to be made as short as possible.

However, there are also other risks that should be highlighted. It is possible that the Resolution Directive and the Deposit Guarantee Scheme Directive reach a lowest common denominator that is insufficient for the Eurozone. It is also possible that there may be inconsistencies between the supervisory decisions at the Eurozone level (SSM) and the national resolution authorities before the Single Resolution Authority is created.

The solution adopted consists of an immediate start of the single European supervision mechanism and a steady completion of the banking union map later on. Given the circumstances, it is the only one possible. There is reason to hope that the process can gather pace once it is launched. In any event, the Eurozone has no alternative, as it is urgent to stop financial fragmentation and make progress toward a sustainable model of Monetary Union.

The banking union is a necessary, but not sufficient condition

The banking union must be seen as a sequential project where the existence of common regulation and supervision must give way naturally to risk sharing (via single resolution and a common deposit guarantee scheme). This in turn will trigger the arrival of fiscal union, or at least a higher level of fiscal union.

Possibly, from a technical point of view, and even in terms of the legitimacy of the banking union, the process would be simpler if it was in reverse: with a fiscal union that made it easier to implement a deposit guarantee scheme and a common resolution fund. However, the direct leap into fiscal union is not politically viable at present. Some creditor countries have manifested their unease regarding the possibility that the banking union could be used to set up a fiscal union by the back door and to "share" the costs of the current crisis. It has to be admitted that there is some basis to the criticism: to the extent that the banking union represents a common reserve of fiscal funds and a mutualization of the deposit guarantee funds, it must be subject to democratic control mechanisms appropriate to budget funds. If the diagnosis of the euro crisis is that a monetary union may not be carried out without certain elements of fiscal union, then sooner or later we have to tackle an in-depth reform of the Treaty. However, the reform of the Treaty under current conditions is unrealistic and in any event it will be a slow process; while the fragmentation of the Eurozone requires an urgent solution. There is undoubtedly a risk that the debate may represent a delay for the banking union, whose potential negative effects on the markets must be countered with other measures. This question will be dealt with in the following point.

2. Complementary measures to the banking union

The banking union may be delayed, because eventually it implies a change to the Treaty and because it is linked to a fiscal union on which it is difficult to reach a rapid solution. We are already experiencing maneuvers by some countries to dilute some of the agreements reached and extend the periods involved. Given the risk of a delay, other complementary measures have to be adopted that separate banking and sovereign risk and limit the fragmentation of the European financial markets.

In fact, the banking union is an extremely ambitious goal that represents a profound change in the European regulatory framework. Under normal conditions, this change would have required a long period of reflection, followed by years of negotiation and a reform of the Treaty, in a similar way to the Monetary Union. However, as it is being carried out under the pressure of the financial markets, that doubted the survival of the euro, the banking union is being constructed taking advantage of a loophole in the Treaty: Article 127.6 allows the transfer to the ECB of "specific tasks related to prudential supervision."

In addition, the establishment of a resolution authority for the Eurozone is the key step still pending for the design of the banking union. And it is particularly difficult due to its interaction with the fiscal union. It also runs up against institutional difficulties involved in the coexistence between the Eurozone and the EU of 28 Member States. Currently, discussions are underway on two Directives, the Banking Recovery and Resolution Directive (RRD) and the Deposit Guarantee Scheme Directive (DGSD), covering the EU-28; but they are also crucial for implementing the third pillar of the banking union: the Single Resolution Mechanism (SRM). The debates of the two pieces of regulation overlap, so there is a fair amount of confusion.

If there is a delay there should be at least a clear road map and a firm commitment to the arrival point, in order to build up confidence in the process. But complementary measures are necessary as well during the transition period. Among them are the following:

- Within the scope of banking regulation, higher capital requirements and the reforms linked to the adoption of Basel III will reduce the probability of bank crises.
- The planned transparency exercises will identify the legacy assets (bad assets resulting from the crisis), through the Balance Sheet Assessment. This will reinforce trust in the institutions that pass this test. This will help reopen the markets and reverse the trend towards financial fragmentation. The credibility of the process is important, so it must be backed by the ECB as future supervisor and also by prestigious private consultants, as it happened in Spain.
- Once the single supervision of the ECB is implemented, the application of common criteria by an international supervisor will also result in higher confidence in the institutions subject to its control.
- Within the scope of the resolution, the approval of the RRD will mean a lower cost for the taxpayer, above all thanks to a demanding bail-in framework, which will mean that any crisis will impact (mainly) on bank creditors. This change is crucial for breaking the link between banking and sovereign risk.
- It is important that supervision should also help break the home bias in public debt holdings. The current concentration of debt portfolios on the country's own sovereign debt is not healthy, and it would be reasonable for supervisors to encourage greater portfolio diversification. The regulation on liquidity coverage ratio should take this objective into account. Although the Capital Requirements Directive (CRD-IV) includes basic indications, the technical standards that the EBA is developing could be relevant.
- Banks' debt issuances are currently excessively conditioned by their country's sovereign rating, which creates a ceiling for the bank's own rating. A change in the methodology would therefore be advisable. This would also comply with the international mandate to

break the excessive dependence of regulation on ratings. This can be achieved by reducing the importance that regulation and market practice give to rating agencies. Higher competition between the agencies would also be positive.

- Some kind of common public backstop has to be created before a common Resolution Authority with its corresponding common fund is in place. The ESM could play a role in this transition period, particularly if the Franco-German proposal of a network of national resolution authorities is successful, and assuming that this common backstop would be activated in case of problems in some Member State.
- Progress in the banking union must go hand in hand with other structural reforms in Europe, both at national and European level.
- Part of the feedback loop between banking and sovereign risk is inherent to the national nature of European banks. Governments and banks are affected by a common national cycle, so they are difficult to separate. The creation of cross-border banks would be a way of breaking this relationship. Among issues that have to be solved on the supply side for this to happen are common regulation, access to debtor information, transparency of fees, and a limitation of supervisory obstacles.

Going into more detail on the previous point, we could ask, why has this process not taken place yet? What supply and demand obstacles prevent the integration of European retail banks?

There are considerable practical difficulties for the complete integration of certain retail segments, for legal and institutional reasons. On the demand side, there are obstacles such as:

- cultural factors: a different culture of saving, preference for deposits/mutual funds, tendency to own a home or to rent, labor mobility, etc., to which the banks have to adapt their supply;
- the need for a close customer-bank relationship where the approachability and trust are fundamental; or
- the limited level of customers' technological knowledge. This is important in segments such as direct banking or payment systems.

On the supply side, the difficulties reside in:

- the different national regulations and institutions, such as the fact that there is no common registry of ownership. The fact that fiscal laws or social policies are different among countries has a particular impact on retail banking.
- asymmetrical information: because banks do not have access to customers' credit information, and customers do not have transparent access to the fees charged to allow them to compare offers and change of bank; and
- the cross-selling strategies that make it more difficult for customers to change bank.

In addition, as banking is a strategic sector, sometimes there has been political resistance to the loss of control over the banks operating in a country.

For example, in the mortgage market there are barriers in the cross-border use of collateral which make it difficult for a bank in one country to grant a loan to buy a real-estate asset in another Eurozone country. There will have to be greater legal harmonization to overcome these barriers.

What measures can be taken to limit obstacles to the integration of retail banking? First, it is crucial to improve customers' decision-making capacity, and to lower the cost of changing of bank. In fields such as payments, significant progress has already been made with the implementation of the Single Euro Payments Area (SEPA), which will be mandatory starting in February 2014. Another positive step would be to make customers' credit information available; first, through opening up the credit bureaus to other entities; and second, by making it easier for customers to access their own credit information and to bring it to a new bank. In terms of regulation, the barriers have to be eliminated and the laws harmonized. If there is positive information in the bureaus instead of only negative information, these entities would be able to play a role for the public good. In short, it is a case of eliminating institutional, political and regulatory barriers to the integration of retail banking. Clearly, the banking union will help in many aspects, such as the "home bias" of supervisors and regulators with respect to local entities, but not in all. In many cases, progress can be made now, and this has not been given sufficient priority by the authorities.

At the end of the process, the consumers of financial products will be benefited by greater competition between banks, with the resulting gains in better offer and lower costs. Spanish banks, which despite the crisis are more efficient than most European banking systems, are well prepared for this competition and should not fear it. This crisis is a good opportunity for improving further efficiency, and the sale of banks intervened by the governments could represent a way of creating cross-border banking groups.

Some 40% of European banks' assets are in banks currently subject to some type of European Union state aid viability or restructuring review, which reveals the size of the problem. International experience shows that state-owned banks tend to be inefficient and eventually costly for the Treasury, so it is important that the countries where a major part of the banking system has been nationalized undertake relatively quick privatization plans. Without doubt, integration will be quicker if this process helps increase the number of cross-border banks.

All the additional measures described in this section will not replace the banking union; rather, they complement it and can play its role temporarily, until a banking union is fully in force. In any event, their implementation will tend to reduce resistance and speed up the process.

Box 2. How could finance for SMEs be promoted in peripheral countries?

One of the keys for a sustained recovery of the economy and employment of the peripheral European countries resides in kick-starting finance to small and medium-sized enterprises (SMEs). That is why public and private initiatives are underway to boost bank and non-bank finance to these companies.

The most appropriate kick-start measures are those that satisfy three criteria at the same time: i) they have a high potential impact; ii) they provide quicker short-term effects; and iii) they represent a smaller budget impact for government.

On the side of **bank finance**:

- Public support could be made more flexible, mainly in terms of the prices of loans to businesses with a higher risk profile. For example, this would be the case of the ICO *Mediación* credit facilities in Spain.
- It is also important to boost finance for working capital, as in too many cases lack of liquidity has led to the liquidation of economically viable SMEs. Useful measures in this respect would include reducing the fiscal cost of high-quality bank invoices (to help their discount), or the strengthening of commercial insurance via public guarantees.
- It would also be a good idea to boost the **internationalization** of SMEs, either through public finance or by the promotion of public or private guarantees. In Spain, there are initiatives to boost mutual guarantee funds (*Sociedades de Garantía Recíproca* or SGR), making them more solvent and bigger. Their efficiency could be improved by increasing coordination and even by the consolidation of the regional SGRs, as well as boosting their synergies with the ICO.

On the **regulatory** side, it is important to reduce the consumption of capital of the loans granted to SMEs. In this respect, the fact that the recently approved European Capital Requirements Directive (CRD IV) reduces the weight in risk-weighted assets of these exposures is good news. It is important that in the transposition to national regulation this is not diluted.

It would also be a good idea to improve the **information** available on companies, so that the banks can attract new customers with higher security. For example, in the Spanish case the SMEs that were customers of the banks that have been restructured sometimes move their business to other banks, but do not have the capacity to provide sufficient information so that the new bank can assess their risk. To mitigate this problem:

- The accounts that companies provide to the European public registries could be improved and harmonized, and its frequency could be made at least annual.
- Positive credit bureaus could be created, with information on non-defaulting companies (and not only defaulting companies, as until now).

On the **non-banking finance** side, the expected impact is more in the medium or long term. Among the suggested initiatives is the creation of European markets for the issue of fixed-income securities by SMEs.

In addition, there are measures that boost investment in the capital of SMEs through **public-private co-finance**. They include initiatives such as seed capital (or business angels), venture capital, funds of funds and crowdfunding (or peer-to-peer finance). In most European countries the scope of these operators is limited. It would be a good idea to boost them through tax incentives and in some cases, through the development of laws or codes of good practices that give them legal security, possibly at European level.

3. Implications of the banking union: the endgame

How should the Eurozone be when the banking union is fully implemented? In other words, what are we heading towards?

It would be reasonable to assume that the banking union would trigger fiscal union in the medium-long term. At the same time, this set-up should be compatible with the no bail-out clause. This clause comes from Article 125 of the Lisbon Treaty, which makes it illegal for one Member State to assume the debts of another one (and it was one of the arguments used to claim that the German Constitutional Court would reject the European bailouts).

In addition, if the banking union operates correctly in the Eurozone, it would provide incentives for the creation of larger, cross-border wholesale and retail banks. Thus in the future we would have a more European rather than national banking system, but one that is also more concentrated and made up of larger entities. This pattern would also involve risks, given that bank concentration could reduce competition. That is why higher integration in the Eurozone is necessary to allow banks to operate in a truly European market.

The fact that banks may be bigger is not of itself negative. Extreme solutions such as the separation of businesses (Liikanen, Vickers) encourage regulatory arbitrage and the channeling of banking activities to shadow banking. Instead, it would be better for the authorities to give appropriate incentives to limit the assumption of risks by the banks and for resolution procedures to guarantee that the cost of mistakes is paid by the bank's shareholders and creditors.

However, this does not mean that cross-border banks with business outside the Eurozone are at a disadvantage. In fact, acquiring business outside Europe will continue to be an advantage, given that the economic cycle of these zones is potentially different from that in Europe and this fact will help diversify risks.

In this cross-border context, technology is a key facilitator for banking expansion. A few years ago, without the advances that are available now, it appeared impossible to manage with the necessary speed and flexibility banks operating in various countries (or even continents) at the same time, with their own different languages and timetables. At that time it was much more difficult to export know-how from one bank to another geographical area, or to have the necessary information available in an updated form to make the right decisions.

What Europe are we moving towards? Without doubt, towards a much more integrated Europe from a monetary, banking, fiscal and political points of view. This will make European banks more stable and provide a more efficient allocation of resources. But it will not be an easy process.

4. Conclusions

The crisis in Europe has represented a blow to the development of the project of European integration. When monetary union began 15 years ago with 11 countries, and then increased until it reached the current 17 members, some of the possible faults that such a union could have were identified. Attempts were made to correct some of these faults through specific agreements; but in the end it became clear they had not been well designed. One example is the Stability and Growth Pact. aimed at guaranteeing fiscal coherence in euro area countries. In other cases there was over reliance in that countries would see the need to implement changes due to the rigor imposed by monetary union itself: such as the need to make reforms that would increase economic productivity and the flexibility of their production factors to react to asymmetric shocks.

All the measures implemented with the "six pack" and the "two pack", together with the measures to guarantee the stability of the structural fiscal deficit are designed to resolve these faults in fiscal design and this excess of confidence in the individual capacity of countries to make reform. These solutions face problems that were already on the radar 15 years ago.

What has resulted lethal for countries in the Eurozone has been the problems that were not on the radar of political action because they were assumed to be irrelevant.

First, the process of financial integration, a logical consequence of a monetary union within a European Union that guarantees and requires the free movement of capital, has been reversed. Today the market is fragmented.

The second has been the perverse link between national sovereign and banking risk.

These two problems have meant a blow to the development of the euro project because they prevent the correct operation of a single monetary policy and because they have reflected the extraordinary difficulty in trusting compliance with the no sovereign bail-out principle, due to the impact that this has on banking risk and thus its impact on the credit risk of households and businesses in a country.

Today in the Monetary Union the postal code of a business or household is much more important for obtaining a loan and determining its cost than the capacity of the household to pay or the feasibility of the company's project. This is incompatible with the existence of monetary union.

The solution to these problems that were until now off the radar must be the banking union. And the process towards for this solution must take place at the same time as the solution to the current crisis, which means that this process is particularly difficult. That is why it is essential to separate the discussion of the division of costs of the crisis, or at least the ex-ante risk assumed to overcome the crisis, from the optimal design of the path towards a banking union.

And it is worth being clear about what the banking union is not. It cannot, and it should not, be expected that the banking union is a solution to all the current problems of the financial system of the Eurozone, or that it is an instrument to save peripheral banks, or that it is a way to achieve the direct recapitalization of banks in this crisis; or that Europe should assume the costs of these national crises; or that it should be a form of establishing transfers today between depositors or taxpayers in one country and the banks of another one. And it can also not be carried out with minor changes to regulation, or with a supervisory system that does not involve the loss of capacity of national authorities in favor of the European ones.

In any event, this article has also argued that this process towards the banking union is not precisely an example of optimal design. Few economists would have planned it in the way it is being developed. But it is a process that is politically feasible and that aims to achieve a balance between optimal design and what is possible, in order to provide incentives and sufficient coverage without still achieving a fiscal union. And it begins with a process of supervision without there being European resolution funds because the partial transfer of the ECB's supervisory powers was included in the Treaty and the mutualization of risks was not.

As it is a political project, in the middle of a financial crisis, with asymmetrical problems between countries and financial institutions, and with doubts about whether what is being agreed can form part of the European Union agreement itself, this process towards the banking union on which the Eurozone is embarked will be long and will have delays. First, because eventually it implies a change of the Treaty if the process is to be completed without legal doubts; and second, because it is linked to a fiscal union on which it is difficult to reach an agreement.

And that is why a road map is needed.

For the banking union process to be based on sound foundations, a rigorous and credible stress test has to be carried out on the banks' portfolios. This test, together with high quality and harmonized supervision and a strong resolution authority (and backed by sufficient funds as a backstop) are essential for the success of this process towards the banking union. The risks in the transition period are significant and must be carefully watched.

The firm path towards the banking union will do much to reduce financial fragmentation and improve the monetary policy transmission. However, other complementary measures are required. A monetary union makes no sense if there is not a higher degree of integration of financial operations in different European countries, and this integration should be extended to the retail sector… If there had been more cross-border banks in Europe, possibly the effect of ring-fencing and financial fragmentation would have been reduced. In the future, the existence of a truly integrated European retail banking, overcoming all the difficulties it faces at present, will be the best test of that the system has recovered from the current fragmentation.

In the best scenario, we have said that all this process would take us to a much more integrated Europe from s monetary, banking, fiscal and political points of view.

Will we arrive at this final scenario? There is no doubt about it. Because as well as being necessary and not sufficient, the banking union cannot be relinquished, and the Eurozone cannot allow itself not to achieve it. Not achieving it would mean a very significant blow to European economic growth. The link between financial integration and growth has been clearly demonstrated; it occurs through a better use of funding sources, higher competition, more efficiency, more technology and more diversification. In addition, the banking union is the logical consequence of the monetary union, and denying this would be like moving off a path, the euro, that we decided to take some time ago. The crisis has demonstrated that the current situation is vulnerable; and a future crisis without a banking union could end up with the break-up of the euro. And that would have extremely negative consequences, both in the short and the long term, and not only in peripheral countries, but also at the core of the Eurozone.

We cannot renounce to the Eurozone, given the the world in which we live. Globalization is unstoppable, and only an integrated Europe makes strategic and possibly economic sense.

In short, there is no Plan B for the banking union, because the alternative is the break-up of the euro at some point. It will not be easy, but the banking union is the next small step in the process of European construction.

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