Banking Union: what remains to be done?

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The Banking Union project, launched in the summer of 2012, was key in reversing the fragmentation trends that were threatening the euro at the time. As is well known, from May 2010 (the first Greek request for a program) to July 2012 peripheral economies of the Eurozone were under the effects of a negative loop between sovereign and banking risk. In some countries like Ireland the problems started on the banking side; in other countries like Greece the problems started on the fiscal side, while Spain, Italy and Portugal were somewhere in between.

Regardless of the origin of the problems, all these countries were very vulnerable to the dry-up of liquidity in interbank markets as a result of the crisis. The fragmentation of wholesale markets undermined the funding of their current account deficits, increased their dependence on the ECB and weakened their banking systems. The expectations of a euro break-up increased sharply in the early years of the present decade, as shown by a synthetic indicator of Eurozone fragmentation developed by BBVA Research, which multiplied by a factor of 5 between early 2010 and the summer of 2012.

Two factors reversed the trend in July 2012: the announcement of a Banking Union in the Eurozone and Mario Draghi's remarks that the ECB would do "whatever it takes" to preserve the euro. As a result of both, the fragmentation index went down steadily and reached back pre-crisis levels in the second half of 2014. The ECB's determination to act was probably more decisive in reversing the trend at the beginning, but banking union was crucial in sustaining the downward trend in fragmentation thereafter, thanks to the impressive progress made in only three years:

· We have now a fully operative new bank supervisor with its headquarters in the ECB, but that encompasses all the national supervisors. A thousand new staff has been recruited, a whole set of new supervisory policies has been approved, an Asset Quality Review and Stress Test was carried out to dispel uncertainties on the health of European banks and a new supervisory culture is in the making, benefiting from best practices among Eurozone supervisors in each area.

· A new Eurozone resolution authority has been created, the Single Resolution Board, with the participation of the national resolution authorities of all the member countries. It started working in January 2015 and will become fully operational in January 2016.

· A new Single Resolution Fund will be set up in January 2016, with a phase in period of 8 years, but with a substantial frontloading the first two years (60%). This SRF, to be funded by banks, entails a significant element of mutualization in banking resolution. It has to be seen together with the bail in tool included in the EU-wide Bank Recovery and Resolution Directive (BRRD), which establishes that bank creditors (excluding deposits) will absorb most of the losses in banking crises, instead of taxpayers. This implies that the Single Resolution Fund will be scarcely used in practice, although there are still important details of the legislation pending, like the definition of the ratio of Minimum Required Eligible Liabilities - MREL - that would ensure that banks have sufficient liabilities with loss-absorption capacity).

· The European Stabilization Mechanism (ESM) has approved a tool for the direct recapitalization of banks designed to avoid that excessively indebted sovereigns are forced to incur in bank rescue operations, thus exacerbating the bank-sovereign risk loop. While subject to demanding conditions and only as a last resort, this instrument is an essential element for the design of the banking union.

All these changes were unthinkable a few years ago. The progress made is more remarkable taking into account the considerable difficulties under which all this measures have been adopted, in the middle of a very profound economic crisis, with banks still under its effects, in the context of a global reform of financial regulation that is changing the foundations of the global banking system, and with important elements of fragmentation still persisting. While it is true that sometimes the European decision making is frustratingly slow, in this case the progress made is impressive.

But what remains to be done? To answer this question it is important to have a view of the endpoint of banking union: a unified banking system in which any citizen in any place of the Eurozone can operate with any bank regardless of where its headquarters are located or whether it has branches in the country of residence of this particular citizen. A useful exercise is to think on the US banking union as a reference. It is clear that we are quite far from that objective.

To reach that point the Eurozone needs to make reforms in areas wider than the banking system. The recently released Five Presidents Report contains a series of proposals and ideas to improve the governance of the area, with changes in the fiscal discipline framework, the macroeconomic imbalances procedure, the coordination of economic policies and the governance of the convergence process, inter alia. The report also contains bold ideas in the financial union front, were the banking union for the Eurozone is complemented with the Capital Markets Union for the EU as a whole, as well as in the fiscal union domain, were a fiscal stabilization function, a mechanism to assess the adequacy of the Eurozone-wide fiscal stance and a euro area Treasury are envisaged.

In the case of banking union two lines of work are necessary: a public backstop for the Single Resolution Fund and a single Deposit Guarantee Scheme (DGS). The first is needed to make the SRF credible, although the new paradigm of bail-in instead of bail-out in banking resolution makes its use very unlikely. Any country in the world has a natural backstop in its national Treasury, with the central bank acting as Lender of Last Resort, but the Eurozone is an exception. The European Stabilization Mechanism (ESM) can play this role of backstop, perhaps complemented with the ESM access to ECB liquidity, although a reform of the ESM Treaty would be needed. It is important to clarify that this should be done with all the safeguards for protecting taxpayers' money and minimizing moral hazard. The second element (a single DGS) is necessary as a step to overcome fragmentation inside the banking union, since the persistence of national DGS would perpetuate the perception of a tight connection between each banking system and its sovereign. The integration of Eurozone DGS can be designed in a way that ensures that there will be no contagion from weak to strong banks or from weak to strong countries. And it can be done preserving current claims and liabilities, through an adequate grandfathering of accumulated funds. A single DGS implies a degree of mutualization that goes far beyond present agreements, and can be seen as part of a fiscal union. A reform of the Treaty may be necessary for this step, although the recent experience shows that substantial changes are possible under the present treaties or through reinforced cooperation.

All these institutional reforms are important. But it is even more important to foster the single market and to increase cross-border competition so that banks' clients can benefit from disruptive technologies that can offer better services with much lower costs. The true banking union is the vision mentioned above, in which any bank can offer any service inside the Eurozone without legal or practical barriers. At a time when the Eurozone banking system is facing a weak profitability horizon, innovation can be a game changer to restore return on equity levels above the cost of capital. Some initiatives are already taking shape in this regard: the Digital Single Market and the forthcoming Green Book on retail banking services. It is important however that all the players (regulators, policy makers, market participants, consumers…) understand that institutional and regulatory changes cannot achieve by themselves the final objectives of banking union. We also need more profound changes in business models, practices, channels, relations with clients, etc.

To sum up: a lot has been done, but we need to continue moving to reach a final point that is still quite distant. The way forward is to keep the momentum and continue advancing towards the final vision of a fully-fledged banking union.