"la Caixa" economic papers

No. 09 JULY 2013

Banking Union: made of concrete or straw?

Jordi Gual

"la Caixa"

RESEARCH DEPARTAMENT

”la Caixa”

Research Department
Av. Diagonal, 629, torre I, planta 6
08028 BARCELONA
Tel. 93 404 76 82
Telefax 93 404 68 92
www.laCaixa.es/research
e-mail: publicacionesestudios@lacaixa.es

"la Caixa" ECONOMIC PAPERS

No. 09 JULY 2013

Banking Union: made of concrete or straw?*

Jordi Gual**

Abstract

The vicious loop between sovereign and bank debt threatens the integrity of the euro zone. This article examines why the banking union is a prerequisite to break this loop and concludes that the current design is clearly insufficient to achieve this goal. In particular, the transitional phase poses serious risks for the euro zone as financial markets remain fragmented and the crisis is far from being resolved.

The article discusses the components of a solid banking union, what I call a banking union made of concrete. Current plans by the euro area envisage a union that seeks to limit the use of taxpayer funds by extending the principle of "bail-in". It is a banking union that runs the risk of being insufficient to face a systemic crisis.

This banking union, albeit limited, is difficult to implement in the short term given the current legal framework of the economic and monetary union. As a result, the union designed for the transitional period, which can be lengthy, will lack key elements such as a pan-European backstop that operates as a lender of last resort for sovereigns. Therefore, it is far from being a banking union made of concrete. This can be a flimsy construction, not even made of wood but of straw. The risk is that it may be unable to withstand the challenges of the current crisis.

Keywords: banking union, bank regulation, bailout, european financial integration
JEL Codes: F33, F35, F55, G28

---

* The Spanish version will be published in *Papeles de Economía Española*, no. 137, 2013, edited by FUNCAS.
** I am grateful for the comments and assistance provided by Oriol Aspachs-Bracons, Enric Fernández, Avelino Hernández, Sandra Jódar-Rosell and Judit Montoriol.

TABLE OF CONTENTS

1. Introduction

The consequences of the international financial crisis that started in the US in 2007 have hit the euro area particularly hard. After the Great Recession of 2009, the euro area's economy suffered a severe relapse in 2011-12 associated with financial problems that began with the Greek crisis at the end of 2009 and died down particularly after decisive action was taken by the European Central Bank, first at the end of 2011 with unlimited three-year refinancing operations (LTROs) and subsequently, in the summer of 2012, with the announcement of the Outright Monetary Transactions (OMTs) programme by the ECB President.

There are many reasons for the euro area's severe financial turbulences during this period but few diagnoses that do not include the effects of the vicious loop between weak sovereign debt in many of the euro area's periphery countries and the weakness of their banks. Such a diagnosis gains official in status when it is acknowledged by the European Council in its declaration of 29 June 2012, marking a fundamental turning point in the focus of the euro area's economic policy to tackle the crisis. In addition to recognizing that the EMU would require some degree of fiscal union in order for it to work properly, an idea that had been floating since the euro was created, there were now considerations about the need for greater integration regarding the regulation, supervision and crisis management of banks. People started to talk openly of a so-called banking union (BU).

In this article, first of all, I will examine the reasons why banking union is crucial in order for the euro to work well. Essentially, I will discuss how it can help to break the vicious loop between sovereign and bank debt.

Secondly, I will briefly review the negative consequences that the lack of a banking union is having in terms of the fragmentation of the euro area's banking markets. The extent of these distortions merely highlights the importance of correcting this defect in the EMU's design.

I will then analyze which components are essential to a banking union, the role played by each of them and some of the possible design options, with their respective advantages and drawbacks.

Lastly, and given the legal and political complexity of constructing the ideal banking union, which I will call a union made of concrete, I will focus my attention on the transition period. The German finance minister himself (Schäuble, 2013) has referred to a feasible instrument for the short and medium term, while building the more solid construct the euro warrants, as a timber-framed banking union[1]. I will argue that such a transitional period may be exceptionally complex and risky and that it will be crucial to ensure this temporary construction is not merely made of straw, leaving it exposed not only to any future financial crisis but to the current crisis itself, which we cannot assume is over.

1. The article by Mr. Schäuble distinguishes between a timber-framed and a steel-framed banking union and it is therefore easy, after this reference, to arrive at the title of this article. See also JPMorgan, 2013.

2. The vicious loop between sovereign and bank debt.

The need to advance towards a banking union becomes evident when we closely examine the problems leading up to the financial crisis in the euro area and, in particular, the thorny issue of the vicious loop between sovereign debt and the situation of domestic banking systems. The academic literature had already recognized the need for greater integration in regulating and supervising banks in the euro area; i.e. advancing towards a banking union. However, the fundamental reasons for these proposals were related to the operations carried out by large European banks in several jurisdictions and the problems of negative "spillovers" between countries that could arise when one of these banks needed to be rescued or encountered difficulties. The problem of systemic risk being passed on between governments and banks within a monetary union can only be partly glimpsed in the literature[2].

As we know, the euro area is a monetary area in which a single currency, the euro, exists side by side with seventeen treasuries or fiscal authorities, unlike the situation in other comparable economic areas such as the US or Japan. This is a critical difference between these economies as it means that the euro area cannot use the same economic policy tools available to the US or Japanese authorities when faced with a systemic crisis, such as the one sprouting in the advanced economies in 2008. Euro area countries do not have a central bank that can act as a lender of last resort to governments, since the European Central Bank is not allowed to exercise this function in the euro area. Such prohibition results both from the ECB's statutes and also from political factors, given that intervening to help some economies in the area would entail an implicit redistribution of resources among countries.

As there is no lender of last resort, euro area governments are more vulnerable to a negative shock on their solvency, such as the one that can arise from the recapitalization of the banking system in a systemic crisis. This makes it difficult to carry out actions such as the preventative recapitalization of banks, which the US Treasury carried out in 2009 and through which a total of $205 billion was injected into 707 banks. This institutional weakness is a serious flaw in the EMU's design and is causing huge difficulties in the euro area during a systemic crisis such as the one we are currently going through. However, it is important to stress that, for reasons I will explain in my discussion of the appropriate design for Banking Union, these weaknesses only come to light in systemic crises and not in individual bank crises, even when the latter are significant as long as their magnitude is limited in relation to the economy in question and its government's fiscal capacity.

The vicious loop between local governments and banks appears both when the initial weakness is due to the financial system and when it comes from the public finances. In both cases, the solvency of the private sector, that of the public sector and the economy's growth potential interrelate in a vicious loop. In the euro area crisis, Ireland would be a clear example of the first case and Greece of the second. As can be seen in figure 2.1, when a government does not have the fiscal capacity to rescue or recapitalize local banks, weak banks find it even more difficult to access international funding. This, in turn, accentuates deleveraging, harming domestic economic activity and ultimately harming the public finances by increasing the cyclical component of the general government deficit.

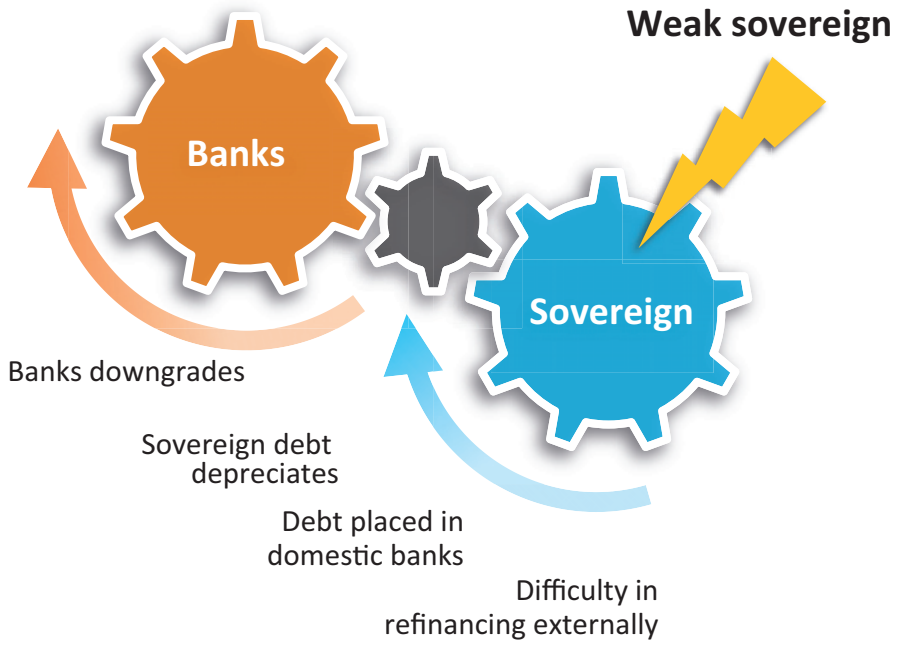
2. See Vives, 2001, Goodhart, 2003, CEPR, 2005 and Dermine, 2006.

Note that the root of the problem lies in the fact that the government has no recourse to a lender of last resort that can provide it with the necessary resources to prop up the banks. Such intervention must take place at least temporarily, while these banks resort to various private measures to improve their solvency and restore their access to the markets. The availability of unlimited liquidity, the usual task of a central bank as a lender of last resort for bank intermediaries, is not enough in a systemic crisis in which investors perceive that insolvency (not only a lack of liquidity) may arise simultaneously across a large part of the financial system.

FIGURE 2.1. From bank risk to sovereign risk

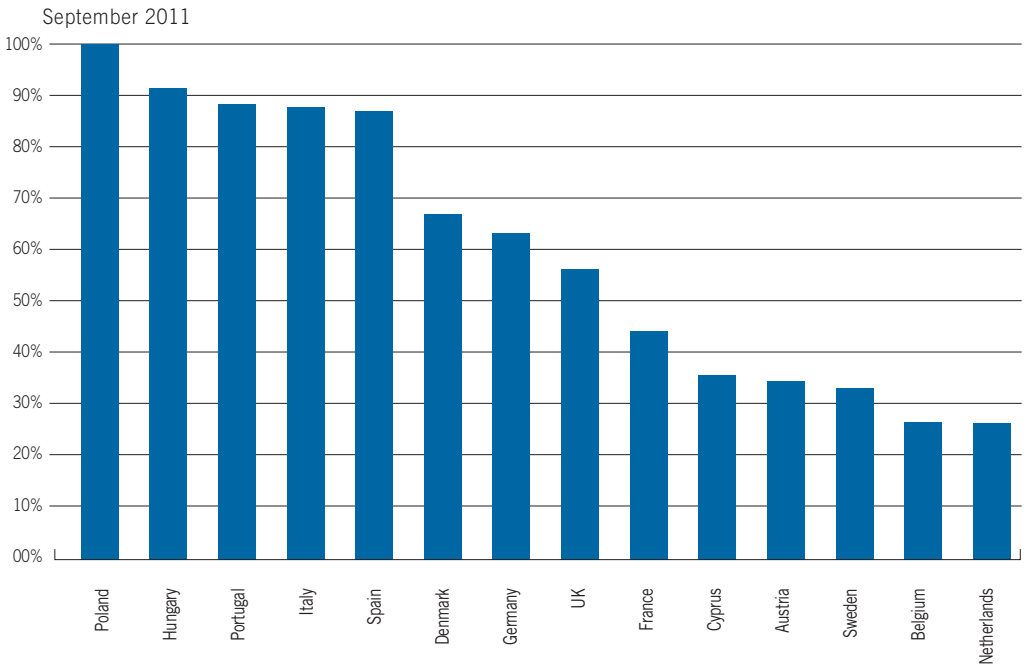
In the opposite direction (see figure 2.2), weak sovereigns may also be the source of serious difficulties for local financial institutions. It is important to note that, in this case, the key factor behind this adverse situation is precisely the local orientation of these banks, the so-called local bias, particularly in terms of their holdings of sovereign debt.

FIGURE 2.2. From sovereign risk to bank risk



As is well-known, European banks have historically tended to hold large amounts of debt issued by their respective governments. This is a common situation in many advanced economies and is associated both with regulatory trends and market dynamics. On the one hand, in regulatory terms, government debt has historically been considered a risk-free asset. On the other, depending on the competitive strategy chosen by the different banks, the banking sector has traditionally been a logical intermediary in public sector financing, as most private savings are channelled to investment through financial institutions. Figure 2.3 shows the local bias in terms of government debt for the financial systems of different countries, a characteristic that was only partly altered during the years of financial integration after the euro was adopted.

FIGURE 2.3. Local bias of the banks in different European jurisdictions
National sovereign exposure(% of the total sovereign exposure of the European Economic Area)



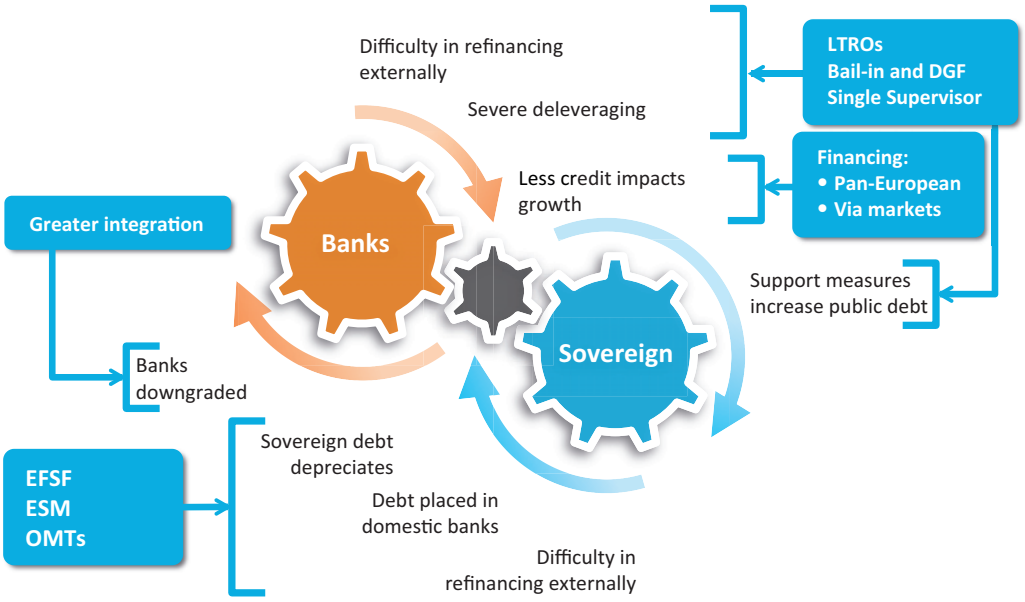
NOTE: Gross exposure. Average per jurisdiction of the banks analyzed by the EBA.
SOURCE: Author based onEBA Capital Exercise 2011 (sovereign disclosure).

In short, the local bias is also closely related to the lack of integration of Europe's banking systems at a retail level, in terms of the existence of pan-European banks. This is a well-documented phenomenon that explains why, when a government in the euro area has difficulty in refinancing its debt internationally, it tends to increase pressure on its local financial system, thereby reinforcing the aforementioned bias. This would not be a huge problem if the government debt were, both in regulatory and also in market terms, a risk-free asset but it can weaken banks if this is not the case. In the euro area, the absence of a lender of last resort for the numerous treasuries within the single currency has meant that the debt issued by the vast majority of these treasuries is no longer risk-free, at least in market terms and perhaps also in regulatory terms. Doubts regarding the value of sovereign debt have also weakened banks via the actions of rating agencies, as banks' ratings, especially when their business is centred on the local market, depend crucially on the sovereign rating.

As we have just seen, the vicious loop described in figures 2.1 and 2.2 can be aggravated by regulatory decisions. This is the case of rating agencies and the key role still granted to them by regulation. Decisions such as the writedown of Greek government debt or the capital buffers required by the EBA in the stress tests of June 2011 to offset the loss in market value of sovereign debt are examples of economic policy measures that, far from resolving the vicious loop, make it even more harmful.

Fortunately, most of the decisions adopted by authorities since the end of 2011, except their handling of the Cypriot crisis, have attempted to relieve the perverse nature of this negative relationship between banks and governments. Figure 2.4 shows how different measures and other changes in market structure affect different phases of the loop.

FIGURE 2.4. Palliative measures adopted in the euro area



EFSF: European Financial Stability Fund. ESM: European Stability Mechanism. DGF: Deposit Guarantee Fund.

The European Central Bank providing unlimited financing to Europe's banks for three years (the long-term refinancing operations or LTROs in December 2011 and February 2012) was a means of guaranteeing the euro area's financial stability, allowing bank and also sovereign debt to be refinanced at a time when the lack of confidence in international markets had totally fragmented the euro area, particularly depriving banks in the periphery countries of access to the markets. This is a temporary mechanism. If it hadn't existed, the bank crisis in many countries would have got worse, seriously harming economic growth and the situation of governments. LTROs also alleviated the loop by offering banks a means of generating revenue, albeit temporarily (the famous sovereign debt *carry trade*), which helped towards their recapitalization.

Another mechanism that could lessen contagion between banks and governments is the existence of clear rules regarding how losses are allocated among the creditors of banks facing problems of viability. When these mechanisms are well-developed, as is largely the case in the United States with its Federal Deposit Insurance Corporation (FDIC) and the federal rules for systemic banks (today the Dodd-Frank Act, Title II) (IMF, 2013a), there is less need for government intervention in the process of recapitalization and the negative impact of a bank crisis on the country is lessened. It is obvious that the vast majority of Eu-

ropean countries have tackled the crisis without having any clear mechanisms at a local level for bank resolution or intervention, and neither are there sufficient instruments in the EU as a whole to tackle this issue in a coordinated way (European Commission, 2012). In the absence of appropriate regulation, only the actions of the European Commission's Directorate General for Competition have helped to guide and control, more or less reasonably, the procedures of bailout and burden sharing that have had to be carried out (see Koopman, 2011).

We should also add that contagion between banks and governments is, per se, a consequence of the eminently local nature of Europe's banks, and the crucial role they play in the economy. If Europe's banks were truly pan-European, the weakness of a certain bank or significant group of banks would not be concentrated in a single sovereign state, thereby generating an asymmetrical shock. Similarly, if the relative weight of banks in financial channels was lower and companies could just as easily access the capital markets, banking problems would not affect real economic activity and public finances so directly[3]. In any case, the development of truly pan-European capital markets for SMEs faces regulatory and market obstacles that are no less than those faced by banks to achieve a truly continental dimension (see Eurofi, 2013).

Contagion between banks and governments has sometimes been due to supervisory errors at a local level, when the local regulator may be influenced by the political environment and turn to a policy of forbearance which ends up being counter-productive and increases the extent of the solvency problems. Yet the boundary is often blurred between appropriate tolerance of liquidity problems and when these actually become a question of solvency. In this respect, the introduction of a single supervisor, the first step in the banking union which we will discuss below, is undoubtedly a factor that helps to reduce contagion.

The actions taken by authorities can also temporarily lessen contagion between governments and banks. In the first phase of the crisis, these actions were carried out by creating the European Financial Stability Fund (EFSF) and subsequently the European Stability Mechanism (ESM). The OMTs announced by the ECB represent a qualitative step forward as they directly aim to restore integrity to the euro area and one of the channels via which they act is precisely by improving governments' access to the markets, with the consequent positive impact on the price of government debt and on the situation of financial institutions. Similarly, to reduce the cost of financing governments and lessen financial instability, the possibility of OMTs also strengthen banks' access to international financial markets.

On the other hand, it is obvious that if Europe's financial system were more integrated, the weakening of a specific country would have less of an effect on the financial situation of its banking system, since the banks' activities would be less related to one specific country and their public sector financing would therefore be more diversified.

In short, throughout the last two years the euro area has reacted to the contagion between banks and governments with numerous measures: initially with adverse effects and subse-

3. However, in financial systems such as the US, where the non-banking channel is important, the effects of the financial crisis were also passed on to the non-financial economy, although the impact was different as this did not happen through the banking channel.

quently with a positive impact, which have reduced a vicious loop that has played a decisive negative role in the crisis. However, as we will see below, this reduction has only been partial, revealing that, ultimately, such interventions have only been temporary, mainly involving the ECB, and that they are merely palliative measures while longer lasting remedies are being built in the form of firm steps towards banking union.

3. The effects on the markets: financial fragmentation in the euro area.

The consequences of the euro area's weak institutional structure, and in particular the vicious loop between sovereign and bank debt, are still being extensively discussed. In terms of the effect on the real economy, it is reasonable to conclude that the liquidity crisis in periphery countries, the capital outflows that accelerated throughout 2012 and the convertibility risk of the euro which many agents incorporated significantly into their expectations all had a notable effect on the economic standstill in the second half of the year, which ended up pushing the euro area into a double dip recession.

From the strict perspective of the financial markets, throughout the euro crisis and especially at its peak before the intervention by the European Central Bank, there was a spectacular rise in the risk premia of periphery government debt compared with the German bund. Some analyses have shown that the levels reached by these premia were way beyond what might have been justified by fundamental determinants (see for example IMF, 2012, page 40-41). Quantifying this deviation from what we might call the equilibrium premium is complex but some researchers have placed it at 300 basis points for the case of Italy (see Di Cesare et al., 2012 and Zoli, 2013).

Those in favour of the ECB's intervention argue that its actions have actually restored the equilibrium premium, at least partly, given the market's anomalous behaviour. On the other hand, both the LTROs and the announcement of the OMTs were also justified by the existence of systemic risks, associated with the liquidity of financial institutions in the first case and the stability of sovereign debt markets in the second. In this case the aim is to stop a "bad" equilibrium from taking hold in these markets. With such an equilibrium, speculative pressure on debt could lead to very high interest rates which, in itself, would result in low growth and would entail an inexorable rise in the debt-to-GDP ratio.

Critics of the ECB's actions tend to attribute the large spreads seen by periphery debt to the situation intrinsic in these countries, namely insufficient reforms to make the economy more flexible and few efforts made to reduce the primary deficit. However, there is no empirical evidence that I know of that justifies this position. In any case, this view argues that the availability of OMTs, and the success they have had in relaxing risk premia, have a negative effect on the economies in question, reducing the pressure to carry out fiscal consolidation and reforms.

In order to avoid such problems of moral hazard, the ECB has conditioned OMTs on an adjustment programme in line with those undertaken by countries requiring a financial bail-out, but it is true that this is not the case if the OMT is not explicitly requested but has an effect merely by being announced. If such a programme is not formally implemented, the only conditionality for those countries benefitting from it is the one already contained in the standard rules governing the monitoring of fiscal and macroeconomic imbalances implemented by European authorities.

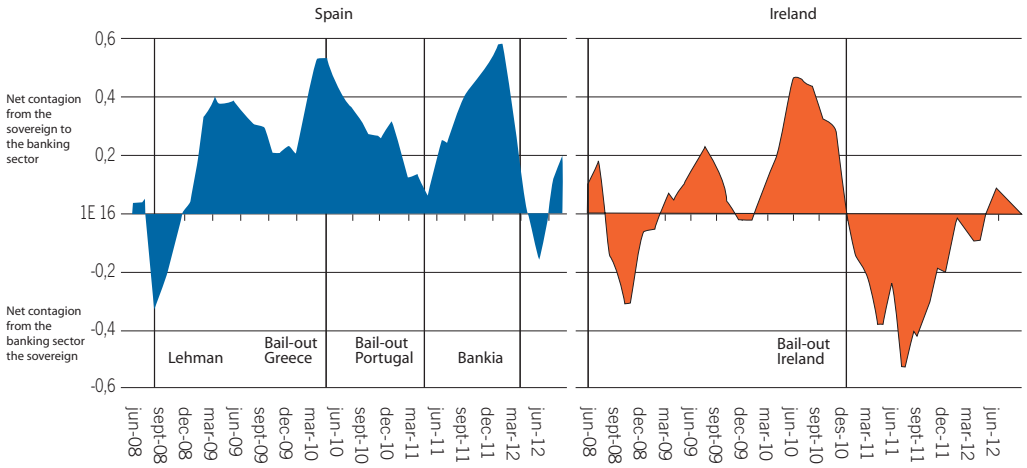
In any case, the large spreads between government bonds caused by the euro area crisis have clearly had a negative effect on other financial markets beyond the sovereign bond markets.

One initial impact occurred in bank funding. The correlation between sovereign spreads and bank debt has been widely documented (see, for example, IMF, 2013b, page 26). It is useful, however, to analyze to what extent this correlation is causal and the direction of this causality since, as we have seen in the previous section, in principle it could be in both directions.

Figure 3.1 uses an indicator of contagion between sovereign and bank risk developed by Arce and Mayordomo, 2012. It shows, in this case for a couple of illustrative countries, how sometimes contagion has come from the sovereign while, on other occasions, the origin has been in banks. We have seen that, in the sovereign case, the initial "shock" might be due to a persistent deviation in the spread from its equilibrium level, for example due to a systemic risk associated with the euro area's integrity. When the origin lies in the banking sector, the initial shock, as shown by the cases of Spain and Ireland, also corresponds to a rise in the bank spread that incorporates systemic aspects, associated with the government's inability to rescue the corresponding banks.

In any case, both when the origin of such turbulences lies in the sovereign or the banking sector, its impact in terms of access to financing in periphery countries has been highly negative throughout the last two years. Figures 3.2 and 3.3 show the high correlation both of sovereign and bank spreads with the financing costs of small and medium-sized enterprises. In both cases, the correlation seems to be weaker for higher spread levels, revealing a rationing effect in credit markets at very high interest rates.

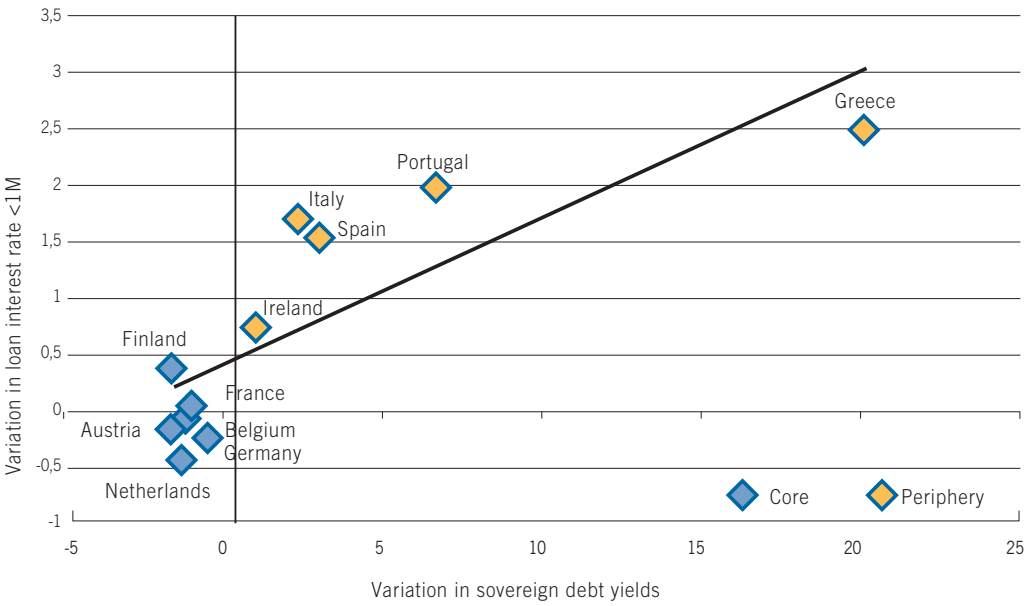
FIGURE 3.1. Contagion in both directions between sovereign and bank risk



METHODOLOGICAL NOTE: This indicator shows the difference between the percentage net change of an equally weighted index of CDS prices for the main banks which is not due to the historical information of bank CDSs but to contemporary shocks in sovereign credit risk, and the opposing net variation; i.e. that which reflects the effect on sovereign risk of shocks affecting the level of financial risk. The indicator is positive when the effect of the shocks on the level of sovereign credit risk in relation to financial risk is higher than the opposite effect. The value of this indicator on any given day is estimated based on the information available for the previous sixty days. The series is also modulated using a sixty-day moving average.

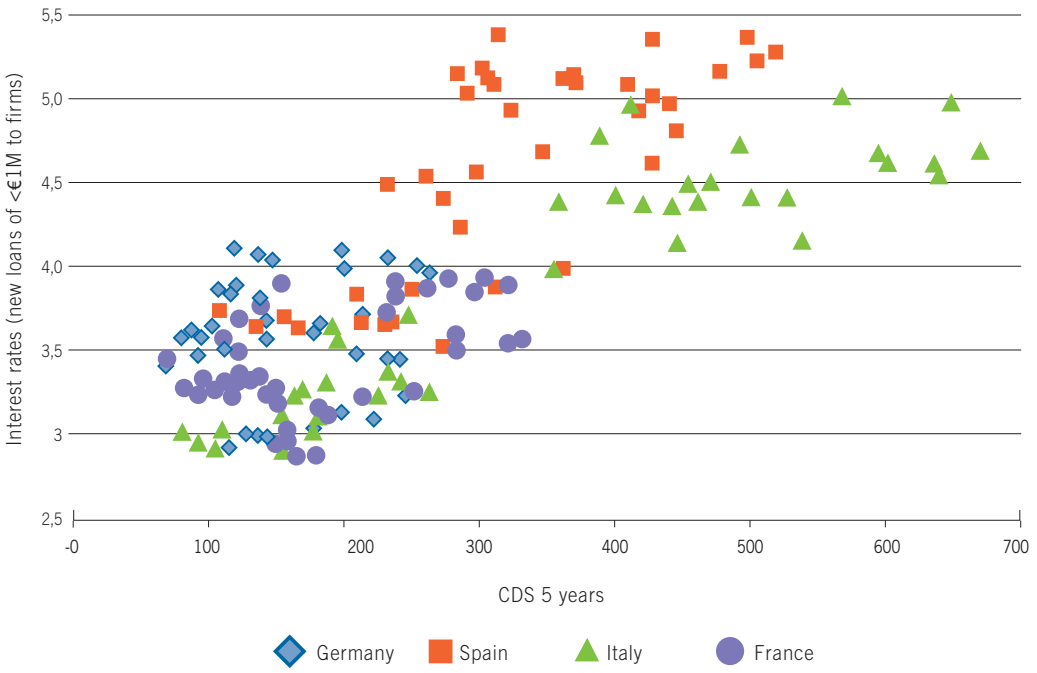
SOURCE: O. Arce and S. Mayordomo, 2012.

FIGURE 3.2 Relationship between sovereign debt yields and bank loan interest rates for SMEs



SOURCE: "Financial (re)integration in the euro area", "la Caixa" *Monthly Report*, June 2013.

FIGURE 3.3. Correlation between interest rates to firms and bank spreads, 2010-2012



4. The key components of a Banking Union

There are normally three institutional and regulatory elements associated with a Banking Union: a single supervisor, a single resolution system for banks in difficulty and an equally integrated deposit guarantee fund. These last two elements must have the appropriate fiscal backstops, ideally of a supranational nature. Two additional conditions that must be met by the institutional architecture of banking union are a) a high degree of harmonization in the requirements for solvency, liquidity and, in general, prudential regulations; and b) "bail-in" or seniority rules for liabilities in cases of insolvency which are also common to all, at least in their fundamental aspects. These two conditions are, naturally, associated with the existence of central institutions that control the supervision and resolution of banks, given that both tasks must be carried out with common regulations so that a level playing field is maintained throughout the euro area and no country enjoys regulatory advantages.

Centralized supervision constitutes a means of preventing national regulators (influenced to a greater or lesser degree by local politicians and industry) from exercising too much regulatory forbearance and will facilitate that the decision-making process regarding supervision takes into account the interactions between the euro area's different banking systems.

In the euro area, steps have already been taken towards creating a Single Supervisory Mechanism and this new responsibility has been assigned to the European Central Bank, with the aim of it becoming operational before the summer of 2014. Decisions have also been taken regarding its scope in terms of the number and size of the banks affected, as well as how it will coordinate with the supervisors of member states (European Commission, 2013[4]).

For this supervisor to be effective, it must have the means to coerce banks, as well as measures for prompt intervention to correct, as soon as possible, any solvency problems that may emerge. Consequently, it must ultimately have the capacity to intervene directly in banks and, under certain circumstances, bring about their resolution.

Regarding the Single Resolution Mechanism, the European Commission is expected to present a proposal in the summer of 2013. The design of this mechanism raises at least three questions: 1) To what extent must this resolution authority be unique and what institutional position should it occupy within the political and administrative structures of the euro area? 2) What must be the nature of the resolution funds assigned to this authority or authorities (private versus public, pre-funded or not, national or pan-European)? 3) To what extent is it necessary to have a pan-European public fund with everything this would entail in terms of sharing budget risks between the different countries of the euro area?

Regarding the institutional aspects and the pan-European nature of the resolution authority, it seems clear that the primordial issue is to guarantee this new body has, first of all, maximum political and legal legitimacy to intervene in banks, as well as the necessary information to be able to take the correct decisions in situations that normally require very fast, decisive action. This would therefore be a quasi-federal body, like the ECB, with senior executive powers, the appropriate legal and political backing and, naturally, in close coordination with the single supervisor.

4. http://europa.eu/rapid/press-release_MEMO-13-251_en.pdf

The most complex issue is, without any doubt, the nature of the resolution funds, due to the fiscal implications should public funds be used.

It naturally seems reasonable to resort, in the first instance, to using funds from the banking sector itself. The aim is to preserve financial stability given a situation of insolvency in one or more banks that may have an adverse effect on the system as a whole given the interconnection between banks, both in terms of interbank operations and also from the point of view of society's confidence in the banking system. It is therefore logical to use private intervention funds. However, we need to clarify that, in any case, such funds are only required temporarily or after using all the bail-in mechanisms that European legislation is in the process of introducing in order to limit the effect of bank crises on public funds, as well as to control the risk assumed by banks.[5]

These funds should be collected previously and be large enough to tackle the resolution of non-systemic crises. The contribution to be made by banks should be determined according to their size and risk profile to ensure that the cost of possible interventions is shared out in line with the banks' own contribution to the risk generated. Contributions designed in this way would also help banks to internalize the negative effects that their decisions may impose on the system as a whole.

It is important to point out that, together with the existence of a private resolution fund that can be used by the single resolution authority, public funds must also be available that, as a last resort, can be used as a bail-out mechanism for systemic banks in difficulty. When a crisis is systemic, along the lines of what happened in the United States after Lehman Brothers went bankrupt or in the euro area between the end of 2011 and mid-2012, any pre-established private fund will not be large enough to be seen as credible by the financial markets and economic agents in general. Under such circumstances, the only guarantee for financial stability is the possibility of the single authority accessing fiscal resources that are large enough to ensure the system's solvency. Such resources are potentially huge and only available to fiscal authorities, and may require temporary coordination with monetary authorities. In the case of the euro, it is evident that this fiscal backstop must be designed at a joint level for the euro area to sufficiently reduce the sovereign risk-bank risk loop.

Obviously, designing such a fiscal backstop is politically complex, given that it entails a potential fiscal redistribution, at least as a possibility. But we must remember that it is linked to supervisory and control mechanisms that are already centralized and pursue goals of a pan-European nature, associated with the euro area's financial stability. Moreover, the nature of this public fund would, in any case, be preventive, a last resort, only to be used in the case of a systemic crisis and the aim of its existence is precisely to stop such situations from occurring.

The last component in a complete design of Banking Union is a shared or common deposit guarantee fund. This fund would also be based on private contributions previously collected from the sector, with bank contributions in line with their risk. If there is a resolution fund with

5. On 28 June, the European Council agreed a common position on the bank recovery and resolution directive which must now be negotiated with the European Parliament. (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/es/ec/137649.pdf).

the characteristics outlined in the previous paragraphs, some analysts question the need for a common deposit guarantee fund. However, we should remember that the aim of the Guarantee Fund is essentially to underpin the confidence of economic agents in the system's stability, something that is vital in modern banking systems based on fractional reserve banking.

As with the Resolution Fund, the Guarantee Fund has two goals. For individual crises, the fund must provide, if necessary, resources that guarantee covered deposits in the case of insolvent banks when the institution is resolved and creditors suffer the corresponding write-downs as per bail-in legislation. As has already been mentioned, the DGF aims to improve confidence in the financial system in order to avoid situations of instability that might arise when some banks enter into difficulty. For this same reason, and as is the case with the resolution fund, this kind of fund is also insufficient and requires a public backstop when the crisis is systemic. Moreover, to guarantee fair competition between different European rivals, it is obvious that this public backstop, once again as a last resort, must be pan-European in nature.

In short, a Banking Union that complements the current economic and monetary union with the aim of permanently destroying the negative loop between sovereign risk and bank risk requires: a series of regulations and institutions that entail centralization at the overall level of the euro area of decisions regarding bank supervision and resolution; the creation of common resolution and deposit guarantee funds for Europe's banking sector as a whole; and the explicit readiness on the part of the euro area's fiscal authorities to share the risks associated with a systemic crisis in order to prevent it and thereby provide the euro area with the levels of financial stability it requires. Only a banking union with these elements will be a banking union made of concrete, sufficiently solid to destroy, once and for all, the negative links between banking and sovereigns in member states.

5. The transition is crucial: can the euro area get away with a relatively flimsy provisional Banking Union?

At the time of writing, end of June 2013, the debate regarding Europe's economic policy is focusing on the necessary components of Banking Union in its transitory stage, until the components of the complete model are firmly and fully in place.

Remember that the single supervision by the European Central Bank is meant to come into force at the start of the summer of 2014, which will require the new authority (in coordination with the European Banking Authority) to previously review the quality of the assets of those banks it will be responsible for supervising, as well as carrying out a stress test on the different systems.

On the other hand, the harmonization of capital requirements is advanced, as the European Council adopted the capital requirements directive and regulation (CRD IV) on 20 June 2013, after the agreement reached previously with the European Parliament. This is expected to come into force on 1 January 2014.

The system's critical element, which has yet to be negotiated between the Council and Parliament, are the rules governing bail-ins and national bank resolution funds. Discussion is centred on the relative seniority of different liabilities, how much discretion national authorities should have in relation to the general rules for resorting to national public funds, and the role played by European public funds as a last resort. Assuming that the proposal agreed by the European Council at the end of June is also agreed quickly by the Parliament, this directive would be passed in 2014 but, in any case, would not be transposed and applied in practice until at least 2015. In principle, bail-in conditions might come into force in 2018 although some countries believe this should be brought forward to 2015[6].

If approved, the agreement reached by the European Council on the resolution and recovery directive would help to weaken the loop between sovereign and bank risk but would still be far from destroying it[7]. The proposal aims to minimize the use of public funds in bank resolutions. To this end it requires a high volume of private bail-in, equivalent to 8% of the balance sheet of the bank in difficulty. After this 8%, and for the next 5% of the losses, a pre-established resolution fund would be used, consisting of contributions from the industry that would have the national government as a backstop (during the transition period and until this fund has effectively received its contributions, the sovereign state will have to advance these funds). For this tranche, the sovereign state could, in turn, request an ESM loan, such as the one received by Spain last year.

Given this situation, the elements that will make up the provisional BU will also come from the proposals introduced by the European Commission regarding the Single Resolution Mechanism and the specific operational rules developed by the Eurogroup regarding the direct recapitalization of financial institutions via the European Stability Mechanism (ESM).

6. Temporarily, burden-sharing rules can be applied based on DGCOMP guidance in the regulations governing state aid.
7. For more details, see "Entidades insolventes: el Consejo opta por el *bail-in* 2.0" (available at www.lacaixaresearch.com).

With regard to the Single Resolution Mechanism, the difficulties encountered in legally and institutionally fitting this function within present-day European institutions are leading some countries to formulate the idea of a college of national authorities as a temporary formula (Schäuble, 2013).

Similarly, direct recapitalization by the ESM (which is actually the same as a public pan-European backstop being available) would not form part of the policy tools available in the short term, insofar as some countries believe that such a function would be difficult to fit within the Treaties since it would mean sharing fiscal risk between countries, as substandard legacy assets may be taken on[8]. From this perspective, the use of pan-European public resources would only be conceivable after the European Central Bank has taken over the work of supervision, once banks' balance sheets have been examined and, if applicable, the appropriate recapitalization has been carried out.

This is a crucial issue. In the transitory regime being negotiated, the single pan-European resource available is access to ESM loans, with the subsequent conditionality. If the bank stress tests by the new single supervisor conclude that a significant number of banks need to be recapitalized, and if these banks cannot recapitalize privately in the markets, it will be necessary for the national public sector to carry out a recapitalization, thereby increasing its debt, although these would be preferential loans like the ones from the ESM (see figure 5.1 for a diagram comparing the optimum BU design and a possible provisional design).

The provisional design therefore presents huge weaknesses in tackling the risks still facing the euro area's banking system. It is a design that does not ensure rapid, decisive action on the part of an independent resolution authority and would also force the member states in question to intervene with their own funds, thereby strengthening the adverse link between weakened banks and a weak sovereign.

We must remember that the current context is one of a systemic crisis in which significant parts of various European bank systems are weak, the euro area is extremely fragmented in financial terms and the weak macroeconomic environment could still lead to a reduction in bank profits and their capacity to generate capital internally.

It is true that the transitory system that looks likely to be imposed is strictly in line with the philosophy that there must be an appropriate correlation between the risks assumed and the control wielded (Weidmann, 2013). But it is also true that, faced with a systemic crisis with significant potentially adverse effects on the whole European financial system and on macroeconomic development, it becomes necessary to introduce risk-sharing mechanisms that help to guarantee the stability of the system as a whole.

8. The conditions for a possible direct recapitalization by the ESM agreed by the Eurogroup in June are very restrictive: this will only be possible once the ECB is acting as a supervisor, after the resolution and deposit guarantee fund directives have been approved, and will require, for example, the bank to already have capital equivalent to 4.5% of its risk-weighted assets.

FIGURE 5.1. The design of banking union

	Banking union "made of concrete"	"Timber-framed" banking union
Supervisory Mechanism	Single	Single
Rules/capital requirements	Harmonization	Harmonization
Bail-in rules	Harmonization	Harmonization
Resolution mechanism	Single authority Common resolution fund (private, pre-established) Supranational fiscal backstop	College of national authorities National resolution funds (private, pre-established) National fiscal backstop + ESM
Deposit guarantee schemes	Common DGF (private, pre-established)	Harmonized national DGFs (private, pre-established)
	Supranational fiscal backstop	Backstops: 1. Loans between DGFs 2. National fiscal authority 3. ESM

Source: Author

Without resorting to arguments of equity or solidarity between different euro area countries, and restricting our analysis to arguments of economic efficiency, one can make the case that the transitory stage of Banking Union requires going ahead with the shared assumption of risk: perhaps in an *ad hoc* way and undoubtedly explicitly. But, in any case, such collective insurance may contribute towards the stability of the whole and (from the perspective of countries that are potentially net contributors) could, in the long run, represent a much more economical alternative than a simple calculation of direct costs and benefits, which misses the indirect benefits in terms of the system's stability.

On the other hand, any insurance or guarantee mechanism introduced during the transitory phase should be combined with a conditionality similar to that which forms part of the ESM support loan programmes. The fundamental difference would be that, in this last case, the loans would increase the vicious link between sovereign debt and bank debt while this effect is avoided in the case of an insurance or guarantee. In both cases, however, it is ensured that the appropriate incentives are maintained in order to avoid moral hazard.

6. Conclusions

The coming months will be decisive for the process of constructing a banking union in the euro area. In the absence of a European legal framework with sufficient democratic legitimacy that involves greater political integration in terms of member states giving up key aspects of sovereignty and jointly assuming risks, it will be necessary to advance with pragmatism and realism.

The criteria to construct a transitory banking union might essentially be of two types. One alternative is to attempt to construct an institutional architecture that, albeit temporary, represents the ideal system to avoid future financial and fiscal crises in the euro area. In other words, by abstracting from current conditions. With this option, transforming provisional banking union into its definitive form would only be a question of adapting the provisional institutions to a future framework with a greater loss of sovereignty, once the Treaties have been revised.

This option, which seems to be the dominant one at the time of writing this article, is very risky for Europe's economy and for the future of banking union *per se*. It assumes that the current financial crisis has already been overcome or that, in any case, the introduction of the regulations for this provisional banking union will not affect how the current crisis evolves.

A second alternative for the design of provisional banking union recognizes that the financial crisis is systemic in nature and is not over yet, and that Europe's highly fragmented financial markets require immediate institutional changes on the part of European authorities, so that the design of a transitory banking union can contribute to resolving the current crisis and not only potential future crises.

The approach taken by the first alternative is the result, on the one hand, of incorrectly diagnosing the causes of the euro area's double dip recession and, on the other hand, is a logical consequence of the resistance shown by creditor countries to share in any losses that might remain from substandard legacy assets.

The diagnosis is incorrect because difficulties in accessing credit (which harm growth in the euro area) are attributed to the widespread under-capitalization of banks instead of focusing attention on the negative effects of financial fragmentation and the high financing costs this entails for companies in the periphery.

Regarding legacy assets, the crucial issue is to determine the point at which banks' balance sheets can be classified as "clean". Note that, in a context of low economic growth, the risk is that asset quality will continue to deteriorate, especially in economies such as the peripheral ones, immersed in deleveraging processes with the risk of deflation. On the other hand, although sharing risk at a pan-European level means that core countries in the euro area would have to assume risks this could, in itself, help the revaluation of assets and the improvement of their quality without any transfers between countries becoming necessary. In any case, the question of legacy assets should be resolved once the ECB takes over the role of supervisor.

Under the baseline scenario, based on a transitory banking union design aimed at avoiding future crises, the risks for the coming months are highly significant. This scenario requires

asset quality reviews and stress tests to be carried out by European authorities (the ECB in coordination with the EBA) before the ECB takes over as the single supervisor in mid-2014. As has been highlighted by the central bank itself (Draghi, 2013), this balance sheet review cannot be carried out unless there is a sufficiently operational resolution mechanism and, most particularly, appropriate recapitalization funds, which must be at a pan-European level if the aim is really to stop the vicious loop between bank and sovereign debt. This pan-European public backstop has not been included in the provisional banking union, the one Mr. Schäuble has called a "timber-framed" banking union, and the risk is that the resulting structure may simply be made of straw, likely to be easily wiped out by the markets should they believe that systemic risk is not under control.

Another factor that contributes to the weakness of the current design of banking union is the increasing role given to bail-in processes. Once again, this is a legislative reform that is correct in terms of its objectives and ideal for preventing future crises. However, the pressures to make it come into force before 2018 could represent a serious source of instability at a time when the economic situation is fragile and, as we have seen, Europe's financial markets are still fragmented and the system has yet to fully recover its stability.

In sum, decisions regarding the transitory architecture of banking union will be crucial. The euro area's economy is going through a fragile recovery from a double dip recession, still afflicted by the serious fragmentation of its financial markets and quite substantial systemic risks. It is crucial to achieve the right design for this transitional phase, making sure the euro area has sufficiently powerful and credible transitory pan-European mechanisms to guarantee financial and bank stability. Otherwise, once again regulatory and economic policy errors might very well send Europe back into another recession.

References

Arce O. and S. Mayordomo (2012). "Contagio de riesgo de crédito entre sectores", Working Paper.

CEPR (2005) *Integration of European Banking: The Way Forward*, Monitoring European Deregulation 3, London.

Dermine, J. (2006) "European Banking Integration: Don't Put the Cart before the Horse" in *Financial Markets, Institutions and Instruments*, volume 15, Issue 2, pages 57-100, May.

Di Cesare et al. (2012) "Recent Estimates of Sovereign Risk Premia for Euro-area Countries", Occasional Paper No. 128, Banca d'Italia.

Draghi, M. (2013) Introductory Statement to the Press Conference, June 6, European Central Bank.

Eurofi (2013), "Challenges and feasibility of diversifying the financing of EU corporates and SMEs", available at http://www.eurofi.net/wp-content/uploads/2013/04/2013_Dublin_-Financing-Corporates_SMEs3.pdf

European Commission (2012), "A Roadmap towards a Banking Union" Communication from the Commission to the European Parliament and the Council, COM (2012) 510 final, September 12th.

Goodhart, C. (2003): "The Political Economy of Financial Harmonization in Europe", in *Financial Supervision in Europe* eds. J. Kremers, D. Schoenmaker, and P. Wierts, Cheltenham: Edward Elgar, 129-138.

IMF (2012), *Fiscal Monitor*, October.

IMF (2013a), "A Banking Union for the Euro Area", Staff Discussion Note SDN/13/01, February 15th.

IMF (2013b), "Financial Integration and Fragmentation in the European Union" IMF Country Report no. 13/73. European Union Financial Sector Assessment Program, March.

JP Morgan Chase Bank (2013) "Three Little Pigs: Europe's banks will get a house of wigs" *Economic Research Note*, May 30th.

Koopman, G-J. (2011), "Stability and Competition in EU Banking during the Financial Crisis: the Role of State Aid Control", *Competition Policy International*, vol. 7 no. 2.

Schäuble, W. (2013), "Banking union must be built on firm foundations", *Financial Times* May 12th.

Vives, X. (2001), "Restructuring Financial Regulation in the European Monetary Union", *Journal of Financial Services Research* no. 19 (1). Pages 57-82.

Weidmann, J. (2013), "Banking Union Properly Structured" in *The International Economy*, Winter.

Zoli, E. (2013) "Italian Sovereign Spreads: Their Determinants and Pass-through to Bank Funding Costs and Lending Conditions", IMF Working Paper 13/84, April.

"la Caixa" Research Department

Publications

All publications are available on Internet:
www.lacaixaresearch.com
E-mail:
publicacionesestudios@lacaixa.es

WORKING PAPER SERIES

02/2013. Vulnerabilidad de las economías emergentes Àlex Ruiz

01/2013. Sareb: claves estratégicas Sandra Jódar-Rosell

09/2012. Ajuste de capacidad en el sistema financiero español Inmaculada Martínez

08/2012. El ahorro y la eficiencia energéticos: un impulso para la competitividad de la economía española Pere Miret

07/2012. *Risk on-Risk off*: las correlaciones en tiempos de crisis Eduardo Pedrerira

06/2012. Commodity Cycles: What Has changed during the Last Decade? Eduardo Pereira and Miguel A. Canela

05/2012. Inversiones financieras en España: impacto de la inestabilidad en los mercados Inmaculada Martínez

04/2012. Is There a Property Bubble in China? Clàudia Canals and Mercè Carrerras-Solanas

03/2012. El sobreendeudamiento de las empresas españolas: ¿problema común o de unas pocas? Sandra Jódar-Rosell and Inmaculada Martínez

02/2012. Hungría y la ayuda financiera de la UE y el FMI: ¿cambio en el mapa de riesgos? Àlex Ruiz

01/2012. Spanish Public Debt: Myths and Facts Oriol Aspachs-Bracons and Joan Daniel Pina

11/2011. ¿Cuándo se recuperarán los precios de la vivienda en Estados Unidos? Jordi Singla

DOCUMENTOS DE ECONOMÍA "la Caixa"

Enseñanzas latinoamericanas para una crisis europea Àlex Ruiz

Los requisitos de capital de Basilea III y su impacto en el sector bancario Jordi Gual

Perspectivas de desapalancamiento en España Oriol Aspachs-Bracons, Sandra Jódar-Rosell and Jordi Gual

Diferencial de inflación con la eurozona: ¿mejora sostenible? Pere Miret

La recuperación del comercio mundial. Lo que la crisis se llevó Marta Noguer

Inmigración y mercado laboral: antes y después de la recesión Joan Elias

"la Caixa" ECONOMIC PAPERS

European Integration at the Crossroads Jordi Gual

Capital Requirements Under Basel III and Their Impact on the Banking Industry Jordi Gual

Should the ECB Target Employment? Pau Rabanal

Integrating Regulated Network Markets in Europe Jordi Gual

MR MONTHLY REPORT- ECONOMIC AND FINANCIAL MARKET OUTLOOK

Report on the economic situation (available also in Spanish version)

CURRENT ECONOMY

FINANCIAL SYSTEM

COLECCIÓN COMUNIDADES AUTÓNOMAS

CÁTEDRA "la Caixa" ECONOMÍA Y SOCIEDAD

El tiempo que llega. Once miradas desde España José Luis García Delgado (editor)

ECONOMIC STUDIES

Europe, Like America: The challenges of building a continental federation Josep M. Colomer

El cambio climático: análisis y política económica. Una introducción Josep M. Vegara (director), Isabel Busom, Montserrat Colldeforns, Ana Isabel Guerra and Ferran Sancho

Academic Advisory Council

The Academic Advisory Council guides the Research Department in its work analyzing the economic and social policies that might be effective in ensuring the progress of Spanish and European society. The members of the Council are:

- Pol Antras
  Harvard University
- Philippe Bachetta
  Université de Lausanne
- Ramon Caminal
  Institut d'Anàlisi Econòmica (CSIC)
- Manuel Castells
  Universitat Oberta de Catalunya y University of Southern California
- María Paz Espinosa
  Universidad del País Vasco
- Josefina Gómez Mendoza
  Universidad Autónoma de Madrid
- Massimo Motta
  Barcelona GSE - Universitat Pompeu Fabra
- Joan Enric Ricart
  IESE Business School
- Xavier Sala-Martín
  Columbia University
- Jaume Ventura
  CREI-Universitat Pompeu Fabra

General Management

- Jordi Gual
  Chief Economist of "la Caixa"

Publishing coordinator: Edicions 62, S.A.
Av. Diagonal, 621-629
08028 Barcelona
www.grup62.cat

Page make-up: Alfa
Design: www.cege.es
Printing: SYL
D.L.: B.20695-2013

"la Caixa"