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Fixing and completing the European Economic and Monetary Union: the costs of the unfinished Banking Union

Over the last few years, Europe has undertaken numerous reforms in different areas, from fiscal to banking and financial stability, in what has been an ambitious response to the urgent need to resolve the problems that followed the outbreak of the global financial and sovereign debt crises. Several initiatives have been taken to strengthen European banks: from the definition and application of common rules, to the consolidation of truly European authorities. The Banking Union is a vital element of this strengthening process.

The Single Supervisory Mechanism, which was completed in an extraordinarily short period of time, entails very extensive and deep integration of national authorities. While the Monetary Union mostly consisted in the sharing of decision making, the SSM envisages the integration of daily operational processes to be carried out at national and centralized level.

The establishment of the SSM, followed by that of the Single Resolution Mechanism, could have been a prelude to a paradigm shift in the level of European integration. However, this has not yet materialized. On the contrary, the Banking Union is still under construction and significant obstacles remain on the path to its completion. Our presence here today therefore provides a timely opportunity to discuss what remains to be done, how to go about it, and ultimately to stress once again how important it is to complete this project, as has been repeatedly highlighted by researchers[1] and numerous representatives of the Eurosystem, first and foremost the ECB President. It is important not only for the sake of the Banking Union project in itself, but also for the achievement of the broader European project.

It was no accident that the original blueprint for Banking Union rested on three pillars (banking supervision, crisis management, and deposit insurance): each one is an integral part

[1] Among others, Balassone F., S. Cecchetti, M. Cecioni, M. Cioffi, W. Cornacchia, F. Corneli and G. Semeraro, 2016, 'Economic governance in the euro area: balancing risk reduction and risk sharing', Occasional Papers, Banca d'Italia, 344; Goyal R., P. Koeva Brooks, M. Pradhan, T. Tressel, G. Dell'Ariccia, R. Leckow, and C. Pazarbasioglu, 2013, 'A Banking Union for the Euro Area', IMF Staff Discussion Note SDN/13/01, February; Schoenmaker D. and A. Siegmann, 'Winners of a European banking union', 2013, VoxEU, 27 February; Gros D. and D. Schoenmaker, 'The case for euro deposit insurance', 2012, VoxEU, 24 September.

of the financial architecture needed to safeguard the soundness and the stability of any banking system, and to break the vicious circle between banks and sovereigns. This is particularly important in Europe where, in spite of the multiplicity of sovereign states involved, we aim to achieve a single European banking market with European players.

The first pillar of Banking Union, the Single Supervisory Mechanism, avoids misaligned incentives by ensuring that appropriate regulatory and supervisory standards are enforced and, at the same time, levels the playing field for cross-border banking. The second pillar, an incentive-compatible resolution framework, aims at reducing moral hazard; it can also preserve financial stability, so long as adequate provision is made for the eventual use of a public backstop for large and complex financial institutions.[2] The third pillar, a common deposit insurance scheme, would lower the probability of systemic stresses by closing off the channels of contagion, i.e. it would provide an effective buffer against a large number of country-specific shocks, thereby lowering the likelihood of bank runs and overall systemic risk.

If the Banking Union were to remain as it is today, the result would neither be compliant with best practices, nor would it have achieved its intended effects. In fact, as Dirk Schoenmaker put it, now that the immediate crisis is past, 'governments have started to shop selectively on the Banking Union list'.[3] In this 'à la carte' Banking Union, the absence of common deposit insurance increases the risk of contagion, while a blunt implementation of the resolution framework with no public backstop in place would heighten financial stability risks.

As recently noted by the Senior Deputy Governor of the Bank of Italy, the lack of a common fiscal backstop 'reflects the unwillingness of many European countries to consider the possibility that the taxpayers of country A may pay, even temporarily, for the crisis of a bank in country B. According to this view, banks, although now supervised and subject to resolution by European institutions, must ultimately remain a national matter.' [4] The outcome is that the bank-sovereign nexus, which the Banking Union was designed to counter, persists, within a complex and incomplete framework.

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[2] Dewatripont M., 2014, 'European banking: Bailout, bail-in and state aid control', *International Journal of Industrial Organization*, vol. 34, issue C, pages 37-43.

[3] Schoenmaker D., 2015, 'Firmer foundations for a stronger European banking union', Bruegel Working Paper, 2015/13, November.

[4] Rossi S., 2016, 'The Banking Union in the European integration process', speech at the Conference on *European Banking Union and bank/firm relationship*, April.

European leaders must therefore not lose sight of the end goal and instead complete the project in a reasonable timeframe. The need to press ahead is made even more urgent by the fact that while the European banking and financial system has demonstrated its resilience, its stability is still at risk.

Indeed, risks to Europe's macro-financial stability have recently intensified. While it is true that the expansionary monetary policy stance in the euro area and in Europe at large is supporting the liquidity of financial markets, curbing tensions on government securities, and easing bank funding conditions, uncertainties have nevertheless increased following the UK referendum and, though perhaps less so, the Italian referendum. Nor, given recent political events, expected policy changes in the United States, and fragilities in emerging economies, are they likely to be dispelled over the medium term. European banks' profitability and their business model are under extraordinary pressure, due to sluggish growth, low interest rates and, to a differing extent across countries and banks, excess capacity, large stocks of non-performing loans and difficult-to-value (level 3) assets. Meanwhile, low nominal interest rates are squeezing the profit margins of European insurance companies and pension funds. At a recent hearing of the Committee on Economic and Monetary Affairs of the European Parliament, the ECB President warned that a lengthy period of low interest rates has created 'fertile terrain' for financial-market risks and called on governments to take action against the risks associated with rising debt levels or excessive valuations, which have resulted in significant vulnerabilities in some European real estate markets.

While they are more solid today than they were in the pre-crisis period, in the absence of an adequate, proportionate and properly functioning safety net, Europe's banks are also more exposed than before to substantial risks to their individual stability.

A common EU deposit guarantee scheme is a crucial component of the safety net and should be set up as swiftly as possible. In November 2015, the Commission presented a proposal for a European Deposit Insurance Scheme (EDIS). The idea is to build on the existing national schemes and then gradually move towards a European construction that would be fully in place by 2024. While the introduction of the third pillar is generally accepted in principle, controversy has arisen recently regarding its timing and negotiations are at a standstill due to the opposition of some countries.

Introducing common deposit insurance is not enough, though. In order to bolster public confidence and to ensure that the Banking Union has the capacity to safeguard financial stability in adverse circumstances, we also need a common public backstop covering both resolution and deposit insurance.

Furthermore, it is important to acknowledge that the ability of the new EU resolution framework to counter systemic crises has been somewhat overstated, especially when combined with the European Commission's approach to competition and State aid. A recent paper by Emilios Avgouleas and Charles Goodhart warns against large-scale, bail-in centred, recapitalizations and illustrates the 'danger of over-reliance on bail-ins' by providing a very insightful description of the risks involved in triggering the bail-in process when risk is not idiosyncratic.[5] While the bail-in tool is actually well-designed for addressing the crisis of individual banks, in the event of a systemic crisis its use risks exacerbating the threats to financial stability rather than stabilizing the system. In those circumstances, the possibility of temporary public support, without necessarily involving banks' creditors, should not only be considered but favoured, to dispel the fear of contagion and prevent the seeds of another crisis from being sown.

Of course, envisaging public support in exceptional circumstances should not undermine efforts to reduce forms of moral hazard that can lead to excessive risk-taking by banks. The risk of imprudent behaviour still has to be contained but it can be tackled in other ways that are more compatible with safeguarding financial stability, along the lines of what happened in the aftermath of the crisis, i.e. by strengthening the prudential framework, adapting the structure of remuneration schemes to reduce incentives for excessive risk-taking, and by making management fully liable in the event of the failure of an institution. At the same time, the burden for taxpayers could be lightened by requiring that public funds be recouped from the banking system at a later stage, when financial stability is no longer at risk – as envisaged by the 'Key Attributes of Effective Resolution Regimes for Financial Institutions', drawn up by the Financial Stability Board.[6]

To conclude, while much has been done to reduce risks, we lag behind on risk-sharing measures, which are their natural complement. Even for those already in place, such as the Single Resolution Fund, the path to complete risk mutualization is very long.

What are the costs of this unfinished construction?

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[5] Avgouleas E., C.Goodhart, 2016, 'An anatomy of bank bail-ins – Why the Eurozone needs a fiscal backstop for the banking sector', *European Economy*, 2016.2., 5 December.

[6] Financial Stability Board, 2011, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', principle 6.5.

An incomplete Banking Union is a source of risk in itself. If neglected for too long, it will discourage banks' reorganizations and consolidation processes as the cost of funding and capital remain subject to excessive uncertainty, with likely undesirable effects on banks' ability to support both investment and consumer spending.

In this transitional phase, when banks are still building up adequate loss-absorbing buffers and Governments are without their traditional tools of intervention, the risks are even greater.

We should also remember that completing the Banking Union is a priority *per se*, and should not be conditional on other interventions. I refer, in particular, to the much debated possible change of prudential treatment for sovereign exposures, which is among the measures called for in order to move forward with the creation of the EDIS. A draft report presented to the Committee on Economic and Monetary Affairs of the European Parliaments (ECON)[7] makes the entry into force of the insurance phase of EDIS conditional on reducing risks in the banking sector. In this regard, while recognising that changing the prudential treatment for sovereign exposures could help to break the bank-sovereign nexus, I believe that it should not be considered as a pre-condition for, or an alternative to, the completion of Banking Union.

A clear timeline for deposit insurance, as we had for the Single Supervisory Mechanism and the Single Resolution Mechanism, would help reassure markets as to the soundness of the overall banking framework and the willingness of Member States to pursue the final design of the Union.

In the meantime, the Single Supervisory Mechanism should continue to focus on further strengthening the resilience of the banking sector. However, we should avoid over-calibration and possible inconsistencies between different measures that might impair the ability of European banks to support the real economy.

A path must be identified to guide banks towards adequate levels of capital and loss-absorbing capacity to increase their stability and readiness to withstand adverse market conditions without compromising their capacity to finance the economy and sustain the

[7] See European Parliament, Committee on Economic and Monetary Affairs, Working Document on EDIS and Draft Report on the Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme (COM(2015)0586 – C8-0371/2015 – 2015/0270(COD)), Rapporteur Esther De Lange.

economic recovery. This is especially true today when banks' profitability remains low and the recovery in the EU is still struggling to gain momentum.

After substantially strengthening capital levels in recent years, EU banks will now be required to increase their loss-absorbing capacity to meet the minimum requirements for own funds and eligible liabilities (MREL). In this regard policymakers face a trade-off: on the one hand, large stocks of liabilities that can feasibly and credibly absorb losses in resolutions contribute to the resolvability of banks and to financial stability, while simultaneously protecting taxpayers; on the other hand, the build-up of adequate buffers of loss-absorbing capacity may be very costly for banks, impair their lending capacity to the real economy, and require time. The review of the legislative framework, starting with the European Commission's recent proposals, should strike the right balance. In any event, it is indispensable to avoid a needlessly high MREL requirement disproportionate to the effective needs of a resolution.[8]

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Let me conclude with two quotations. In a recent speech at the EMU Forum, Peter Praet said 'Completing the union is sometimes framed in terms of a trade-off between risk sharing and risk reduction [...] I believe both routes need to be followed and to move forward in parallel [...]. A European Deposit Insurance Scheme would enhance overall depositor confidence ... This is the very foundation of insurance: by pooling resources and risks across a larger and more diverse group, the overall shock-absorbing capacity of the system increases. In this sense, risk sharing turns into risk reduction'.[9]

In a working paper published a few months ago on the economic governance of the euro area, a group of researchers at the Bank of Italy reviewed the measures taken concerning sovereigns and banks since 2010 and concluded that Europe is now at a crossroads: 'either it finds the strength to return to its roots and embraces a second (and deeper) round of reforms based on enhanced risk sharing, or it risks running into pro-cyclical excesses that may finally tear it apart'.[10]

This forum may therefore provide a valuable contribution to enhancing the awareness of policymakers about the dramatic, yet possible outcomes of a piecemeal, short-sighted approach to the completion of Banking Union.

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[8] Bank of Italy, Financial Stability Report No. 2 / 2016, November 2016, p. 36-37.
[9] 'The importance of a genuine banking union for monetary policy', Vienna, 24 November 2016
[10] Balassone et al.