Towards a European Banking Union

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I vividly remember when, in my capacity as director for international affairs at the Italian Treasury, I participated in the informal Ecofin meeting in the Portuguese city of Porto in September 2007. The first signs of the global financial crisis ahead had just begun to appear, but the prevailing mood was still one of confidence, if not complacency. A small and somewhat arcane segment of the US financial system, the *subprime*, was creating trouble across the Atlantic. Europe was not overly exposed to the US real estate sector, let alone to that small component of it, and hence was deemed likely to prove immune. Then, during that meeting, the UK delegation suddenly left the room and we were informed that a run was in progress on a British bank called Northern Rock. Travelling at the speed of light on news and market wires, the crisis had crossed the ocean. Shortly afterwards, it would cross the channel as well, becoming the euro crisis. We did not expect then, or at least I did not, that those developments would turn out to have a fundamental impact on the euro and the European institutions. Among the few to grasp the full implications of those events was the Italian Finance Minister of the time, the late Tommaso Padoa-Schioppa. He believed that the crisis would, in time, give rise to the opportunity and the need to create a new financial architecture for Europe. He argued that Europe should react by creating a unified regulatory and supervisory framework spanning the entire continent; a banking union to complete and support its still unfinished and fragile monetary union. He proposed that vision repeatedly, in Porto and on several other occasions during his few remaining months as minister, receiving virtually no support from his European peers.

Five years on, discussions are now well underway regarding the establishment of a banking union, and, as a first step, of a supervisory authority for the euro area. The prospect of creating such a union materialised in 2012. In June, the European Commission proposed to take steps in this direction, covering the supervision of cross-border banks and EU deposit guarantee and resolution schemes, and on 29 June 2012 the Euro Summit formally asked the Commission to prepare a proposal for creating a Single Supervisory Mechanism (SSM) involving the ECB and without changing the Treaties. From that moment on, preparations accelerated. On 12 September, the Commission published a draft Council regulation entrusting the ECB with a specific, but comprehensive list of tasks related to the supervision of euro area banks. After appropriate consultations, this text will be submitted for approval to the European Council.

Strengthening bank supervisory and regulatory integration in Europe is the unavoidable consequence of recognising a fundamental inconsistency in European monetary and financial architecture: the singleness of money and financial markets on the one hand, and the fragmentation, along national lines, of banking supervision and banking safety nets on the other. The founding fathers of the euro were well aware of the 'inconsistent trinity' of fixed exchange rates, national monetary policies and open capital markets: a monetary union and the ECB were the answers. However, they were less aware of – or could not act on – another inner contradiction, different in its manifestation, but similar in logic. In the current structure of the monetary union, fragility in national banking systems is immediately transmitted to the domestic fiscal sector, igniting an adverse fiscal/financial loop that weakens both. Either can be the source; countries with very different starting conditions can end up facing similar problems shortly after, all the more so if financial and fiscal weaknesses are compounded by other economic imbalances. The first casualty is financial integration. The integration of the European monetary, banking and securities markets has been

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severely damaged in the last five years, as documented by reports published by the ECB and the Commission. Countries that lose market confidence and market access are progressively isolated from the area's financial sector, with devastating implications for both the conduct of monetary policy and the single European market. Once this happens, dangers for financial and monetary stability for the area as a whole are just around the corner.

This article, written at a point where negotiations on the creation of a European banking supervisor are well advanced, but have not yet been concluded, will begin by reviewing the reasons for launching this ambitious project. It then mentions the main elements and guiding principles of the prospective SSM, followed by some remarks on an area at the boundary between banking supervision and other policy areas: macro-prudential policy. The article concludes with an issue of great importance, namely the need to establish a European bank resolution authority as a complement to the SSM.

Why a banking union?

In an integrated currency area, financial stability is a matter of collective responsibility. In the euro area specifically, the mismatch between centralised monetary policy decisions and national banking responsibilities has been a destabilising factor throughout the recent period. It still undermines our ability to tackle the crisis in a more effective way.

Growing pressures in funding and lending markets have led to a fragmentation of the euro area banking system along national lines. Links between banks and their own sovereigns have grown tighter. The correlation between the funding cost of euro area banks and those of the respective sovereigns have increased, particularly in the peripheral economies. Countries that lose market confidence become progressively dependent on domestic sources of funding (where and insofar they are available), more prone to capital outflows, and less responsive to monetary policy. The divergence in bank funding conditions at national level in turn gives rise to cross-country differences in lending conditions. The retrenchment of credit supply within national borders, coupled with funding pressures, impairs the transmission of monetary policy, which in the euro area functions primarily *via* banks. Lending conditions for households and firms become tighter than they should be, given the prevailing monetary policy stance, and less predictable. The need to remedy this situation explains large part of the extraordinary monetary policy decisions made by the ECB in the last 18 months, including especially the Securities Market Program and the Outright Market Transactions.

The adverse loop between banks and sovereigns also undermines national efforts towards re-establishing fiscal sustainability. Countries undergoing fiscal adjustment tend to be penalized by financial markets, on account of the additional burden of supporting the domestic banking system. As a result, their banks face increasing refinancing pressures and the fragmentation of the euro area banking system increases further. In these conditions, the effort to re-establish both banking stability and fiscal sustainability can become self-defeating.

The cornerstones of a European bank supervisor

First and foremost, the SSM must be designed so as to avoid a repetition of the mistakes of the past. Historical experience shows that, while crises differ from one another in important respects, they tend to have some common originating elements. These elements include accelerated credit expansion, increasing leverage in the financial and the non-financial sectors, asset price bubbles; and ultimately the loss of contact by financial market participants with economic reality and fundamental values. For several years prior to this financial crisis, accelerated credit growth was widely observed in the banking sector, leading to imbalances and asset bubbles. With hindsight, supervisors were often lenient, constrained either by their mandates, or by other national pressures, or often by both. In Europe, a slow and insufficient reaction was also induced probably in the hope, which turned out to be a fallacy, that the euro and its well-functioning governance would prove sufficient shelter.

Besides taking these systemic repercussions into account, an effective European supervisor should also be designed to ensure even-handed supervisory control across the euro area. Supervisors should be free from local pressures and interests. They should be able to independently assess the situation of individual banks, and connect it to the systemic context. A single supervisory authority in the euro area means going a long way – but not quite *all the way*, as this paper argues – towards solving these problems. In theory, building such an authority around the ECB is not the only solution, but it is the only practical one in the present cir-

cumstances; the ECB has the legal means and, in conjunction with the national authorities, which in most cases coincide with the national central banks, the resources and technical capability to carry out this complex task successfully. This does not imply that the task facing us is easy, or that results will be immediate. For the ECB, and for the more seasoned authorities that carry out supervision in the member states, the new supervision mechanism will represent a sea-change, a 'new frontier', comparable in many ways with the creation of a new currency and a new central bank before the beginning of this century.

Some observers have noted that the presence in the same house of monetary policy and supervisory decisions can lead to overburdening, role confusion or distorted incentives. The international comparison, where banking supervision in most cases involves central banks, does not support this claim in an unambiguous way, provided that appropriate safeguards are in place. Nor have supervisory models built on a strict distinction of the respective authorities proven exempted from incidents. Nonetheless, the risk of 'contamination' between monetary policy (and its overriding goal, price stability) and prudential supervision (aiming at the safety and soundness of credit institutions and the stability of the financial system) is real and should be taken seriously. To guard against this risk, certain principles must be respected.

Firstly, a clear separation needs to be maintained between supervisory decision-making and monetary policy. The draft regulation that is presently under negotiation in the European Council foresees the establishment of a separate Supervisory Board within the ECB to carry out most of the regular supervisory tasks and to take most decisions, under the ultimate authority of the ECB Governing Council. The separation is to be enshrined in the legal text, but in addition, the ECB Governing Council needs to define – and make public – internal procedures to adequately separate day-to-day supervisory activities from monetary policy, and to draw a clear distinction between internal work lines. The internal working modalities should be transparent and known to the public. In my view, their design should not pose any great problems: the experience of other central banks with supervisory responsibility provides a basis for the implementation of this separation principle. The ECB has also, in this respect, the great advantage that the goal of monetary policy is specified in an objectively measurable manner: a rate of HICP inflation close to, but below, 2 percent in the medium term. A price stability objective so clearly defined cannot easily be overlooked or dismissed.

The second principle is that the SSM should possess a complete set of supervisory instruments. For the new system to operate effectively and efficiently, the perimeters of supervision must be sound and clearly established. This means the functional perimeter (which tasks should fall under the responsibility of the supervisor?), the jurisdictional perimeter (which countries should be covered?), and the institutional perimeter (which banks?).

The draft regulation is clear in all three respects. In the first area *(functional)*, it entrusts the ECB with a broad range of specific tasks, instruments and powers, ranging from authorisation to undertake banking activities, or major acquisitions and participations, to the full range of Pillar 2 activities, including capital adequacy, risk and other internal controls, at the group level and for individual entities, including stress testing. The regulation also allows the ECB to obtain all necessary information, in addition to the usual statistical supervisory reporting, through off-site and, if necessary, on-site inspections. Macro-prudential tools are covered and investigatory, early intervention and sanctioning powers are also mentioned in some detail.

In relation to the second area *(jurisdictional)*, although the SSM is intended primarily to cover the euro area, it is foreseen that non-euro area member countries may also participate in the system. This option is important because it helps to preserve the single market and to promote financial integration in the EU as a whole. In this context, I do not share the oft-expressed view that enhancing supervisory convergence among 17 EU countries out of 27, including some of the largest countries, risks undermining the cohesion of banking markets in the Union as a whole. On the contrary, I also expect this move to exert a beneficial influence beyond the boundaries of the euro area.

Thirdly, setting the institutional perimeter correctly involves answering a question that has been the subject of lively debate, namely: should all banks be covered (there are over 6,000 in the euro area), or merely the 'important' ones? And what defines 'importance'? The supervisory system will encompass all euro area banks, to prevent segmentations in the banking sector. The more significant banking groups and stand-alone banks, whose influence spills over national boundaries into the euro area as a whole – indeed, in

some cases, to the global economy – or that have a systemic influence on their respective national economies, will require closer scrutiny and the involvement of the centre, meaning the Supervisory Board and the ECB's staff in Frankfurt; although these groups and individual institutions will still work in close cooperation with the national authorities in many of their daily activities. As one moves down the dimensional scale, to banks of national or local relevance, the role and responsibilities of national supervisors should correspondingly increase, and become predominant. The ECB will organise itself with the national authorities so that the best expertise can be used wherever it is available. Importantly, the Supervisory Board should be able to obtain information on all banks and to decide, whenever it sees the need, to bring under its direct scrutiny banks that entail specific problems of high relevance.

The third principle is that the supervisory authority should be independent, but also transparent and strongly accountable. In virtually all countries, legal provisions protect the independence of monetary policymakers, to prevent conflicts between long-run gains from price stability and short-term benefits from monetary accommodation. Bank supervision is different, but a similar trade-off arises; and surely, external pressure is no less important. The ECB is protected by strong statutory provisions on independence. In addition, the ECB should also enjoy operational independence as a supervisor, as prescribed by the Core Principles set out by the Basel Committee on Bank Supervision. The counterweight of independence, democratic accountability, must be equally strong, at both the European and national levels. The ECB will cooperate fully in this area with the relevant authorities – primarily the European Parliament and Council.

Micro joins macro: a macro-prudential supervisory approach

Understanding the relation between supervising individual banks and preserving systemic financial stability is essential for designing an effective SSM. Before the crisis, banking supervision was, in all countries, fundamentally 'micro-based', i.e. it was focused on ensuring the safety and soundness of individual institutions taking the rest of the financial system as given. In recent years the emphasis has shifted towards a macro-prudential approach, focused on detecting and preventing systemic risks. Credit institutions may be 'systemic', for a variety of reasons; for the interconnection and cross-exposure with other banks; because of market inter-linkages; through the intermission of the domestic fiscal sector; or in other ways. When systemic institutions are present, the traditional micro-based approach, assuming that the rest of the system remains stable and exogenous, fails because it overestimates the efficiency gains and underestimates the negative externalities stemming from certain types of financial innovation. A micro-based supervisory approach is more likely to err on the side of leniency. It is now broadly accepted that some of the structural changes that occurred in the last two decades have facilitated the build-up of systemic risks. Deregulation and financial innovation in most developed countries have led to a profound overhaul of banks' business models, creating incentives to take on more risk.

European legislation contains a variety of instruments to conduct macro-prudential policy including countercyclical capital buffers, surcharges differentiated across banks according to their contribution to systemic risk, liquidity and leverage requirements, stable funding provisions, to name a few. Others, like loan-to-income or loan-to-value ratios, remain confined within national legislation. The draft Council Regulation on the SSM places the instruments included in European law in the SSM's realm of competence. While this approach is beneficial, it must also be recognised that national authorities also have a legitimate interest in some of these instruments for domestic regulatory purposes. Ways will need to be found to reconcile those interests with the integrity and the effectiveness of the SSM.

Completing the union: a European bank resolution authority

Another key component of a banking union worth mentioning is a single bank resolution authority. Its objective is to ensure, in an area-wide consistent way, the orderly resolution of insolvent banks, with minimum or no recourse to the taxpayer. In the absence of such an authority, bail-outs would often remain the easiest option in the face of legal, institutional and political difficulties, especially if cross-border entities were to be involved.

The European Commission's directive on recovery and resolution takes a step in the right direction, by establishing a common resolution toolbox. This, however, does not go far enough, because the outcome can

very much depend on the application of those tools in individual countries. A European Resolution Authority (ERA), free of the constraints of national mandates, is needed to exercise this function in an even-handed manner across the euro area. The authority should have tools to address banking crises pre-emptively, safeguarding financial stability and minimising taxpayer exposure to losses. Once created, the ERA will use homogeneous tools, principles and procedures and implement them consistently across all banks and countries in its jurisdiction.

The ERA and SSM are natural complements. The SSM removes what has to date been the guiding principle of the EU's cross-border supervisory framework, the home country control. In the current setting, national resolution authorities – responsible to fund resolution and to cover insured depositors – have an incentive to postpone bank resolution, requesting emergency financing for as long as possible in the hope that this may turn things around, rather than taking swift action. As a supervisor, the ECB, on the other hand, may be exposed to criticism for being excessively severe and putting national funds at risk when it pushes for resolution actions at the national level. Once banks are regulated and supervised at an area wide level, a common resolution authority inevitably becomes a necessity.

Further down the line, the SSM and ERA could eventually be accompanied by a joint deposit guarantee scheme. This scheme could also be put under the control of the ERA, which would then, like the FDIC in the United States, be able to exploit the synergies between the related activities of bank resolution and depositor protection.

Conclusions

Establishing a banking union is a critical step towards completing the construction of a stable Economic and Monetary Union. Establishing an effective European bank supervisor is the essential starting point, because such a supervisor can provide a rigorous and even-handed assessment of bank soundness and financial stability, which is the premise for all policy decisions.

However, the supervisory arm is not sufficient. In the end, there must be certainty within the system that each bank, however large and important, can exit the market, if necessary, at the lowest possible costs in terms of systemic stability and use of collective resources. Only a European resolution authority, with jurisdiction over the same geographical area as the single supervisor, can perform this function effectively.