Salvatore Rossi: The Banking Union in the European integration process

Speech by Mr Salvatore Rossi, Senior Deputy Governor of the Bank of Italy, at the Conference "European Banking Union and bank/firm relationship", CUOA Business School, Altavilla Vicentina, 7 April 2016.

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How we got to a Banking Union

The Banking Union is the latest born sectorial union in Europe. Differently from the Monetary Union, it was not born in a positive and joyful climate, as that accompanying the new pro-European thrust between the 80s and 90s of last century. It came into being as a hurried response to a situation of extremely serious crisis, which threatened the very essence of the European Union, at the start of this decade.

Immediately after the outbreak of the global financial crisis – an epidemic which spread quickly from the original US onset to the rest of the world – Europe started to be worried about its banks. There was a widespread belief that, in the presence of big European intermediaries operating on a global scale, national supervisory and crisis management systems were getting increasingly less effective.

The European reaction was typical for the EU institutional architecture: a stratification of complex bureaucratic bodies with unpronounceable acronyms. Since 2011, the national regulatory and supervisory authorities and the European Committees coordinating them were placed under the umbrella of the European System of Financial Supervision (EFSF), made up of the European Systemic Risk Board (ESRB) and the three sectorial European Supervisory Authorities (ESA): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

This complex and heavy structure began to crumble when the so- called "sovereign debt crisis" became serious in Europe. Let us not be deceived by the highly technocratic sound of this expression. It was actually a rapid and wide spread of a basic doubt on the very meaning and purpose of the European Union and on the single currency in particular. A doubt that began to creep in not only among academics, but also among leaders and peoples of all European countries. The genie got out of the lamp and since then it has not been put completely in again.

The crisis was triggered by the disclosure of the very poor conditions of the Greek public accounts between late 2009 and early 2010. It was like a long compressed spring being released. The Northern European countries voiced loud and clear that they did not trust the will of Southern countries to make their economies more healthily competitive and financially sound. Southern countries on their turn started to complain about the inadequacy of a strict financial orthodoxy at a time when it was necessary to avoid sinking into a new big depression by means of expansionary policies. International markets and investors understood immediately that the possibility of a political split on the euro could no longer be ruled out and started to "price" it in when assessing government bonds which – one day in the future – might be denominated in a reborn national currency (either very devalued or revalued). We saw the spread between the yield of the bonds of "peripheral" countries and that of the German bund peak to levels that should be unthinkable in a monetary union.

It was immediately clear that banks were the weak link in the chain.

There's indeed an obvious link between the public finance and the financial statements of the banks in a given country. Banks normally – I would say naturally – invest a considerable part of their assets in government bonds of the countries where they operate, mainly for the management of their liquidity; if yields go up, the value of those bonds falls and banks must record losses in their accounts; at the same time raising funds on the wholesale market becomes more expensive. Banks undergoing difficulties raise the suspicion in the market that they will be saved by the State, which makes the perspectives for the public budget even worse. A vicious circle that must be broken[1].

Hence the idea of a Banking Union. European banks – it was stated – must be perceived as a European, not a national, issue: if one of them goes into crisis it must be clear that the solution will be found at a European, and not at a national, level. The Four Presidents' Report illustrating the project was presented in June 2012.

However it was immediately clear that the implementation of this project would be undermined by the geopolitical conflict that was tearing Europe apart. It consisted in three key pillars and a "joint". The key pillars were: a single resolution mechanism for banks within the euro area – the main pillar – together with a single deposit insurance scheme in case of a bank's liquidation and a single supervisory authority, operating on the basis of common standards and practices. The "joint" was a sort of public and common financial safeguard clause (*backstop*), supporting both crisis resolution procedures and the deposit insurance scheme. This joint had already been identified as the existing European Stability Mechanism (ESM).

The view that the prerequisite for all this was the creation of a single supervisor was immediately put forward, because this would have helped eliminate the mutual distrust, and so it had to be the starting point. The Single Supervisory Mechanism (SSM) was set up in a record time: it was made up of the European Central Bank and the national supervisory authorities, and became operational in November 2014. Such rapid implementation was possible thanks to a provision in the Treaty expressly assigning the ECB prudential supervision functions. In addition, the SSM could right from the beginning rely on a whole set of common prudential rules (*single rulebook*), contained in the package of regulations CRR/CRD4 which had already transposed Basel III agreements in Europe.

In the meantime, crises of banks of different sizes had spread in many European countries, due to reasons ranging from the burst of real estate speculative bubbles, as was the case in Spain and Ireland, to the contagion of "toxic" instruments in structured finance, as in Germany. Banks in distress were saved using public resources (bail-out): 240 billion euro in Germany, borne by German taxpayers, 50 billion in Spain, financed with the European funds collected by the ESM, 40 billion in Ireland and almost the same amount in the Netherlands, and so on. In Italy public intervention was only a tiny fraction of those just mentioned and – what's more – took the form of a loan, very profitable for the State. On the other hand, in Italy the burden of deteriorated loans was getting heavier and heavier, mainly as a consequence of the long recession.

The massive public bailouts of European banks ended in the first half of 2013. In July 2013 the European Commission issued a Communication laying down guidelines on State aid, binding for all the member States. Since then State aid could be granted only under very stringent conditions and subject to a "*burden sharing*" by shareholders and subordinated bondholders: a principle similar to the "*bail-in*" underpinning the new European Bank Recovery and Resolution Directive (BRRD), which was being drafted.

The new way of solving banking crises

In April 2014, the European Parliament approved the BRRD, which fully introduced, as from 2016, the bail-in principle. Since the beginning of this year the Single Resolution Mechanism (SRM) has become fully operational in the euro area, the first – and central – pillar of the

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[1] As to the nature of the vicious circle see L. F. Signorini, Speech for the round of meetings "Towards a European Banking Union", Università Cattolica di Milano, 27 March 2014.

Banking Union, managed by yet another new authority, the Single Resolution Board, supported by similar newly set-up national authorities.

The founding principle of this new regulation is not: "European banks are a European issue", but: "European taxpayers must be protected against banking crises", those in their own countries and especially those in other countries. The cost of a banking crisis should no longer be borne by the taxpayer but by the saver/investor.

The idea is that if a bank goes into crisis, to the point of being "failed or likely to fail", and no market solution can be found, there are only two viable options: to liquidate it, i.e. to close it down permanently, stopping all operations and freezing all creditors until, years later, it is clear what remains after the liquidation of assets; or, in case of an overt public interest in the bank's survival, to bail it in, placing the burden of covering losses and reconstituting the required regulatory capital primarily on shareholders, bondholders and large depositors, i.e. those with more than 100.000 euro (not protected by deposit insurance schemes). If those resources are not enough, the Single Resolution Fund intervenes. This fund is privately financed by the contributions of all the other banks belonging to the system.

The first applications of this scheme, in Portugal and in Italy, despite the partial form in force until the end of last year (i.e., the burden sharing), have shown limitations and risks. The sacrosanct principle of taxpayer protection is not being questioned, but a debate is still possible and necessary about its rigid and mechanical application, in a context of equally rigid, when not misinterpreted and analytically unsound, protection of competition in the banking market; it is like treating banks as all other businesses, such as a supermarket or an advertising agency; and not like companies that, while competing with each other, rely on the confidence of savers, that is an impalpable and volatile public good, the loss of which may threaten the stability of the entire financial system, thus of the entire economy. Taxpayers and savers are not alien to one another, but they represent, as a whole, the same community, that of citizens.

Thus, the functioning of the SRM from now on appears to be affected by uncertainties.

On the one hand, decisions on the introduction of completely innovative standards and rules have been centralized in Brussels. Some of the BRRD rules leave room for discretion, aimed at balancing the different objectives of a "resolution" procedure: protection of taxpayers, but also of systemic stability, depositors' protection, continuity in the supply of essential financial services. These objectives may conflict: pragmatism, flexibility, and reasonableness will be necessary to reconcile them[2].

On the other hand, the regulatory framework is still evolving; the international standards for the Total Loss Absorbing Capacity (TLAC), issued last November by the Financial Stability Board for large global banks, will have to be transposed in Europe, consequently modifying the current provisions of the BRRD.

During the technical negotiations on BRRD held in 2013 the Italian authorities (the Bank of Italy and the Ministry of Finance), had formally argued, presenting supporting documentation[3], in favour of applying the bail- in tool only to newly issued bonds expressly containing a contract term entrusting the authorities with the power to write-down or convert them upon the occurrence of the conditions for resolution. In addition, to allow time for investors to become aware of the new rules and for banks to provide an adequate buffer of bail-inable liabilities, we insisted on the need to defer the entry into force of the new rules to 2018. The objections raised in technical contexts, by both the Bank of Italy and the Ministry

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[2] For a discussion of the application and procedural aspects of the new crisis management system, see F. Panetta, Hearing at the Finance and Treasury Commission of the Senate, 29 October 2015.

[3] I. Visco, Speech at 22nd Congress ASSIOM FOREX, 30 January 2016.

of Finance, were not taken into account. The political pressure coming from the Northern European countries prevailed.

A temporary public backstop still needs to be designed for cases where the application of the bail-in might exacerbate, rather than alleviate, the risks of systemic instability. It would be fully consistent with the provisions of the Key Attributes of Effective Resolution Regimes of the Financial Stability Board, that are the global standards for the resolution of large financial intermediaries' crises.

The lack of such instrument is not accidental: it 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.

The single deposit guarantee scheme

The second key pillar of the Banking Union (the European deposit insurance scheme) seems to be still a long way in the future.

The last Five Presidents' Report of June 2015 underlined the need to continue moving ahead in relation to the single deposit insurance, because without it the euro runs the risk of being unable to absorb generalised confidence shocks; the Report recalled that – in comparison to national systems – a common guarantee scheme is more likely to be neutral over time for public finances, because risks are more spread and contributions are levied on a wider range of intermediaries[4].

The European Commission recently made a proposal – submitted to Ecofin last December – to change the SRM Regulation in order to create a European Deposit Insurance Scheme (EDIS), fully funded by private resources provided by all banks in the euro area. The proposal was submitted for consideration to the Council, which set up a special working group.

The EDIS is intended to establish a mutual system of private deposit insurance based on the Deposit Insurance Fund (DIF), to which the already existing national funds would gradually transfer the resources collected by the participating banks. The scheme would guarantee the same protection in all the countries participating in the SSM; it would increase confidence in the European banking system on a level playing field.

The EDIS should be established in three stages. In the first one (reinsurance, until 2019) the DIF would cover up to 20 per cent of the financial requirement or the losses of national funds. In this stage the DIF would provide assistance only after the national funds have used all the available resources (both ex-ante contributions and ex-post ones, in case additional funding is needed). In the second stage (co-insurance, from 2020 to 2023) the share of the financial commitment and of the cost of the assistance borne by DIF would gradually increase (up to 80 per cent); in this stage the intervention by the DIF and by the national funds would occur in parallel. In the third and last stage (full insurance, from 2024), the DIF would provide all funding.

Thus, we are talking about a scheme which does not envisage any public backstop, and has a very long transition. Nonetheless such proposal has faced firm opposition from some countries (among which Germany, the Netherlands and Finland). They call for the harmonisation of major national regulations – bankruptcy laws, collateral framework, tax rules, company law and consumer protection – before mutual guarantee schemes are even

4 For an in-depth study of the Five Presidents' Report, see I. Visco, *European Union: progress or regress?,* Speech at the 50th Anniversary Conference of Istituto Affari Internazionali, 13 November 2015.

discussed; and, above all, they call for the preliminary introduction of prudential requirements for banks' sovereign exposures. Discussions seem to be deadlocked. A climate of mistrust still prevails along national borders.

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Let me sum up. The Banking Union original plan envisaged that if a European bank went into crisis, the first common funds to be used to save it should be private, but, if that were necessary to preserve financial stability, then also public funds should be used; should the crisis not be resolved and the bank be wound up, deposits below a certain threshold should be guaranteed, again with common private funds, but, if need be, with public ones as well; a unified approach to banking supervision at the European level would prevent suspicions of favouritism and moral hazard by national authorities.

The Single Supervisory Mechanism has been fully in place since a year and a half now. It is working, despite having been developed in a very short time and despite the objective coordination difficulties among authorities with different histories, traditions and practices. Cooperation between the national and the central level, after some initial friction, is now smoother.

The Single Resolution Mechanism has only recently become fully operational and differs from the original project. It presents implementation issues and also risks for the systemic financial stability.

The single deposit guarantee scheme is still missing and there are heated discussions about its design.

Therefore the Banking Union implemented so far is neither perfect nor complete.

Its difficulties are those of the entire European Union. Those who recognize its indispensable role and care about its fate must work with renewed determination to strengthen it.