Wolpertinger Conference

# Banking Union: experience so far and future prospects

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## 1. Rationale for the Banking Union

Banking Union (BU) in the euro area is the latest step in a long journey.[1]

The project for an integrated and unified Europe was designed right after the Second World War and was ambitious but pragmatic: ambitious in the ultimate objective of ensuring peace and prosperity to the European people after centuries of bloodshed; pragmatic because an explicit choice was made to start the process with the economy, instead of the much more challenging political sphere. Still, the political value of the project was clear from the beginning. Monnet called it its 'sense of direction'.[2]

The Treaty of Rome, of which we celebrated last year the 60th anniversary, was the first milestone. The project of monetary unification, revived in the 1990s after a first abortive attempt at the end of the 60s, was an even braver achievement. The euro was adopted on 1st January 1999 thanks to the efforts of statesmen and civil servants like Ciampi, Delors, Kohl, Mitterand and Padoa-Schioppa, all belonging to a generation that had not forgotten the wars in Europe. The challenge was enormous: let's not forget that many in the academic world, especially in the United States, thought the project was economically wrong and politically frail. However, for over a decade, the balance between costs and benefits appeared positive.

The real challenge for the European Monetary Union came with the sovereign debt crisis at the beginning of this decade. Prompted by the revelation of the true condition of Greece's public finances, the crisis rapidly evolved into a basic mutual distrust among European countries: some (public opinion, governments, even national central banks) started to fear that, thanks to the common currency, other countries would finance their profligacy with the money of taxpayers in the first group of countries; the second group of countries began to blame the first group for

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[1] Rossi (2017).

[2] Monnet (1955).

imposing excessively 'austere' policies on everyone in the name of the common currency.

The markets viewed those feuds as a sign that Europeans no longer considered the euro indestructible and that they could call into doubt the irreversibility of the common currency. The possibility of 'redenomination' of public debts into re-born national currencies, though remote, started to be priced in and spreads soared, reflecting expectations of devaluation/revaluation. Banks in weak countries, whose balance sheets were full of national public bonds, incurred heavy losses at market value. The prospect of a generalized bank bail out in those countries stoked expectations of an unsustainable evolution of public finance, in a vicious circle.

It was a political crisis disguised as a financial one.

The Banking Union was initially meant to be a response to that situation.[3] The idea was to establish the principle that European banks were first of all European. If one runs into trouble, it's a European concern, not only a concern for the country where the bank is based.[4]

The actual implementation of the project took a different direction.

The prerequisite of common supervision was realized first: since 2014 'significant' banks are supervised by a European authority (the Single Supervisory Mechanism, based in Frankfurt).

Next came the core of the new regime: since 2016 a bank can no longer be bailed out with taxpayers' money. In the event of serious trouble, it can be either bailed in – that is rescued, but with a big sacrifice being made by shareholders and private creditors – under the direction of another European authority (the Single Resolution Mechanism, based in Brussels), or liquidated.

Finally, a European insurance deposit scheme, still to be created, will reimburse small depositors of liquidated banks, with money coming from the rest of the banking system, not from taxpayers.

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[3] EU Commission (2015).

[4] Rossi (2016).

The proposal for a public backstop for both the Single Resolution Fund and the Common Deposit Insurance Scheme has been de facto ruled out.

The legal framework consists of an intricate web of directives and regulations: on the supervision side are the Capital Requirements Directive (CRD), the Capital Requirements Regulation (CRR) and the SSM Regulation; on the crisis management side, the Bank Recovery and Resolution Directive (BRRD) and the SRM Regulation, together with the Communication of the EU Commission on the application of State-aid rules to banks (Banking Communication). In both areas, the European Banking Authority (EBA, an authority currently based in London but soon to move to Paris, in charge of prudential regulation) has issued a number of implementing guidelines and technical standards.

In substance, European banks have become European only in one sense: they are supervised and resolved at the European level. The vicious link between sovereigns and banks has not been severed, but a straitjacket has been imposed on banks to ensure that, should a sovereign experience a flight from its bonds, the country's banks cannot be bailed out by taxpayers, either of that country or of any other countries. More specifically, a German taxpayer can never be asked to contribute financially to the rescue of an Italian bank whose balance sheet is sinking under the weight of Italian public bonds that are losing more and more market value. If that happens, the creditors of the bank, mostly Italians, must bear the brunt on their own. And there is no longer any question of euro irreversibility, because the case of Greece has shown that a sovereign state can even default without leaving the euro.

## 2. Experience so far, with the SSM...

Any assessment of the BU should take into account the historical trajectory towards the integration and unification of Europe, the external and the internal context, and the political motivations and constraints of the project. We should not overlook the fact that a strong anti-Europe mood has swept through some of our countries in recent years, combining criticism of the European construction, sometimes well-founded, with populistic cries.

Bearing this in mind, the first pillar of the BU construction – the SSM – has undoubtedly been a political success so far.

Within a couple of years a very complex institutional and regulatory architecture has been set up from scratch, mobilizing ideas and resources from national supervisors (National Competent Authorities, NCAs) and the European Central Bank, under which the Mechanism has been placed. President Draghi called the SSM 'the greatest step towards economic integration since the creation of Economic and Monetary Union'.[5]

The SSM relies on more than 6,000 experts based both in Frankfurt and in all the euro-area capitals, working together. Off-site supervision of each significant bank uses a unique format, the Joint Supervisory Team (JST), which is composed of supervisors from both the ECB staff and that of various NCAs. Less significant banks (20 per cent of euro banking assets) continue to be directly supervised by the NCAs, with the SSM (staff and Board) overseeing the process to ensure homogeneity across jurisdictions.

A fundamental tool for harmonizing concepts and practices in the area was published a few months ago, the SSM Supervisory Manual.[6] But the methodological effort is never-ending: we are now working to improve the Supervisory Review and Evaluation Process (SREP), partly in order to promote convergence in the prudential treatment of significant and less significant banks.[7]

Further improvements are currently being discussed: how to streamline the decision-making process; how to enhance cross-fertilization in the on-site teams and their community spirit; and how to improve coordination between prudential supervision and anti-money-laundering oversight.

The discussions within the SSM Board, the NCAs' input gathered through written procedures and the contribution of technical working groups have helped to address all the relevant issues, even the most controversial ones. For instance, regarding Non-Performing Loans (NPLs), while everyone agreed on the need for the banks most affected by this problem to get rid of their NPLs, there was much discussion about how to proceed at the SSM level. The solution, which we are

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5 Draghi (2015).

6 ECB (2018a).

7 ECB (2018b).

now working on, is based on a bank-by-bank approach[8] and seems to go in the right direction, without entailing any illegitimate foray into the regulatory field. We should take into full account the specific business models of banks and avoid unjustified differences of treatment.

## 3. ... and with the SRM

The performance of the new crisis management framework is less easy to assess.

According to the existing legal framework, if problems arise in a bank, first the SSM is supposed to engineer early intervention to redress the situation. If, in the end, the bank is labelled 'failing or likely to fail', the SRM comes into play. The SRM is composed of the Single Resolution Board (SRB), acting as a central resolution authority, and the 19 National Resolution Authorities (NRAs); it has within its remit both significant and less significant banks, but the latter only if they have cross-border activities. The SRM decides first of all whether there exists a public interest to justify the rescue of a failing bank under the common 'resolution' procedure. If not, the bank must be liquidated according to national rules. The European Commission ensures that the national government's financial support, if any, complies with State-aid rules.

I do not want to recall here Italy's painful experience with the four small-to-medium banks put under 'resolution' in 2015, because the story is common knowledge by now. The SRM was not yet operative and the procedure was left to the national resolution authority (the Bank of Italy) but the fundamental elements of the new legislative and regulatory framework were already in place, only with the lighter 'burden sharing' instead of the bail-in.

In almost three years of actual operation, the SRM has stepped in only once, for an important Spanish bank. In four other cases of 'failing or likely to fail' banks it concluded that the public interest requirement was not met and diverted them to national insolvency rules, which are not harmonized.

The mechanism has shown, in my view, elements of strength but also of weakness.

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8 ECB (2108c).

Among the strengths, I would cite the strict logic of the construction. If I want to invest my money in a bank's shares or bonds, or even to make a large deposit, I must know from the outset that I may lose everything and no public entity whatsoever will come to my rescue. Moral hazard is no longer allowed. Banks need much more capital than before, but shareholders and subordinated bondholders must consider them riskier than before and thus request a higher return. Consequently, banks need to be much more profitable.

Among the weaknesses I see a lack of clarity so far about the so-called MREL (Minimum Requirements for own funds and Eligible Liabilities to be requested of each bank) and, most important, an apparent divergence of views on the concept of systemic financial stability. I'll touch upon both later.

## 4. Challenges ahead

Let me talk briefly about some of the challenges we are facing, starting with the SSM.

As discussed above, the implementation of the SSM has been successful so far, thanks to the work of all the people involved in Frankfurt, Rome and elsewhere. But the style of supervision needs to be fine-tuned. This does not come as a surprise, since prudential supervision philosophies and practices are different in the various countries, not least because of their historical evolution. Still, it is a matter that needs careful consideration in the light of the final objectives.

Having put aside the original goal of the BU – cutting the perverse link between sovereigns and banks – the aim of common supervision of our banks should be to keep them well-equipped to fulfil their fundamental task, that is to provide credit to the healthy part of the economy. A bank crisis, still possible for many reasons, should be addressed in a unified, European way, minimizing the financial involvement of taxpayers and thus moral hazard.

What we should avoid as supervisors is losing sight of these final aims in order to pursue a sort of bureaucratic integrity. More capital and fewer NPLs is a prudent and sound policy for banks but if, absurdly, capital requirements were raised to 100 per cent of total assets and NPLs reduced to zero, both stocks and new flows, supervisors would be 100 per cent safe, but the banking business would cease to

exist, at least in the form we have known for centuries. Credit would disappear and banks would only invest in the equity of no-risk subjects, such as monopolies and rentiers. We all agree that capital markets should be more developed in continental Europe, and the financing of our economies more diversified, but bank credit will remain important for many years to come, particularly loans to small and medium enterprises, and its regular flow should not be slowed without reason by the obsession of supervisors to avoid blame if one borrower is late with a payment.

I come now to the crisis management framework and the SRM.

As I said before, the MREL issue needs to be clarified. MREL sets the minimum level of bail-inable items on the liability side of each bank's balance-sheet. The owners of those items (shareholders and creditors), once identified, become hostages: if the bank falls into the clutches of the SRM, they will be the first to go. A careful and pragmatic calibration of the new requirement is essential. On top of that, banks should be given enough time to meet it without disrupting their business.

Then there is the issue of financial stability or, more generally, of macro-prudential supervision. The SRM has given the market to understand that the public interest test – set by European legislation to decide whether to proceed with the resolution or consign the failing bank to the national authorities for liquidation – can only be passed in the case of big banks, whose systemic relevance is beyond doubt. This conveys an idea of systemic risk based only on absolute dimensions. It rules out the possibility that smaller or even mid-size banks, if they fail, pose risks for financial stability, even though they contribute to funding the SRM and are subject to MREL. But, at least according to some views, financial stability can be national or even sub-national, and hence affected by the failure of a local bank.

We were talking about the alternative resolution-liquidation, but the criticism may be extended to the no-bail-out principle underlying both. The International Monetary Fund has suggested a 'financial stability exemption', whereby it is explicitly recognized that the SRM is meant to deal with idiosyncratic events and that the existing arrangements could not solve system-wide crises.[9]

[9] IMF (2018).

Prudential supervision has been micro for decades, if not centuries. The macro-prudential perspective is relatively new and still little understood and not widely adopted around the world. We all know that there can be a trade-off between micro and macro policy objectives in the financial system.[10] For instance, if we want to protect macro financial stability, we may contemplate bailing out a bank with taxpayers' money, but if we want to avoid any moral hazard at the micro level, we have to rule out as far as possible the involvement of taxpayers in rescuing banks. A balance must be found between these conflicting objectives.

## 5. Conclusions

Let me conclude. In an incredibly short timeframe a comprehensive framework for banking supervision and crisis management in the euro area has been designed and put in place; thousands of experts are working together to achieve common goals; methodologies, tools and resources have been pooled in order to benefit from the best national practices; cooperation between the centralized hubs (in Frankfurt and Brussels) and the national authorities has been fruitful, even in the case of disagreement. Last but not least, banks in the euro area are now stronger than 10 years ago.

This positive experience shows that the challenges ahead can be successfully addressed in a pragmatic way.

Banking supervision needs to be constructive, not destructive. This is always true, but in the euro area today it needs to be constantly remembered. Prudential rules and practices should be strict but proportionate, and they should always keep the playing field level. We should also take into account the competitive conditions between our banks and banks outside the euro area.

We live in times of rapid change in the way financial business is conducted around the world. The application of technology to banks and other financial companies is revolutionizing the market.[11] Supervisors need to look forward as

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[10] Visco (2018a).

[11] CGFS (2018), Panetta (2018), Visco (2018b).

much as they can. European supervisors, and legislators behind them, need to be particularly forward-looking in their commitment to operate a brand new system of common banking supervision and crisis management. They have to adjust it as drawbacks and innovations emerge.

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