BANKING UNION AND POSITIVE CONTAGION

The decision to initiate banking union was part of a complex sequence of European decision-making in the late spring and early summer of 2012, which makes it difficult to identify unambiguous lines of causality. The sequence included, among other critical developments, the Greek election of 17 June 2012, which allowed the formation of a government that would work cooperatively with the country's official creditors; the euro-area summit of 28-29 June; and the statement of 26 July by ECB President Mario Draghi in London that "within [his] mandate, the ECB is ready to do whatever it takes to preserve the euro"[30]. Following the latter pronouncement, the ECB announced its unprecedented Outright Monetary Transactions (OMT) programme, first in general terms on 2 August and then in more technical detail on 6 September.

Mr Draghi's London remarks and the OMT programme signalled the ECB's readiness to buy massive amounts of sovereign bonds of fragile countries, under certain conditions, in order to ensure the effectiveness of monetary policy throughout the euro area. They triggered a major turnaround in market perceptions, paused contagion and instead produced positive contagion in contrast with the disruptive contagion of market turmoil from smaller peripheral countries to Spain, Italy and to a lesser extent France in the previous year. The trend of decreasing sovereign spreads has continued essentially uninterrupted until now, as illustrated by Figure 1.

To disentangle the relationship between banking union, OMT and market perceptions, one must go back to the drivers of both the crisis and the policy response. It is now widely accepted that the root cause of the (negative) contagion before mid-2012 was the interdependency between sovereign credit and bank credit, or bank-sovereign vicious circle. The fact that the banking systems of most euro-area countries were essentially national, rather than integrated into a broader European system, meant that a key determinant of banks' real and perceived strength would be the contingent or actual support provided to them by the sovereign. In such a setting, banking-system fragility

EUROPE'S RADICAL BANKING UNION

by

Nicolas Véron

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Europe's radical banking union

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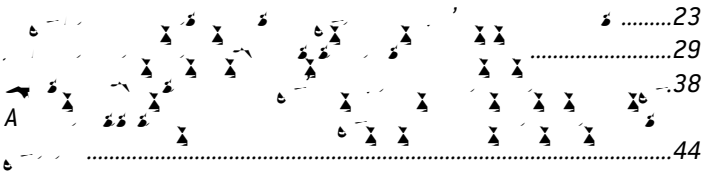

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FOREWORD

Banking union is perhaps the most transformative institutional response to the crisis experienced by the euro area in the last few years. Bruegel scholar Nicolas Véron argues in this thought-provoking essay that banking union ultimately enabled the European Central Bank's announcement that it would buy large quantities of government bonds if needed and on the condition of a financial support programme. The Outright Monetary Transactions (OMT) programme was only acceptable to the ECB and governments in the context of a significant and substantial step towards more institutional integration, which the banking union project arguably constitutes. I am sure this link between OMT and banking union will be much debated. But there is no doubt that the OMT programme was central in calming markets and bringing to an end the very acute phase of the euro-area crisis.

Banking union, as it stands, remains unfinished. However, important building blocks have been put in place. The creation of a new single supervisor in the ECB, the Single Supervisory Mechanism (SSM), is a substantial step forward. This new euro-area institution now has the authority to supervise but also to withdraw the banking license of any bank in the euro area. A single resolution mechanism has also been created to carry out the task of resolution and recovery.

The extent to which these new institutions transform the European banking landscape and how they improve crisis management in the euro area will depend on how they deliver. As always, new institutions will have to pass leadership tests with determined and courageous action.

SRB is headed by Elke König, formerly president of Germany's national banking supervisory authority (BaFin), and includes five other Executive Representatives[10]. Both organisations use English as their internal working language and for most (but not all) of their communication with stakeholders[11].

The legal basis for banking union is a series of legislative texts that were adopted in 2013 and 2014 following initial political decisions in 2012. The SSM Regulation of October 2013 is based on Article 127(6) of the Treaty on the Functioning of the EU (TFEU), which was included in the Maastricht Treaty to enable the conferral of supervisory responsibilities to the ECB, but had barely been activated before 2012[12]. The SRM Regulation of July 2014, which establishes the SRB, is based on Article 114 TFEU, the common basis for internal market legislation which had already been used to create new EU agencies. The SRM Regulation also establishes the SRF under the authority of the SRB, but its financing arrangements are detailed in a separate intergovernmental agreement signed in May 2014. These were complemented by other pieces of EU harmonising legislation that were adopted during the same period (even though some were initially drafted before the

banks represent almost 85 percent of the euro area's total banking assets[17]

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The decision to initiate banking union was part of a complex sequence of European decision-making in the late spring and early summer of 2012, which makes it difficult to identify unambiguous lines of causality. The sequence included, among other critical developments, the Greek election of 17 June 2012, which allowed the formation of a government that would work cooperatively with the country's official creditors; the euro-area summit of 28-29 June; and the statement of 26 July by ECB President Mario Draghi in London that [its] [20].
Following the latter pronouncement, the ECB announced its unprecedented Outright Monetary Transactions (OMT) programme, first in general terms on 2 August and then in more technical detail on 6 September.

Mr Draghi's London remarks and the OMT programme signalled the ECB's readiness to buy massive amounts of sovereign bonds of fragile countries, under certain conditions, in order to ensure the effectiveness of monetary policy throughout the euro area. They triggered a major turnaround in market perceptions, dubbed 'positive contagion' in contrast with the disruptive contagion of market turmoil from smaller peripheral countries to Spain, Italy and to a lesser extent France in the previous year. The trend of decreasing sovereign spreads has continued essentially uninterrupted until now, as illustrated by Figure 1.

To disentangle the relationship between banking union, OMT and market perceptions, one must go back to the drivers of both the crisis and the policy response. It is now widely accepted that the root cause of the (negative) contagion before mid-2012 was the interdependency between sovereign credit and bank credit, or bank-sovereign vicious circle. The fact that the banking systems of most euro-area countries were essentially national, rather than integrated into a broader European system, meant that a key determinant of banks' real and perceived strength would be the contingent or actual support provided to them by the sovereign. In such a setting, banking-system fragility

results in growth-crippling credit scarcity and a potentially massive financial burden for the government. Sovereign weakness, in turn, is transmitted to the banks, directly through their holdings of sovereign debt and indirectly through the erosion of value of the explicit and implicit public guarantees. In a monetary union, this deadly embrace is compounded by the impossibility of mitigating a 'sudden stop' through devaluation, and by the tendency among many policymakers to view the competition among European banks as a proxy for competing national interests, or 'banking nationalism'[21].

The pattern of sudden stop was familiar in the context of emerging economies, but was difficult to accept for European policymakers who could not think of their ostensibly developed countries as subject to the same type of risk. Thus, they had to come very close to the brink of euro-area breakup to accept that the crisis could not be addressed without accepting that [redacted], the very first sentence of the public statement following the euro-area summit of 28-29 June 2012[22]. Put simply, this could be done either through fiscal union, or through banking union. After the failure of half-hearted attempts to make meaningful progress towards fiscal union in the second half of 2011, banking union was in practice the only remaining option. To its credit, the International Monetary Fund, which had more familiarity with similar situations in emerging economies, was the first public organisation to articulate this vision with clarity in late January 2012, following years of advocacy of EU banking policy integration[23]. It would take five more months for European leaders to reach a similar conclusion.

Beyond the aspiration to break the bank-sovereign vicious circle, the leaders' declaration of 29 June 2012 included two specific policy commitments. The first announcement was the creation of the SSM, with the specific reference to Article 127(6) that implied that the ECB would be the new central supervisor. The second commitment was a pledge to allow the European Stability Mechanism (ESM), the common euro-area fund that was then in the process of being established, to recapitalise banks directly under certain conditions.

Conversations with key witnesses confirm that leaders had agreed during the summit that such direct recapitalisation of banks by the ESM may be applied retroactively, at least in the cases of Spain and Ireland. In other terms, member states that recapitalised troubled banks could expect that the ESM would, at some point in the future, take over the corresponding capital instruments from them. However, this agreement on retroactive effect was not mentioned explicitly in the public statement, partly because negotiations on Spanish banks were still ongoing, and only the general principle of ESM direct recapitalisation was announced[24]. The declaration also included language that could be interpreted as making it easier for the ESM to buy Italian and Spanish bonds, with the ECB acting as its agent[25].

The promise of direct bank recapitalisation by the ESM followed almost a year of debates on this option, initially championed by the EBA and resisted early on by the German government[26]. At the time of announcement, it appeared more tangible than the creation of the SSM. The latter

BANKING UNION AND THE REDUCTION OF MORAL HAZARD

In addition to creating the space for the ECB's announcement of OMT, the commitment to banking union in June 2012 had another short-term impact. It lent credibility to the notion that the EU would gradually move away from its almost universal preference for bank bailouts (the reimbursement by governments of all creditors of failing banks, and even in some cases of shareholders) towards a default recourse to 'bail-in' (the forced imposition of losses on creditors and other claimants to finance an non-viable bank's orderly resolution). This in turn reduced the perception of contingent government liabilities arising from problems in individual countries' banking systems, further contributing to the reduction of the bank-sovereign vicious circle.

Before 2012, almost all bank failures in the euro area had been addressed with full publicly-funded bailouts of all creditors no matter how junior, and no matter how small the bank, with only a partial exception in Ireland. This near-absolute pro-bailout stance had been established at the very outset of the crisis in late July 2007 with the rescue of IKB, a medium-sized German bank, and also echoed previous episodes of bank crisis management in Europe, eg in France and Scandinavia in the early 1990s[34]. It had been further reinforced by the unique political economy of banking in Europe. Supervision had remained a national competence even as other EU policies (single market, competition policy, and in the euro area, economic and monetary union) had introduced an increasingly binding framework of cross-border competition and integration. This combination had created powerful tensions between each national banking supervisor's prudential mandate and the concern to protect and promote the domestic banking industry in the increasingly open cross-border competition. The latter objective tended to prevail, especially in countries where elites share a belief that the national interest is somehow aligned with the interest of iconic companies or national champions, a group that typically includes banks. Such banking nationalism predated the crisis. For example, the governor of the Bank of Italy in 2005, Antonio Fazio, was alarmingly explicit about wielding his supervisory

authority to preserve the 'Italianity' of two banks that were the targets of takeover bids by companies headquartered in Spain and the Netherlands respectively, and to ensure that they would remain in domestic hands[35].

During the first five years of financial crisis in Europe from mid-2007 to mid-2012, banking nationalism prevented national public authorities from adequately addressing the systemic problem of weak bank balance sheets, and led them to an almost universal preference for regulatory forbearance in order not to put 'their' champions at a competitive disadvantage. When a bank became obviously too weak for authorities to pretend it was sound, banking nationalism reinforced the preference for bailouts, ostensibly to preserve financial stability but also largely motivated by the desire to bolster financing conditions for the country's other banks[36]. This misalignment of the incentives of public authorities with their prudential mandate goes a long way to explain the failure of successive EU-wide stress testing exercises in 2009, 2010 and 2011 to restore confidence, because the crucial balance sheet assessments remained in the hands of national authorities[37]. Most euro-area member states had never bothered to pass legislation that would allow the orderly resolution of non-viable banks while bailing-in creditors. Even those countries that adopted such legislation in the wake of the crisis, such as Germany, were reluctant to use it in actual cases of bank crisis management. Thus, the structure of banking supervision in Europe and its fragmentation in line with national borders encouraged moral hazard and excessive risk-taking by the banks, in spite of various forms of political backlash against government-funded bank bailouts that gathered steam after the first few years of crisis.

Conversely, the shift towards banking union in mid-2012 suddenly made the participation of bank creditors in future bank restructurings a more credible proposition, because it promised to remove many of the drivers of the prior race to the bottom. Indeed, the first instance in which the European Commission's competition policy arm was able to impose shareholder wipe-out and junior creditor bail-in on a large scale was on

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INTRODUCTION

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The extent to which these new institutions transform the European banking landscape and how they improve crisis management in the euro area will depend on how they deliver. As always, new institutions will have to pass leadership tests with determined and courageous action.

In the unfolding Greek crisis, the new supervisor has already played a positive role by clearly laying out the supervisory limits to the Greek banks. More specifically, the SSM has put a ceiling on Greek banks' exposure to the Greek government. Some have criticised this as a step that puts undue pressure on the Greek government to come to an agreement with its creditors. However, the imposed limits actually make the Greek banking system more resilient in the face of Greek political uncertainties. This increases the probability of liquidity provision in the case of an outright default because Greek banks will be less exposed to the Greek government.

The SSM has therefore already made an important contribution to crisis management. The exposure limits increase the chances that Greek banks will survive a Greek government default and will continue to receive ECB liquidity. This, in turn, increases Greece's chance of staying in the euro area. Arguably, therefore, exposure limits imposed and executed by the SSM increase the stability of the euro area. Generalising this policy should now be considered and is also feasible thanks to extraordinarily low interest rates.

Time will tell how much European banks will change their business models and to what extent cross-border banking integration will happen. It is possible that the institutions created so far remain too weak and that more fiscal integration and ultimately political union is needed to sever the link between banks and sovereigns to the extent needed for a sustainable economic and monetary union. But the current banking union is certainly a radical and a welcome break from past national banking policies. Please enjoy this authoritative new Bruegel essay.

Guntram Wolff, Director, Bruegel
Brussels, May 2015

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