The European banking union from the Spanish perspective: Myths and reality

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Progress on the European banking union remains limited. Nevertheless, a strong banking union is needed for the financial stability of the entire Euro zone, not just individual countries.

The European banking union project has drawn a significant amount of recent attention. However, despite the inevitable trade-off between the time needed to establish it and the quality of the union, progress on implementation remains limited given the lack of political consensus. Additionally, certain design aspects, in particular related to the Single Resolution Mechanism (SRM), fall below expectations. Market fragmentation is still high and in part attributable to government policies across the EU. Empirical results suggest that government implicit support to the banks –the so-called implicit guarantees– can be twice or three times larger in countries such as Austria or Germany than in Spain, Italy or Portugal. Evidence shows a 1% increase in the implicit guarantee (resulting in lower funding costs for banks) is passed on in the form of a 0.52% lower interest rate applied to firms for bank loans. Thus, a strong banking union would not only benefit peripheral countries engaged in recapitalization and restructuring efforts, but also the Euro zone as a whole.

Status of the banking union project: A (too) long and (too) winding road

The European banking union was originally designed as a tool for crisis prevention. However, it has been recently viewed as a project with a much broader scope and with implications for financial stability related to the transmission of banking shocks across Europe and the development of sovereign crises. In fact, most international observers see financial market fragmentation and ad-hoc domestic bank bailout and bail-in policies as a key source of vulnerability for the Euro zone as a whole.

The banking union project follows up on the efforts made in Europe to better design the financial safety-net, comprising the set of regulations and supervision rules and bodies dealing with financial stability in the EU. The most important efforts in this sense were the proposals of the so-called Larosière group[3] in 2009.

Most recently, it was the Internal Market and Services Unit within the European Commission (EC) that took the lead and assumed the responsibility of designing the necessary steps towards a common resolution framework that, ultimately, would be the seed of the banking

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[3] http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

union. In particular, the development of the so-called "Bank Recovery and Resolution Directive". Specifically, the EC has been seeking to develop:

(i) A regulation giving strong powers for the supervision of all banks in the euro area to the ECB and national supervisory authorities with the creation of a single supervisory mechanism;

(ii) A regulation with limited and specific changes to the establishment of the European Banking Authority (EBA) in a way to ensure a balance in its decision-making structures between the euro area and non-euro area Member States;

(iii) A communication outlining the Commission's overall vision for rolling out the banking union, covering the single rulebook, common deposit protection and a single bank resolution mechanism.

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During 2012 and 2013, there have been several proposals made to progress on these goals. However, the theoretical design goes much further than political consensus and practice. Overall, the general impression is that the debate on the banking union has been more focused on how solidarity would potentially work for some member countries than on the real benefits of the banking union for the Euro zone as a whole. However, this perspective proves to be wrong and the Spanish case is a good example. The Spanish banking sector has gone through a considerable transformation and restructuring over the last few years. In particular, it is following a broad EU resolution program (the so-called Memorandum of Understanding or MoU) since 2012. This specific program and the EU aid attached to it, may not have been necessary if a banking union had been in place, as the markets would have understood that any potential losses, bail-in and bailout mechanisms and depositors protection, would have been backed by a strong unified protection system. However, even if Spain has benefited from the financial assistance of the EU, it would ultimately assume the costs and pay back that aid. This virtually means that the only current benefit of developing a strong banking union for countries such as Spain is that a signal has been issued to the market that the EU is slowly progressing towards cohesion and abandoning fragmentation. Overall, the banking union would benefit the entire Euro zone but, in the short-term, it is necessary to understand that the project itself has value as a signalling device. If the proposals are strong and credible, markets will see the Euro zone as a consolidated project. If they are weak, fragmentation will continue to be considered as a threat for the Euro. Hence, the consideration that the banking union is only useful for currently troubled banking sectors is only a myth and the reality is that the benefit of this union is for the entire Euro zone.

One way of showing the status of the banking union is comparing the theoretical designs with current developments, as shown in Exhibit 1. The current situation is described on the left-hand side of the exhibit, with financial fragmentation (different domestic financial conditions), multiple banking supervision and deposit guarantee frameworks and decentralized resolution mechanisms. At the right-hand side of the exhibit, we depict the desirable structure of strong banking union with a single supervisor with broad powers, a single resolution authority (including common bailout and bail-in mechanisms), the harmonization of the necessary legal environments (even including the EU Treaty) and a system that prevents the too big to fail problem for systemic financial institutions. However, the situation is still far from such a desirable outcome. The current status of the project is somehow closer to the structure shown in the central column of Exhibit 1, a weak union with a single supervisor, domestic

Exhibit 1

Theoretical progress towards a strong banking union

THE CURRENT SITUATION	THE WEAK UNION	THE STRONG UNION
Fragmentation	A limited single supervisor	A single supervisor with strong powers
Multiple supervision	A European resolution net with little integration	A single resolution authority
Decentralized resolution	Little consensus on bail-in	Harmonization of regulatory environments with the assumption of decentralization of fiscal sovereignty
Multiple deposit guarantee funds	Legacy assets to be nationally assumed	Too-big-to-fail prevention

Source: Authors' own elaboration.

resolution authorities with little integration, little consensus on bailout measures and the problem of legacy assets –which consists of how to deal with the losses of the current crisis– likely to be assumed by each domestic counterpart.

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The theoretical ingredients of a strong banking union suggest that there is an inevitable trade-off between quality and speed in the achievement of the established goals, as the regulatory changes required will need some time to be approved, in particular, an amendment of the EU Treaty. However, the recent developments within the EU suggest that neither the timing nor the ingredients are ambitious enough. The conclusions of the recent meeting of the European Council on June 27th-28th reveal that the progress and the consensus are limited, rendering the project a weak one at present. The conclusions of the Council (EUCO 104/2/13 REV 2) suggest that "in the short run, the key priority is to complete the Banking Union in line with the European Council conclusions of December 2012 and March 2013. This is key to ensuring financial stability, reducing financial fragmentation and restoring normal lending to the economy."

It is not that the main ingredients are not included in the proposals of the Council, it is just that their design reveals a lack of completion that puts the whole project at risk. In particular, the Council mentions the three main goals in the short-run:

(i) A new Single Supervisory Mechanism (SSM). However, as we will discuss later on, the proposals for such SSM makes it virtually vulnerable and ineffective.

(ii) The transition towards the SSM, where the Council suggests that "a balance sheet assessment will be conducted, comprising an asset quality review and subsequently a stress test. In this context, Member States taking part in the SSM will make all appropriate arrangements, including the establishment of national backstops, ahead of the completion of this exercise." This second goal in itself reveals that the responsibility and supervision powers still remain very much attached to national bodies.

(iii) The Eurogroup has agreed on the main features of the operational framework for direct bank recapitalisation by the ESM. At this stage, the main agreement consists of the problem of legacy assets being assumed by each member state but there is not really a consensus on how direct bank recapitalization may work in the future. The Council states that "the European Stability Mechanism will, following a regular decision, have the possibility to recapitalise banks directly," but little progress has been made on this particular feature.

As it seems that the main efforts up to now have been concentrated in trying to reach consensus on a fully effective SSM, it is worth noting that this requires a Single Resolution Mechanism (SRM) for banks covered by the SSM. The European Commission's proposal establishing an SRM has been debated during the Council of June 2013, with little progress. The main criticisms on current proposals are twofold. First, the role of the ECB as the head of the SSM lacks the necessary powers, which are still under discussion and likely to be more limited than expected. Second, some of the main ingredients for an effective SRM are there, but some of them are also affected by limited scope and a worrisome lack of firepower (limited budget).

In the current discussions with the EU, the main resolution measures would include:

– Bail-in measures (the imposition of losses, with an order of seniority, on shareholders and unsecured creditors);

– The sale of (part of a) business;

– Establishment of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity);

– Asset separation (the transfer of impaired assets to an asset management vehicle).

Bail-in mechanisms are key as they establish the necessary liability responsibility scheme to face the losses of bank resolution mechanisms before tapping public funds (that is, imposing part of the losses on taxpayers). Under the current European Council's general approach, eligible deposits from natural persons and micro, small and medium-sized enterprises, as well as liabilities to the European Investment Bank, would have preference over the claims of ordinary unsecured, non-preferred creditors and depositors from large corporations. The deposit guarantee scheme, which would always step in for covered deposits (i.e. deposits below 100,000 euros), would have a higher ranking than eligible deposits. Other liabilities would be permanently excluded from bail-in, such as covered deposits, secured liabilities (i.e. covered bonds), liabilities to employees of failing institutions (salary and pension benefits), commercial claims relating to goods and services critical for the daily functioning of the institution; liabilities arising from a participation in payment systems which have a remaining maturity of less than seven days; and inter-bank liabilities with an original maturity of less than seven days.

All these bail-in measures are indeed very important to create an effective SRM but are only a part of it. As in previous occasions, the focus has been more on who will assume the losses than on common mechanisms. Even if it has taken some time to reach such consensus on bail-in ingredients, this has been the main element of progress. However, there are other key ingredients where progress has been much more limited. In particular, the mechanisms for bank recapitalizations, which have been set as very restrictive and quantitatively limited. The current agreement is to set up ex-ante resolution funds to ensure that the resolution tools can be applied effectively. These national funds would have to reach, within 10 years, a target level of at least 0.8% of covered deposits of all the credit institutions authorised in their country. To reach the target level, institutions would have to make annual contributions based on their liabilities, excluding own funds, and adjusted for risk. A first exemption to this rule is that member states establish their national financing arrangement through mandatory contributions without setting up a separate fund. The member states following this alternative would have to raise at least the same amount of financing and make it available to their resolution authority immediately upon its request. This alternative seems quantitatively equivalent to a common resolution framework but, in practical terms, involves more fragmentation and lack of centralized control.

The evidence of lack of consensus and prolonged fragmentation extends to deposit guarantee schemes, where member states would be free to choose whether to merge or keep separate their funds for resolution and deposit guarantee schemes (DGSs). More evidence of fragmentation in the DGSs can be found in that the current agreement establishes that "lending between national resolution funds would be possible on a voluntary basis. Resolution funds would be available to provide temporary support to institutions under resolution via loans, guarantees, asset purchases, or capital for bridge banks."

The proposal for a common DGS system allows these decentralized actions in spite of "flexibility" but this may cause this important ingredient of the financial safety net to remain fragmented in Europe. The current agreement mentions that "flexibility would only be available after a minimum level of losses equal to 8% of total liabilities, including own funds, has been imposed on an institution's shareholders and creditors, or under special circumstances, 20% of an institution's risk weighted assets where the resolution financing arrangement has at its disposal ex-ante contributions which amount to, at least, 3% of covered deposits." In quantitative terms, this flexibility seems too large and likely unnecessary.

Another limited agreement has been made regarding the so-called "minimum loss absorbing capacity." In particular, national resolution authorities will be required to set minimum requirements for own funds and eligible liabilities (MREL) for each institution, based on its size, risk and business model. A review in 2016 would enable the Commission, based on recommendations by the European Banking Authority, to introduce a harmonised MREL applicable to all banks. This sets a too long perspective to really decide on the minimum common funds for bank loss absorption within the Euro zone. Moreover, current discussions have implied that the maximum common funds compromised by banking union members in the interim will be around 60 billion euros, which is a significantly small amount of firepower.

Therefore, considering recent developments, we can conclude that the road will not only be too long but also too winding. As shown in Exhibit 2, the best we can expect is to reach a single resolution framework and the necessary tools for bail-in, bailout, deposit schemes and prevention mechanisms to be ready by 2018-2020. However, the problem will not just be the time but the likely limited scope and firepower of the project. There is still time to make the necessary amendments but the precedents are not promising.

The political, financial and economic features surrounding the banking union developments suggest that financial fragmentation in Europe is not a trend but a consequence of a weak and too decentralized financial structure. As shown in Exhibit 3, the widely commented financial fragmentation in Europe is a sum of four main

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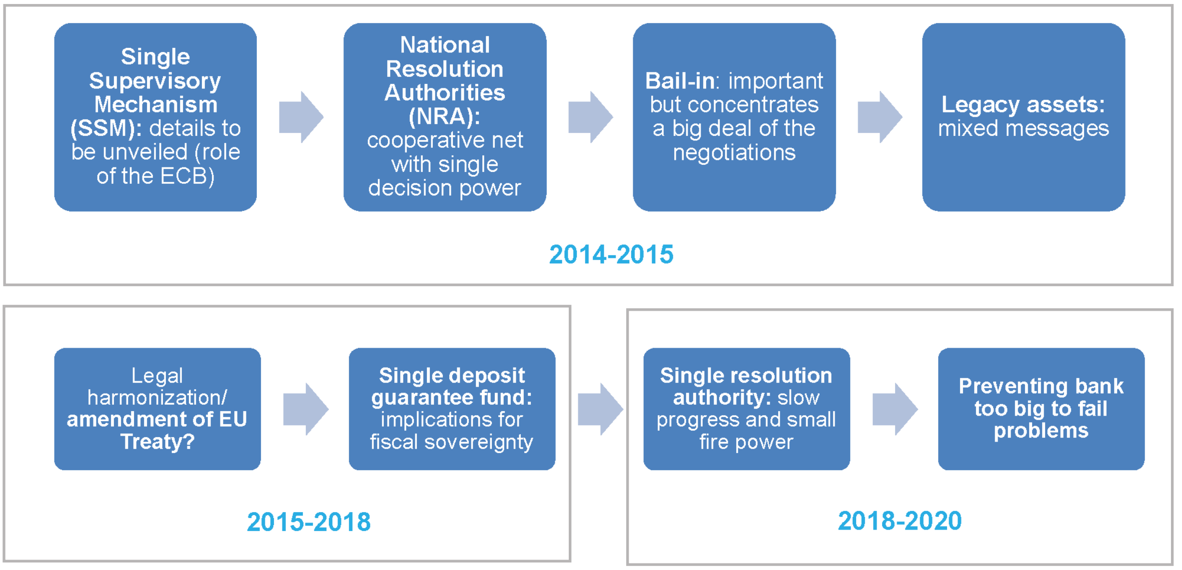
Exhibit 2

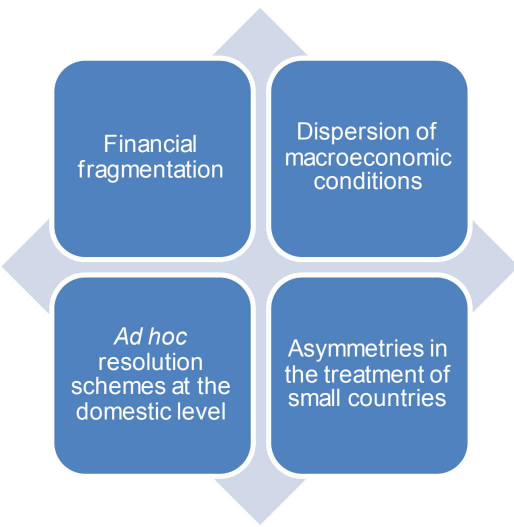
Which road to follow?



Source: Authors' own elaboration.

Exhibit 3

Sources of financial fragmentation in Europe: Fragmentation as a consequence, not a trend



Source: Authors' own elaboration.

components. The first one is what we can call "true" financial fragmentation, that is, differences in the financial structure that makes access to finance easier and cheaper for households and firms in some Euro zone countries as compared to others. However, the structural differences were there before and during the crisis. The financial crisis is a second source of fragmentation itself, as it exacerbates the differences in financial conditions between countries with severe recessions and others with more favourable economic environments. These differences cause country-risk premiums and investors' perceptions to be very different across member states. A third source of fragmentation is the ad-hoc resolution of the banking problems at domestic levels. The lack of a common resolution tool makes each country undertake its own resolution actions with consequences for investors' perceptions and, therefore, financial conditions. Finally, a fourth factor would be the asymmetries in the treatment of small countries as opposed to larger countries in the common resolution actions in areas such as EU bail-out and bail-in rules, with the Cypriot case as the most prominent example. This differential treatment also exacerbates investors' perceptions of financial fragmentation in the Euro zone. Taking all these sources into consideration, fragmentation looks more a consequence of structural differences and a lack of a banking union than a trend.

A game of hidden incentives: Who benefits from the fragmentation of the Euro zone financial safety-net?

Given the lack of political agreement to achieve what we have defined as a "strong" banking union, we wonder why a project that would theoretically benefit the entire Euro zone is currently weak. The complete analysis of the rationale behind this problem involves many political and economic features that go beyond the scope of this note. However, we focus on certain aspects of a game of incentives that leads some countries to adopt a more favourable position than others as long as market fragmentation persists. At least, in cases where the support of domestic authorities to those banks is concerned. Specifically, we refer to the implicit and explicit guarantees provided by governments and domestic safety-nets to banks in different Euro zone countries. This section illustrates some of these benefits both as evidence of financial fragmentation and as a part of a complex incentive system in bank supervision and regulation across Europe. The findings shown correspond to broader research undertaken at Funcas by the authors.[4] In particular, we discuss two main conclusions:

i) The evidence of substantial differences in implicit and explicit guarantees given by domestic governments to their banks across EU countries.

ii) The relationship between the implicit guarantees and the fragmentation in European markets (expressed as the different interest rate spreads borne by corporations to obtain bank funding).

As for the guarantees, the implicit ones refer to the difference between the all-in credit rating (AICR) and the "stand-alone credit rating" (SACR) provided by Moody's. The AICR isolates any external support to the bank while the SCAR takes into account assumed government and central bank support motivated by systemic concerns. The difference between the two types of ratings is referred to in this context as the implicit guarantee provided by the authorities to a bank in a given country. As noted by the OECD,[5] this implicit guarantee works to reduce the costs for a bank of obtaining external funding in the markets. Turning the ratings into a numerical scale, the implicit guarantee can be expressed as the percentage reduction in the cost of debt (interest rates) for the bank.

As for the explicit guarantee, we measure the difference between the risk assumed by the banks and the explicit safety-net mechanisms put in place in a given country. In particular, these mechanisms are the solvency requirements and deposit guarantee schemes. Per Carbó Valverde *et al.* (2012),[6] we define the safety-net benefits as the percentage of deposits that would potentially be covered with public funds (taxpayer support) in the event of a bank failure. This means that our measure of the explicit guarantee shows to what extent banks can potentially benefit from taxpayer support taking into account the regulatory structure in a given country.

Our estimates of the implicit and explicit guarantees are based upon a sample of 102 large banks in Austria, Germany, Belgium, Finland, France, Netherlands, Spain, UK, Italy

[4] A complete version of this research and findings will be published in volume 136 of *Papeles de Economía Española* - Autumn 2013.

[5] Schich, S. and H.K. Hwan, "Developments in the Value of Implicit Guarantees for Bank Debt: The Role of Resolution Regimes and Practices, OECD Financial Market Trends, vol. 2, pp. 1-31.

[6] Carbó Valverde, S., Kane, E. and F. Rodríguez Fernández, (2012), "Regulatory arbitrage in cross-border banking mergers within the EU", Journal of Money, Credit and Banking, vol. 44, pp. 1609-1629.

and Portugal from 2007 to 2012. The results are shown at the aggregate level for these countries in Exhibit 4. Implicit guarantees are shown as a percentage decrease in interest rates for bank funding given the government implicit support and the explicit guarantees are shown as Euros per Euro of deposits. Exhibit 4 reveals that the magnitude of the implicit support is significantly large in countries such as Austria (4%), and Germany, Belgium and the UK (3.5% in all three). However, the implicit guarantees are considerably lower in EU peripheral countries, such as Portugal (0.7%), Italy (1.4%) and Spain (1.8%).

As for the explicit guarantees, they are large in countries, such as the UK (0.215 Euros per Euro of deposits), France (0.194) or Finland (0.187) and relatively similar in Spain (0.167) and Germany (0.162).

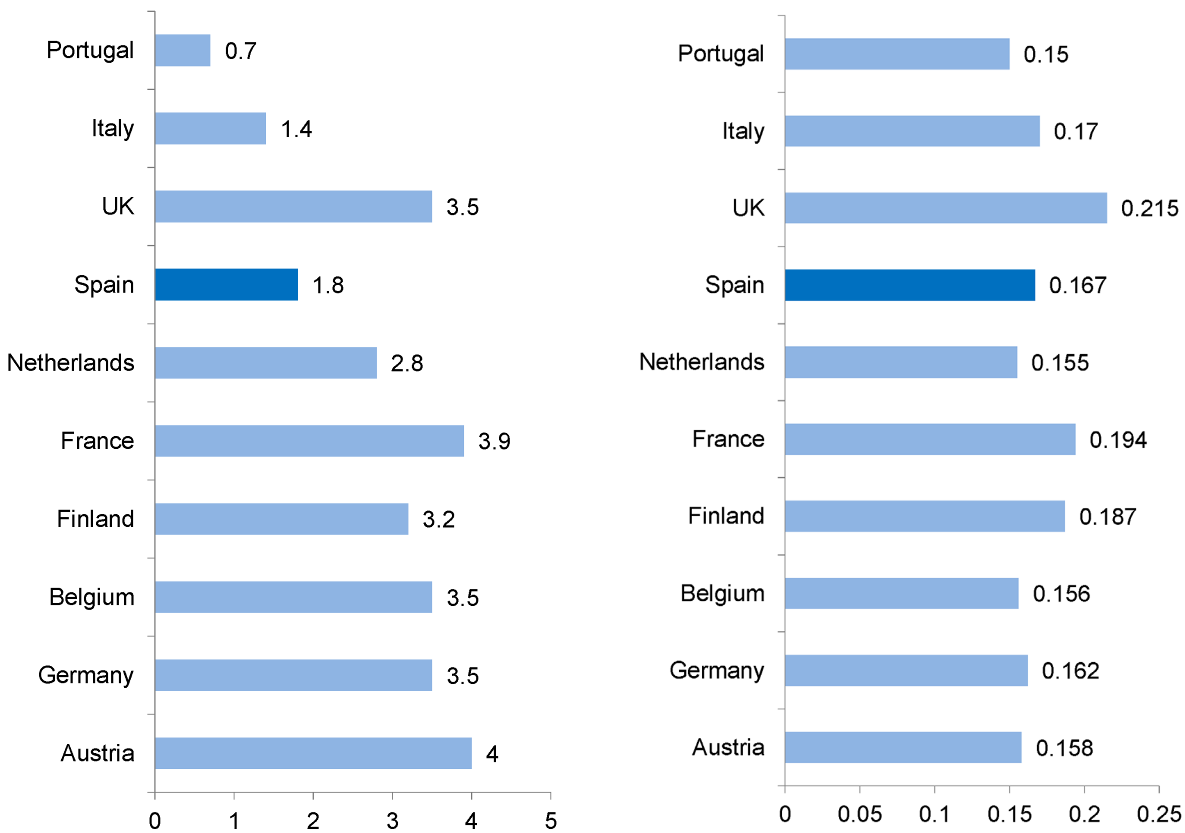
Given the values of the guarantees estimated, and, in particular, of implicit guarantees, it seems that some EU countries benefit from government support and their banks obtain lower funding in the markets. This is a source of financial fragmentation that can be mostly attributed to public policies and that generates potential regulatory arbitrage across banking sectors. Given that these benefits

Exhibit 4

Implicit and explicit guarantees for the EU banking sectors

Implicit guarantees (rating spread for implicit government support)

Explicit guarantees (Euros per Euro of deposits)



Source: Authors' own elaboration.

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in bank funding can be passed on to firms (and households), fragmentation extends to the corporate (and mortgage) market, where financial conditions can be more favourable for the firms (households) in the countries where banks enjoy larger government support. Along with other sources of fragmentation, such as country risk premium, this may create significant differences in the access to finance for firms across EU countries. In order to test these potential implications, the abovementioned research conducted at Funcas by the authors of this note includes some estimates of the determinants of the interest rate spreads that firms pay in the sample of EU countries above. This spread is computed as the difference between the average interest rate paid by firms for bank funding minus the 1-year Euribor rate. The database employed to undertake these estimations is Amadeus, provided by Bureau Van Dijk. We consider a sample of 21,236 firms over 2007-2010 and we analyze the determinants of the rate spreads paid by these firms. In particular, the spreads are explained by aggregate macroeconomic and financial variables –the ten-year sovereign bond rate, bank loan growth, the average implicit guarantees, the average firm NPL ratio and GDP growth– and firm-level variables -such as the collateral pledged by the firms (tangible assets/total assets), and the external financial dependence (the ratio "bank loans/cash flow" of the firm). In Table 1, we show a selection of the estimated coefficients for the most relevant variables in the study. For the purpose of this note, the most interesting result corresponds to the implicit guarantees. In particular, the empirical findings suggest that a 1% increase in the implicit guarantees (a 1% reduction in the cost of bank debt) is passed on to the firms as a 0.52% reduction in the cost of their funding. This result supports the idea that implicit government support to the banking sector is a significant source of financial fragmentation in the EU countries.

Table 1

Government support and financial fragmentation: Empirical evidence

Determinants of the interest rate spread paid by financial corporations in the EU	
Ten-year sovereign bond rate	0.46** (2.84)
Bank loan growth	-0.29** (4.15)
Implicit guarantees	-0.52** (3.27)
Average firm NPL ratio	0.38* (3.95)
Collateral (tangible assets/total assets)	-0.29* (2.06)
External financial dependence	-0.11* (1.93)
GDP growth	-0.31** (5.18)
R^2	0.68
Country dummies	Yes
Fixed effects	Yes
N. firm X year observations:	76,258

Note: The table shows a selection of the most relevant coefficients. The equation is estimated using fixed effects panel data and including country and time dummies.

Source: Authors' own elaboration.

Conclusions

This note surveys the main recent developments and remaining challenges for the European banking union from a Spanish perspective. The main conclusions, taking into account the data and empirical analyses discussed, are as follows:

– The European banking union project has shown limited progress. Admittedly, there is a trade-off between the quality and strength of the banking union and the time to achieve it. However, the recent resolutions and agreements have shown that neither the time nor the progress is ambitious enough. The main weakness refers to the Single Resolution Mechanism (SRM), since the current agreements depict a too decentralized framework with too limited quantitative resources.

– There seem to be hidden incentives in various EU countries to achieve a banking union. In theory, such a union will end with the dispersion in government support to banking sectors at the national level. We show some empirical findings that suggest that this government support is taking the form of implicit guarantees in various EU countries and, contrary to expectations, the banks enjoying larger government support are not those from peripheral countries.

– The empirical results suggest that implicit guarantees can be twice or three times larger in countries such as Austria or Germany than in Spain, Italy or Portugal. We also show some evidence that a 1% increase in the implicit guarantee (resulting in lower funding costs for banks) is passed on in the form of a 0.52% lower interest rate applied to firms for bank loans. This is suggestive of the existence of a significant source of market fragmentation attributable to government policies across the EU.

– The risks that bank market fragmentation would pose in terms of financial stability (i.e. deposit flight) if they were to remain in the medium-term, are substantial. For this reason, it seems critical, if not urgent, to make more real progress in the implementation of the banking union if the Eurozone aims to put the financial crisis behind it as soon as possible.