The ECB and banking union: Towards a more integrated and resilient Europe

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Europe´s recovery from the recent crisis is largely attributable to the role played by the ECB and the support of European authorities in creating the banking union. Despite noteworthy progress, further strengthening of Europe´s institutional and legal framework is necessary to construct a more united and resilient Europe to face future challenges.

The recent crisis proved a formidable challenge for EU political and economic institutions. One of the European institutions critical to Europe´s emergence from this crisis was the ECB, which, in addition to consolidating its traditional role as the guarantor of price stability, also took on new responsibilities. During the crisis and post crisis period, the ECB´s tasks included defence of euro integrity, reliance on non-conventional monetary policy measures and a new mandate for banking supervision. Despite this broader role for the ECB, it cannot act alone to secure the integrity of the European project. This will require further strengthening of European institutions. One of the preliminary ways in which this institutional strengthening is being achieved is through progress on the banking union. In the immediate future, to complete banking union, additional steps will need to be taken to create a Single Deposit Guarantee Scheme (SDGS) and common public backstop under the Single Resolution Fund (SRF). Over the longer term, review of treaties and necessary transfer of sovereignty to make progress on fiscal and political union will also need to be considered as steps to deepen European integration.

The length and depth of the economic and financial crisis in Europe literally put our economic and political institutions at risk, forcing them to make decisions and take steps into uncharted territory. In insolation, any of the shocks to which the euro area has been subject in recent years – the banking crisis, sovereign debt crisis, risk of break-up of the euro, and finally, risk of deflation – would on its own have been destabilising. But the situation was compounded by Europe's institutional architecture being too weak to adequately address all these risks. What is more, the lack of predictable and harmonised rules for crisis management led to a growing fragmentation in financial markets, such that banks' cost of funding came to depend to a large extent on the strength of their home country, thus reinforcing the vicious circle between banks and sovereign debt. The evolution and overlap of these shocks, in conjunction with the weakness of institutional

[1] BBVA Research. Note that this article was written in January 2016 and therefore the text does not reflect recent developments which took place in February and March.

architecture, proved to be a veritable stress test for the European authorities.

This 'perfect storm' was weathered successfully thanks to the role played by the European Central Bank during the crisis, and the institutional stimulus European authorities gave to building a genuine banking union. This article analyses the main successes achieved by Europe's institutions and the challenges to be addressed in the months ahead in the European institutional context in order to build a more integrated and resilient Europe.

The ECB's role during the crisis and future challenges

During the crisis, the European Central Bank (ECB) has consolidated its traditional monetary role as the guarantor of price stability, while it has also been able to take on new responsibilities as the guarantor of financial stability and as a banking supervisor.

Going forward, in the monetary policy arena, the big question is whether the ECB will manage to bring inflation to its target zone of 2% in 2017. The ECB, which has relied on non-conventional policy tools to confront the crisis, now needs to determine whether these measures are to become a permanent part of the 'typical' arsenal in the future. What is more, the key role it has played in preservation of the euro may turn against the ECB as long as its excessive risk-taking is seen as a sign of partiality or if future crises can be attributed to its intervention over this period. The solution is to advance towards a more integrated Europe characterised by greater solidarity.

The ECB: A controversial but necessary role in defending the integrity of the euro

Last autumn, Mario Draghi completed his first four years at the head of the ECB. He took over in the midst of the international financial crisis and had to face a string of idiosyncratic shocks affecting the euro area. In addition to the banking crisis, there was the debt crisis, and the risk of the break-up of the euro, followed by the risk of deflation. Hopefully the second half of his mandate will be less challenging. But before looking to the future, it is worth exploring and taking a look back at the role played by the euro area's central bank.

In 2011, the ECB had to become actively involved in financial bail-out programmes for Ireland, Portugal and Greece. Its participation in the so-called 'Troika', along with the International Monetary Fund and the European Commission, gave it the credibility it needed at the time. Some people considered playing this key role to be overstepping its power, jeopardising the independence of its monetary policy mandate, and the financial stability of the euro area. As we shall see, the implementation of the European Stability Mechanism (ESM) is an important achievement, and the ESM has become established as a central instrument for the management of future crises.

Maintaining the liquidity of Greece's banks via an emergency credit line while fears of a Greek exit from the euro were rife was also controversial. Following the principles established by W. Bagehot almost 150 years ago (Bagehot, 1873), the ECB took decisive action to provide liquidity to prevent a systemic crisis (allotment of liquidity to meet all demand, relaxing collateral policy, extending repayment periods for refinancing transactions, and providing emergency liquidity), always rigorously applying the relevant rules. This entails supplying liquidity to solvent banks in return for adequate collateral, mitigating both unnecessary exposures on its balance sheet and the problem of moral hazard.

The way in which this liquidity is provided includes refinancing operations, known by their initials LTROs and TLTROs. LTROs (long-term refinancing operations) are part of the ECB's open market operations, and are long term. Their maturities, initially three months, have been extended to three years in successive bouts of

the crisis. Considerable use was made of these modes of financing in the three-year auctions in December 2011 and February 2012, when a total of over a billion euros was applied for. Moreover, in June 2014, the ECB approved a new series of eight long-term financing operations, referred to as targeted longer term refinancing operations (TLTROs), with the specific aim of stimulating lending to the private sector in the euro area (excluding loans for home purchases). TLTRO[2] loans have maturities of four years (until September 2018), provided the banks comply with the predetermined criteria, namely demonstrating that credit has performed better than the benchmark defined by the ECB. If not, banks will have to repay the loans in September 2016. So far, six of the eight scheduled operations have taken place, with 418 billion euros being applied for. The volume of applications in these auctions was significantly less than originally estimated, particularly in the most recent auctions, given the excess liquidity in the system.

In parallel, following the outbreak of the financial crisis, the ECB adopted a fixed-rate full allotment procedure for all financing operations (this procedure has been extended until December 2017).

Once the ECB had ensured the financial system's liquidity needs had been met, in August and September 2012[3] it launched its outright monetary transaction (OMT) programme. This was designed to safeguard the integrity of the euro and to transmit monetary policy in the single currency area. The programme allows the ECB to buy unlimited amounts of sovereign debt issued by countries in the euro area over a period of one and three years, provided strict conditions are met by beneficiary countries, so as to solve the 'moral hazard' problem. The announcement of this programme was a complete success, as it showed itself to be fully effective at eliminating the risk of the euro's break-up, even before being brought into action. This success is due to two particular features of the programme: unlimited liquidity and the ECB's *pari passu* –rather than its previous preferential creditor– status. The programme faced a legal challenge from the German constitutional court, forcing the European Court of Justice (ECJ) to rule on its legality. In June 2015, the ECJ ruled that the programme is compatible with European Union law as the ECB has not exceeded its authority regarding monetary policy and the programme does not infringe the bar on offering monetary finance to Member States.[4]

The ECB vis-à-vis non-conventional monetary policy

In its more traditional monetary policy and price stability role, the ECB is using all the instruments available to it to enable inflation to converge to its 2% target. In 2014, and in 2015, in particular, it became clear that this objective was at risk. The conventional measures adopted up to that point had proven insufficient, mainly as a result of sluggish growth and the slump in the oil price. Raising inflation has become a critical issue, given the current context of high debt and risks to growth against a backdrop of persistently low inflation.

In this context, in September 2014, the ECB launched an asset purchase programme (APP), which initially included only private assets, but was expanded in January 2015 to include public debt issued by central governments and agencies and European institutions in the euro area.[5] The programme set a monthly target of 60 billion euros until at least March 2017 (following an extension to its duration, which was originally until September 2016 and pending a decision of the monetary policy meeting in March, where it

[2] July, 3rd, 2014, https://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_2.en.html

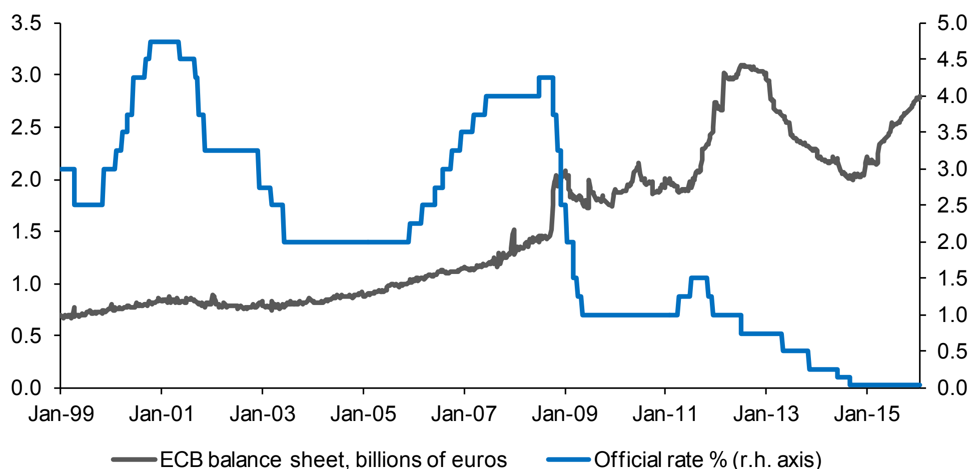
[3] *Technical features of OMT* (September 6th, 2012). http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

[4] In any event, the German constitutional court will have the last word, and on February 16th, there will be another session on OMT.

[5] *Asset purchase programme* 22/01/2015 https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.es.html

Exhibit 1

European Central Bank balance sheet and official intervention rate



Source: ECB.

is possible that it will be extended again). As a result, the size of the ECB's balance sheet has increased significantly (Exhibit 1), becoming an effective monetary stimulus tool in an environment where interest rates have reached zero.[6]

Another of the measures used by the ECB has been to cut the official interest rate to a record low of 0.05% and to move the deposit facility rate into negative territory, for the first time ever, where it is currently at -0.30%.

The route has not been easy. The ECB has faced criticism and even legal challenges to some of its decisions as regards the application of these measures. However, in hindsight and after intense discussions of recent years, facing these challenges has helped dispel some of the misunderstanding about the meaning and limits of the ECB's mandate. This has confirmed the independence of the Governing Council's decision-making from the political viewpoints of Member States.

New times call for new approaches, and the ECB is proving itself to be especially pragmatic in this respect. The crisis has revealed that the capacity of central banks is not exhausted when interest rates reach zero. The available arsenal is broad, and the ECB will remain immersed in a context of non-conventional policies for some considerable time to come.

The current macroeconomic environment represents a change of monetary policy paradigm from previous stages of the ECB's existence. New times call for new approaches, and the ECB

[6] The ECB estimates that the non-standard measures adopted since the summer of 2014 have produced a net effect equivalent to an interest rate cut of 100 basis points (under normal conditions). https://www.ecb.europa.eu/press/key/date/2016/html/sp160204.en.html

is proving itself to be especially pragmatic in this respect. The crisis has shown that the capacity of central banks is not exhausted when interest rates reach zero. The available arsenal is considerable.

Looking to the future, as stated above, the ECB has relied on non-conventional policy tools to confront the crisis and needs to decide whether these measures are to become permanent options. This is a fascinating debate, and one that affects not only the ECB but many other central banks that have drawn upon this new arsenal of monetary policy measures during the crisis. The ECB will rely on non-conventional policies for a considerable time, such that it is still too early to start thinking about an exit strategy.

Banking supervision: A new ECB mandate

Together with the foregoing, the ECB has also taken on a new and important responsibility in the form of single banking supervision for the euro area, better known as the Single Supervisory Mechanism (SSM). In early 2016, the SSM was already fully operational and has had many achievements. In little more than a year (the SSM came into effect in November 2014) it has developed its supervision methodology, obtained the necessary resources to implement it (around a thousand staff in Frankfurt), and has become a key player in the global financial system, being one of the world's biggest supervisors in terms of assets under supervision.

These achievements, in such a short period of time, are due not only to the efforts made in Frankfurt, but also to the work of national authorities, which, it should not be forgotten, are part of the SSM alongside the ECB. Indeed, it is the national authorities that have the knowledge of entities' strengths and risks, which is a key factor in this first stage.

The SSM's new supervision methodology seeks to obtain a broad view of entities, beyond the content of their financial reports, in relation to four pillars: internal governance, risk management, business model, and capital and liquidity analysis.

The entry into force of the SSM has also affected entities' day-to-day operations. The SSM's key tool for its functions is the new supervision methodology, known as SREP (Supervisory Review and Evaluation Process). This methodology is a holistic and forward-looking process in which the supervisor aims to obtain a

Exhibit 2

The four pillars of SREP

Source: SSM and author´s own elaboration.

broad view of the institution beyond the content of financial reports, although these remain extremely important. Rather than being a mechanical and purely quantitative process, it is understood as taking into account an analysis of qualitative aspects of the entity that require the supervisor maintain a constant dialogue with it. Specifically, the four pillars on which the SREP rests are: i) internal governance and risk management; ii) business model analysis; iii) capital; and iv) liquidity.

- The first pillar involves, among other things, an exhaustive assessment of the entity's organisational structure, verifying that the decision-making processes are appropriate and that the members of the board of directors meet the requirements for them to carry out their duties. This aspect has always had particular significance for the SSM, where there is a clear commitment to international best practices. However, there are divergences between entities' models of corporate governance across the euro area. For example, two-level boards, in which there is a supervisory board concentrating on overseeing the management team, is a widespread structure in some countries such as Germany or the Netherlands, but is not found in other countries such as Spain or France. It must of course be recognised that no particular model of governance is intrinsically superior. The supervisor therefore has to know and monitor the weaknesses of each and enhance its strengths.

- Analysis of the business model, the second pillar of SREP, assesses the ability to generate profits over twelve months (viability) and three years (sustainability). This is one of the aspects where it is less clear how SSM will carry out its analysis. As in the case of corporate governance structures, in the euro area there are almost as many different business models as entities, with no model necessarily being economically superior. On this point, the challenge is to evaluate whether entities are able to remain profitable in an environment as difficult as today's. Moreover, the aim is to analyse an entity's capacity to generate profits over the whole cycle, as well as in the short and medium term. This is conceptually simple, but there are uncertainties regarding its practical implementation.

  Although banks' profitability improved slightly in 2015, many entities have levels of return on equity below their cost of capital, casting doubts on the medium- and long-term viability of their business.

  This low profitability is due to both structural and temporary factors: i) sluggish economic growth, leading to slow credit growth; ii) persistently low interest rates; iii) an excess of unproductive assets (from defaults or foreclosures) in some European financial systems, which puts a brake on future business; iv) new regulatory requirements on capital, liquidity and leverage, among others; and v) the effects of the digital transformation on the banking sector. This is all forcing banks to rethink their strategy. Identifying which businesses can generate recurrent revenues in excess of the cost of capital and which cannot is one of the key challenges for entities' managers and supervisors.

- The last two pillars – liquidity risk and capital – look at factors such as credit risk, market risk and funding risk. There are still divergences in these areas in terms of the implementation of the regulation across countries, such that it is not possible to talk of complete uniformity or comparability. However, the European authorities are working actively on this and laying the foundations for convergence within a reasonable time frame.

  On the last two pillars, the supervisor encourages entities to undertake a self-assessment of their liquidity and capital risks. This self-assessment is known as ICAAP (Internal Capital Adequacy Assessment Process) and ILAAP (Internal Liquidity Adequacy Assessment Process). In both cases, the supervisor tries to analyse

the robustness of entities' capital and liquidity under stress scenarios as well as under normal circumstances.

This first supervision exercise under the SSM, which was preceded by a review of the quality of banks' assets and a first stress test, was rated very positively. Evidence of this is the euro area's resilience in the face of the Greek crisis in the summer of 2015. As Rome was not built in a day, the SSM could not be built in a year. Three factors stand out among the main challenges for the next few years: i) harmonisation of regulations and supervisory practices, an issue on which, with the national options and discretionalities project, progress is on the right track; ii) viability of business models; and iii) greater European and international cooperation, and perhaps the transparency with which supervision is exercised and the dialogue between supervisors and institutions should be strengthened. There has been a marked improvement on this point, as highlighted by the recent publication of the SSM's supervisory priorities for 2016.

However, the significance of the ECB's new role goes beyond addressing these three challenges. Its real importance lies in its capacity to achieve two objectives: rebuilding confidence in the banking system and undoing the fragmentation of the financial system.

Going forward the ECB alone is not enough

The exceptional role of the ECB during the crisis needs to be understood in the context prevailing during this unique period. The key role it has played in holding the euro together may ultimately have negative implications if the excessive risks taken are seen as a sign of partiality in application of monetary policy, or if, justifiably or not, the ECB is held responsible for future crises, damaging its credibility.

What path should be taken to strengthen the role of each of the European institutions? As mentioned, the ECB cannot remain the main pillar in the fight against crises in Europe indefinitely. Other European authorities have to assume their responsibilities, through a dual strategy of developing a harmonised legal framework and strengthening the institutional framework with closer integration and new transfers of sovereignty to supranational authorities. The "Five Presidents' Report" (discussed in more detail below) lays the foundations for the European institutional framework and is the ideal complement to the ECB.

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Banking union and the "Five Presidents' Report"

Banking union emerged as a quantum leap for the monetary union, a major stride towards financial integration and towards the completion of the construction of the euro. The progress so far on achieving banking union has been tremendous, indeed inconceivable just a few years ago. In fact, it represents a significant transfer of sovereignty from those countries sharing the common currency to the new supranational authorities, with a large component of solidarity from the public sector, to an extent unprecedented since the birth of the euro.

Banking union is a forward-looking project and therefore designed not to resolve the problems of the past but to avoid and address the problems that

may arise in the future. Banking union has come a long way, but its successful implementation so far should not lead to complacency, as the future challenges are far from trivial.

Successfully completing it along the lines set out in the road map known as the *"Five Presidents' Report"* is now even more necessary than ever in order to continue making progress on building genuine monetary, economic and political union.

Banking union is a first step on the way to addressing the challenges of the future

The first step towards the constitution of the European institutional framework after the crisis was taken in late 2012 with the report "Towards a Genuine Economic and Monetary Union",[7] the final version of which was approved by the European Council in December of that year. This document, which was referred to informally as the "Four Presidents' Report", was directed by the president of the European Council, Herman Van Rompuy, in collaboration with the presidents of the ECB, the European Commission and the Eurogroup. Van Rompuy presented a first view of the profound institutional reform Europe needed to undertake in June 2012 in an attempt to calm the markets by signalling European Union leaders' firm determination to move towards a more united Europe.

The report proposed the creation of a banking union, fiscal union, and economic union, so as to develop a stronger and more integrated Europe as a means of overcoming the crisis. The strategy, which was approved in December, proposed a path towards banking union to achieve three goals: (i) increasing the strength and resilience of the EU's banks through enhanced prudential and supervisory requirements; (ii) reducing the cost of bank failures by providing an effective resolution framework that seeks to avoid bank bail-outs and enhance deposit protection; and (iii) reducing the fragmentation of financial markets in Europe by breaking the vicious circle between banks and sovereign debt by centralising decisions and responsibilities in new supranational institutions, and by establishing a genuinely European network of solidarity such that participating banks will come to share risks.

Banking union has three main components. The first is the development of a new harmonised regulatory framework applicable to all financial institutions operating in the European Union (the Single Rule Book). The regulatory areas in which harmonisation of legislative frameworks is being pursued are:

- *Common regulations to strengthen capital and liquidity requirements* (known as CRR/CRD IV).[8] These regulations implement new global standards on bank capital laid down by the Basel Committee on Banking Supervision (Basel III) in the European Union's legal framework. The new banking legislation strengthened the capital requirements, demanding more and better quality capital, and included regulations on liquidity and leverage in order to reduce the likelihood of bank failures. The CRR/CRD IV package came into force in January 2014 (including the Directive's implementation in national legislation) and can now be said to be fully in place and taken on board by financial institutions and the market.

- *Common regulations to address financial difficulties while minimising recourse to taxpayers' money* (known as BRRD).[9] BRRD establishes a series of common rules applicable to all European Union countries to address the resolution of banking groups facing capital or liquidity problems, minimising the cost to taxpayers and safeguarding the

[7] http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf

[8] CRD4-Capital Requirement Directive (Directive 2013/36/EU) and CRR-Capital Requirement Regulation (Regulation 575/2013).

[9] BRRD-Bank Recovery and Resolution Directive (Directive 2014/59/UE).

critical operations the entity may perform. A key plank of the new regulations is that the cost of recapitalising an entity will fall mainly on private creditors through what is termed a 'bail-in', rather than on taxpayers. The principle of "more bail-in and less bail-out" undoubtedly helps break the sovereign/banking sector linkage.[10] It is worth noting that the BRRD entails significant institutional change. It creates a new resolution authority with extensive powers of intervention in entities both during resolution processes and when establishing preventive measures (*e.g.* resolution plans) facilitating a potential future resolution. The BRRD was phased in gradually over the course of 2015 (it came into effect in Spain on June 18th, 2015, with Law 11/2015).

- *A new version of the Directive on deposit guarantee schemes* (known as DGSD),[11] aiming to harmonise financing and coverage of deposit guarantee schemes throughout the European Union, which came into force in July 2015. Under this Directive, bank deposits from all banks operating in the European Union are guaranteed up to a maximum of 100,000 euros per customer and bank in the event of a bankruptcy. One of the main points addressed by the Directive is how guarantee schemes are to be financed. In general, deposit guarantee schemes will be financed with *ex ante* contributions from financial institutions determined according to their size and risk profile. If *ex ante* contributions prove insufficient, the fund will collect ex post contributions from the banks, and in the last resort option, it will draw upon alternative financing mechanisms such as public loans, loans from deposit guarantee schemes in other Member States or private loans from third parties. Finally, it should be noted that the harmonisation of the rules on deposit guarantees does not include the creation of a single guarantee scheme for the euro area. As will be discussed in more detail below, this is an issue that will need to be addressed in the years ahead.

The second pillar of banking union is the Single Supervisory Mechanism (SSM). The SSM changes the rules of the game for banking supervision, entailing the creation of a centralised system of European supervision that encompasses both the ECB and the national supervisory authorities in the countries of the euro area. The ECB will directly supervise 'significant credit institutions' and will work very closely with national supervisory authorities to supervise the other credit institutions. It can take over responsibility for a less significant bank if necessary to ensure the overall functioning of the SSM. Creation of the SSM is the complement to monetary union and a common legislative framework that ensures homogeneous interpretation and application of supervisory practices across the EMU.

And finally, the third pillar of banking union is the Single Resolution Mechanism (SRM). The SRM therefore comprises a new centralised decision-making system on banking resolution throughout the euro area comprising the National Resolution Authorities (NRAs), a new Single Resolution Authority, a Single Resolution Fund and a single set of rules for resolution (in line with the framework for the management of the crisis defined in the BRRD).

Banking union represents the biggest transfer of sovereignty in Europe since the creation of the euro.

The Single Resolution Authority, which has been fully operational since January 1st, 2016, will apply the resolution rules determined in the BRRD uniformly to entities located in the euro area.

[10] Proof of this is that the rating agencies are changing their risk assessment methodologies to eliminate sovereign support from financial institutions´ ratings. This change in rating methodologies meant the loss of 1 or 2 levels in the ratings of the main European financial institutions in 2015.

[11] DGSD-Deposit Guarantee Scheme Directive (Directive 2014/49/EU).

This new Brussels-based authority can impose preventive measures to minimise the impact of an institution's resolution. But, perhaps its most important role is during resolution itself. The Single Resolution Fund may be drawn upon up to a limit of 5% of the total liabilities of the institution being resolved in cases where the bank's private resources are insufficient to cover the cost of the resolution process, and once private creditors have assumed losses of at least 8% of the institution's total liabilities. The Single Resolution Fund is one of the major innovations of this third pillar. It will be financed by European banks and is due to reach its general target level of 55 billion euros in 2024. Its financial capacity will be progressively mutualized, starting at 40% at its inception (2016) until it reaches 100% in 2024.

To conclude, banking union represents the biggest transfer of sovereignty in Europe since the creation of the euro. Throughout the process, there has been a strong political will and a sense of urgency at the level of both the European institutions and Member States. Although complacency at times risked stalling the process, Europe's leaders fortunately managed to reach a consensus on the key issues.

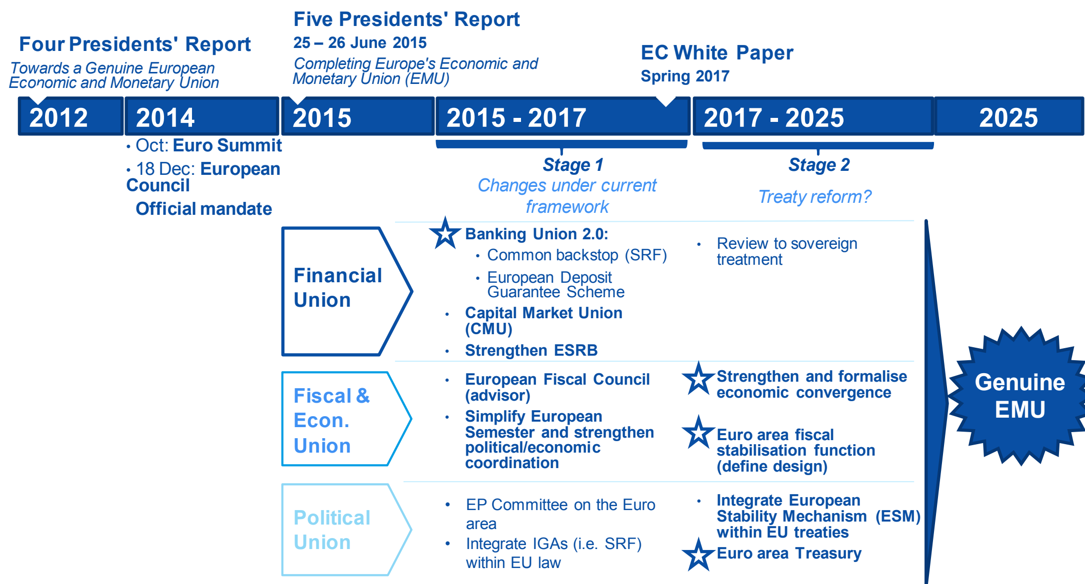
However, Europe's authorities are today aware that a Single Deposit Guarantee Scheme is needed. Starting banking union without this fund was accepted temporarily as a lesser evil in order to get banking union under way in 2015. But banking union will need to be completed in the near future with a Single Deposit Guarantee Scheme and closer economic and political integration.

The European project for the next ten years as a mechanism to confront the challenges of the future

The new step taken by Europe towards greater integration was set out in the report "Completing Europe's Economic and Monetary Union" presented in June 2015, better known as

Exhibit 3

Towards a genuine European Economic and Monetary Union



* ESRB – European Systemic Risk Board, IGAs – Intergovernmental Agreements, SRF – Single Resolution Fund

Source: BBVA Research.

the "Five Presidents' Report"[12] (the President of the European Commission, Jean-Claude Juncker, the President of the Euro Summit, Donald Tusk, the President of the Eurogroup, Jeroen Dijsselbloem, the President of the European Central Bank, Mario Draghi, and the President of the European Parliament, Martin Schulz).

This new European proposal is half way between ambition and pragmatism. It correctly establishes the need to bolster the euro area's financial stability by developing new mechanisms of solidarity while ensuring that governments and economic actors behave responsibly. This pragmatism is manifested throughout the types of goals established in two distinct stages. In the first stage, work focuses on ambitious but achievable goals, while in the second stage, it focuses on other more ambitious aims that require a profound rethinking of European and national institutions. Specifically, in the short term, *i.e.* between now and June 2017, the plan seeks to complete banking union by creating a Single Deposit Guarantee Scheme (SDGS) for banks operating in the euro area and a common public backstop for the Single Resolution Fund (SRF).

- Setting up a common deposit guarantee scheme is essential to completing banking union and, thus, making progress towards eliminating the risks of fragmentation associated with the sovereign/banking vicious circle. The proposal presented by the European Commission on November 24th, (European Commission, 2015) is undoubtedly a step in the right direction, establishing different levels of shared responsibility over time. Viewed in isolation, the reinsurance system envisaged for the period up to 2020 in the first phase (referred to as European reinsurance), does not appear to be a major advance on the current system. However, the path embarked upon with what is termed co-insurance or progressive mutualisation as of 2020 will facilitate the transition to the third phase. The path charted by this roadmap ends with full mutualisation or pooling in 2024 with exclusive use of the SDGS. This will not be easy to achieve, as there is a split within the EU over how fast progress ought to be.

- As regards the public backstop, there has been a lot of discussion about the financial power of the Single Resolution Fund. There are many doubts about how the resolution of an entity will be financed during the Single Resolution Fund's transitional period, when the existing resources will be limited. Additionally, the fund may be too small in absolute terms in the event of a systemic crisis and widespread bank failures. It is therefore necessary to devise a public backstop that gives credibility to the whole process. One solution would be to assign this role to the ESM (European Stability Mechanism), which was designed to provide support during the sovereign-debt crisis, but which has adequate financial capacity, resources, and governance, along with the authority to directly recapitalise crisis-stricken entities, which seems to fit the bill for the backstop role. However, giving it this role would mean reforming the ESM treaty, a step some countries remain reluctant to take.

  The ECB's role in the current banking and sovereign crisis could be taken on by the ESM or an equivalent body. In this way the ECB would therefore need to limit its participation as

Setting up a Single Deposit Guarantee Scheme is essential to completing banking union and, thus, making progress towards eliminating the risks of fragmentation associated with the sovereign/banking sector linkage. However, it will not be easy to achieve, as there are divisions within the EU regarding the speed at which progress needs to be made.

a guarantor of financial stability to an advisory role, while acting as a provider of liquidity in the last

[12] http://europa.eu/rapid/press-release_IP-15-5240_en.htm

resort, avoiding many of the issues concerning its independence mentioned above.

Over the longer term, from 2017 to June 2025, the unavoidable, but complex, review of the European Union's treaties and the necessary transfer of sovereignty to strengthen fiscal and political union, needs to be considered. Three elements have been highlighted in order to be able to complete the architecture of Europe's Economic and Monetary Union (EMU).

- First, economic union needs to be deepened, which requires closer convergence between countries and strict compliance with the rules already agreed, as well as completion of banking union, as already discussed.
- Secondly, fiscal union between member countries needs to be sped up. This necessitates establishing a macroeconomic stability mechanism for the euro area. The creation of a euro area Treasury would be a positive step towards the coordinated development of common fiscal policies. We need to arrive at a situation in which ever more decisions in the euro area are taken at the supranational level.
- Thirdly, greater democratic participation and parliamentary scrutiny of progress towards political union is needed. An economic government for the euro area, backed by an elected parliament for the euro area, would strengthen accountability and the acceptance of reforms. This requires a bigger transfer of sovereignty from the national to European level, where it will be essential to guarantee that national parliaments are better coordinated and their views are taken into account at the European level. It is essential to formalise a joint decision-making mechanism between national parliaments and the European Parliament.

In mid-2017, the European Commission is due to publish a white paper with a roadmap for the development of this second phase (2017-2025), such that 2016 will be a busy year and a key one in terms of political debate. It is important that this debate be approached in an inclusive way, by means of a public consultation and with the support of expert groups. Only then will it be possible to guarantee it has the legitimacy and support necessary for the European project to progress successfully.

Concluding remarks

Over the last four years, European political and economic authorities have made considerable strides towards the construction of a more united and resilient Europe that is better able to weather future crises. However, there is still work to be done, and the successes reaped should not lull us into complacency. We need to complete banking union and embark on the path towards fiscal union and political union. In short, the aim is to build on the current euro as it exists today to equip it with a more robust architecture, able to confront the challenges of tomorrow. This is essential in order to be better able to withstand future financial and economic shocks, and to ensure the ECB works optimally by eliminating the constraints on its monetary authority operations – an institutional structure characterised by the segmentation of capital markets and banks, without a single fiscal authority acting as a counterpart.

The recipe has been known since the "Four Presidents' Report" in 2012. The roadmap the European authorities are due to follow over the coming years was unveiled in the summer of 2015 in the "Five Presidents' Report", with the aim of making further progress towards European integration. The plan aims to achieve genuine monetary union within ten years, with a gradual two-stage approach. The first stage, ending in 2017, seeks to complete banking union with the implementation of a Single Deposit Guarantee Scheme in the euro area. And the second, from 2017 to 2025, envisages the unavoidable, but complicated, treaty review to make progress towards fiscal and political union.

At present, European countries express differences in terms of their points of view and levels of ambition, which could be a stumbling block on the road ahead. European leaders need to take a long-term view when addressing these topics, making sure they are sufficiently forward looking. Now, more than ever, there is a need to clarify the extent to which the countries concerned are willing to transfer sovereignty, and how fast they want to move forward on the construction of the Europe we want for the future.

References

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