Toward a European Banking Union: Taking Stock

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The creation of a European banking union was initiated, among other things, to decouple any potential future banking crises from sovereign debt crises. One of the building blocks for banking union is joint European banking supervision as embodied by the Single Supervisory Mechanism (SSM), which will become operational in late 2014 under ECB leadership. Another fundamental pillar is the planned Single Resolution Mechanism (SRM), an instrument to deal with distressed banks in the future. The conference weighed the costs and benefits of this large-scale institutional reform. It brought together a diverse international audience of 420 leading policy, business and finance experts as well as renowned members of the global academic community.

In his *opening remarks,* OeNB Governor *Ewald Nowotny* discussed the impact of the EU's banking union on economic policymaking, the banking industry and the economy at large. Banking union is aimed primarily at breaking the nexus between government and banks. The clear rules on bank resolution, which form one building block of banking union, will help sever the link between financial system instability and resulting threats to fiscal sustainability. In light of the weaknesses in the banking sector that the crisis has exposed, banking union has also been designed to support banks in fulfilling their economic role of supplying businesses and households with credit. Another area which the crisis revealed to be flawed is the institutional framework of the European banking markets, which continued to be regulated at the national level notwithstanding the far-reaching integration of the euro area financial market that had been achieved before the crisis. The euro area-wide harmonization of banking supervision and bank resolution will ease the fragmentation of banking markets in the euro area. Banking union is expected to increase the efficiency of financial intermediation by banks above all in those euro area countries which were affected most by the sovereign debt and banking crisis and in which the low interest rates did not feed through to the customer level. Furthermore, supervisors will also have to bear in mind the impact their actions have on the real economy. The more stringent supervision of banks' balance sheets must not compromise banks' willingness and ability to share the risks of the real sectors of the economy. Centralizing banking supervision at the European level constitutes a milestone in deepening and completing the euro area's economic and institutional integration. Broadening the reach of banking union to include other EU Member States beyond the euro area is mutually beneficial; therefore it would be in everyone's interest if as many countries as possible decided to join.

In her *opening address, Sonja Steßl,* State Secretary in the Austrian Federal Ministry of Finance, also stressed the importance of banking union for break-

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ing the vicious cycle between banks and sovereigns. As bank bail-outs and other support measures have increased public debt in almost all EU Member States, Steßl favored a continued contribution by banks, in the form of a levy, to reduce public debt. Other ways to reduce the heightened debt level advocated by the State Secretary are a shift in the tax burden from taxes on labor to higher taxes on property and inheritance, or a curb on tax evasion and on profit shifting. In the same vein, Steßl voiced support for a financial transaction tax (FTT) that would act as a positive incentive by reducing the profitability of merely speculative trading and would hence contribute positively to financial stability. She expressed confidence that it would be possible to broaden the base of the FTT, which currently mostly targets stocks and some derivatives, within a reasonable time.

The *keynote addresses session,* entitled "European Integration and European Banking Union: Strategic Issues," was chaired by *Ewald Nowotny.*

The keynote address by *Axel A. Weber,* Chairman of the Board of Directors at UBS, focused on the impact of banking union on the European banking market. As money can take the form of either banknotes or deposits held at commercial banks, monetary union undoubtedly requires a certain degree of centralization not just of its monetary policy decision bodies but also of its banking supervisory systems. While agreeing that banking union will weaken the nexus between banks and sovereigns by lessening the scope and ability of the government to intervene, it will not be able to break it completely. Links between governments and banks would remain, as banks are, for example, the largest buyers of government bonds, as both governments and banks are subject to the same business cycles, and as deposit insurance will remain national for the time being. Weber welcomed the harmonization of rules and standards brought about by banking union, which is valuable especially for internationally active banks. But banks could also improve their situation themselves by increasing their capital base in time. Capital will in the future constitute a significant competitive advantage. Referring to the comprehensive assessment of banks by the ECB and the national competent authorities presently underway, he pointed out that banks should address any capital needs in the currently benign environment and not wait until the publication of the stress test results. If problems of individual banks become publicly known, it could be very difficult to raise additional capital. Referring to the asset quality review (AQR) and the upcoming stress tests, Weber pointed out that it could be problematic to put banks that have just come through a crisis under stress. In concluding, he expressed concerns that a different stance of monetary policy in the U.S.A. and the euro area might lead to higher volatility in financial markets.

The keynote address by *Vitor Constâncio,* Vice-President of the European Central Bank, discussed the consequences of banking union for European integration. One of the objectives of banking union was to address the absence of European supervision and resolution in the context of the high degree of interconnectedness of banking markets in the euro area, which had contributed to the buildup of imbalances in both creditor and debtor countries. Moreover, banking union aims to achieve a smooth transmission of monetary policy across all euro area countries. As the banking system is the predominant source of finance for the European economy, increasing its effi-

ciency is certainly essential for economic recovery. Euro area bank balance sheet repair has been under way for some time already, with banks increasing capital and implementing write-offs, partly anticipating the comprehensive assessment. But while the ongoing deleveraging in the banking sector certainly plays an important role in the inadequate current levels of credit supply to the real economy and it is therefore necessary to strengthen European banks to consolidate the recovery, the deleveraging is far from sufficient for jumpstarting growth in Europe, as factors related to the demand side may play an even more important role. A major channel by which banking union will contribute to financial integration will be by separating banks' robustness from sovereigns. In Constâncio's view, the Bank Recovery and Resolution Directive (BRRD) is the most crucial regulatory change in Europe in relation to breaking the bank-sovereign nexus, as it represents a true paradigm change, ending the culture of bail-out and ushering in a culture of bail-in. The BRRD implies that participant countries will shed a considerable amount of sovereign power, and at the same time the banks' strength will no longer be influenced by the ability of governments to provide domestic banks with the implicit subsidy of public support.

Session 1, entitled "Toward a European Banking Union: Transitional Issues," was chaired by Andreas Ittner.

Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, discussed the challenges in establishing the SSM. The first and most immediate of these challenges is to rebuild confidence in euro area banks. To this end, the comprehensive assessment conducted by the ECB and the national competent authorities will play a key role. The goal of the comprehensive assessment is to foster transparency of banks' balance sheets, to repair them where needed and, consequently, to foster confidence in the banks, thereby unlocking a revival of credit in the euro area. The second immediate challenge is to complete the SSM preparatory work in time before assuming supervisory responsibilities in November of this year. Much work has been done and several milestones have been reached, most recently the Framework Regulation that lays down the rules ensuring the smooth functioning of the SSM. The long-term challenges are to perform supervision with a truly European view, to ensure the effectiveness of the Supervisory Board of the SSM, to foster convergence of supervisory practices and to integrate local supervisory best practices to the benefit of all SSM members. Nouy concluded that the banking union was testimony to what Europe can achieve when it sets its mind to it, and by working together the ECB and the national competent authorities could meet their remaining challenges.

Elke König, President of the Federal Financial Supervisory Authority in Germany, elaborated on the current preparations for the results of the comprehensive assessment. She pointed out that this assessment was an exercise of historic proportions and that its results had to be reliable, credible, of high quality, and enforceable. Outside help from certified public accountants and auditors has been drawn on not only because of a lack of supervisors but also to get outside credibility. In the same vein, ECB country teams not only support national supervisors but also ensure consistency across the whole euro area. König pointed out the high operational risk involved, given the sheer volume of data to be handled in a short time span. While AQR findings

have to be on a standardized and contestable basis for the upcoming stress test, the AQR methodology might depart in some cases from accounting rules. She then discussed issues related to the methodology for the stress tests that the European Banking Authority (EBA) had released in April. Concerning the assumptions on funding, there is no aim to replace central bank funding by market funding, which might lead to inconsistencies between banks. Banks that have issued equity in the capital market might be subject to ad hoc publication requirements on communications with supervisors. In concluding, König expressed confidence that no major issues would emerge at German banks as a result of the AQR.

Session 2 on "The European Banking Union in a Global Context" was chaired by *Ernest Gnan,* head of division at the OeNB.

Sigríður Benediktsdóttir, Director at the Central Bank of Iceland, looked at the effects of European banking union on outsiders. The effect on banks outside banking union depends on the relative credibility of the supervision, resolution and deposit insurance bodies as well as on the importance that the market gives to strong and credible supervision. One measure of the market evaluation of the relative costs and benefits of banking union will be whether banks would try to avoid or would strive to be within the definition of a major subsidiary in the euro area which fall under the supervision of the SSM. For supervisors of large international banks, dealings with home-host issues are likely to end up with the ECB rather than individual national supervisors. While cooperation with one supervisory entity for the whole euro area should be easier than having to deal with a number of European national supervisors, it is conceivable that the ECB may seek to exert more authority than that presently held by existing national bank supervisors. Furthermore, credible supervision and resolution for the euro area banking sector may increase financial fluctuations in countries outside banking union, as especially during periods of turmoil, funds will flow to banks in countries with more credible supervision and backstops. From the perspective of Iceland, it remains to be seen whether although all EU and EEA countries have to implement the European regulatory framework, enough credibility can be built up by implementing the "same" regulatory framework as the euro area. Credibility proved not to be sufficient during the last financial crisis. For the world financial system, it is important for the move toward European banking union to end up in a "race to the top" without hampering the efficiency of financial intermediation.

In his presentation "Optimal Regulatory Areas: A Tentative Conceptual Framework," *Giovanni Dell'Ariccia,* Assistant Director at the International Monetary Fund, discussed tradeoffs and externalities associated with joining a banking union. By eliminating one macroeconomic policy lever, banking union makes it more difficult to tailor regulatory actions to individual countries. At the same time, it enhances the need for coordination with other macroeconomic policies, e.g. monetary policy. While banking union can eliminate a race to the bottom, free riding on the improved regulation within banking union (without having to carry the costs of participating) may hinder the emergence of a more comprehensive union once a partial banking union is formed. The "net benefits" of banking union are larger for countries that have similarities, such as for countries already

in a currency union or for countries with similar financial structures (e.g. bank-based or market-based systems). In the same vein, the benefits are larger for countries with a higher degree of financial and economic integration, e.g. with a strong presence of foreign banks. Concerning the exchange rate regime, benefits are inversely correlated with monetary policy independence (because central banks are the lenders of last resort and liquidity providers), but it may work both ways, as entering a banking union might involve the loss of a policy lever.

Session 3 on "Regulatory Capture" was chaired by *Martin Summer,* Head of the Economic Studies Division at the OeNB.

Engelbert Dockner, Professor at the Vienna University of Economics and Business, gave an overview of the recent theoretical and empirical literature on regulatory capture. He distinguished between a broad definition of regulatory capture – a process through which special interest groups affect state intervention in any of its forms – and a narrow interpretation – regulated financial service firms manipulate the state agencies that are supposed to control them. According to Dockner, there are three major economic incentives for regulatory capture. First, regulators are hired by the industry because of their valuable skills and networks. These jobs are better paid than those in the state agencies. As the employers will prefer regulators who appreciate the private sector, regulators will try to signal their positive attitude toward the industry's demands. Second, regulators depend on information provided by the industry. They may trade information for better treatment. Third, regulators need industry-specific human capital. To counteract these incentives for regulatory capture, Dockner suggested, among other things, the participation of public interest groups, limiting the size of the industry players, and far-reaching disclosure requirements.

Thierry Philipponnat, Secretary General of Finance Watch, which is a Brussels-based non-governmental organization that conducts research and advocacy on financial regulation, pointed out that the proximity between the business elites, the relevant political elites and the regulatory authorities is a very natural phenomenon. Yet, the consequences of this proximity should not be underestimated. In addition to possible complacency, it may cause a blurring of the lines between public and private interests. According to Philipponnat, the separation of public and private interests is even more demanding at the European level. The European Union is working on building a single market, but it is not a homogenous political zone. The different Member States care more about their national interests than about the European interest. Moreover, they equate their national interests with the interests of their national champions. The simplest way to mitigate the national proximity problem is to increase the distance between regulators and supervisors on the one side and regulated and supervised entities on the other side. In this respect, Philipponnat views the European System of Financial Supervision (ESFS) and banking union as major improvements.

The first day of the conference was closed by the traditional Kamingespräch with *Michael Spindelegger,* Austrian Vice Chancellor and Federal Minister of Finance. Spindelegger emphasized that decoupling the banking industry from sovereign debt was an important step forward. He estimated that the restructuring of Hypo Alpe Adria would add approximately 1.2% to the deficit in

2014 and would raise sovereign debt by 5.5%. The Single Resolution Mechanism will reduce the burden on taxpayers, noted Spindelegger. Major Austrian banks face double taxation: They have to pay a special bank levy and have to contribute to the European Resolution Fund simultaneously. Spindelegger agreed with industry representatives that this was a competitive disadvantage compared to the neighboring countries and that it could hamper credit growth. But given the huge amount of government aid which will most likely not be fully redeemed, there is no leeway for abolishing the bank levy. Spindelegger announced that 10 EU Member States will introduce a financial transaction tax. A technical proposal is due at the end of 2014.

Peter Mooslechner, Executive Director of the OeNB, opened the second day of the conference with a panel discussion on "Implementing the SSM – Implications for Banks and Regulators." The panelists were *Helmut Ettl,* Member of the Executive Board of the Austrian Financial Market Authority, *Hans-Helmut Kotz,* Professor at Goethe University Frankfurt, and *Andreas Treichl,* Chairman of Erste Group Bank AG. *Ettl* expected a radical change for banks and supervisors alike. Before the SSM, the size of banks was measured relative to national GDP. In six Member States the total assets of the largest banks exceeded national GDP. After the introduction of the SSM, the relevant benchmark will be euro area GDP. The total assets of the largest European banks will then only be around 20% of the relevant GDP. As a consequence, the bargaining power of banks will decrease. Ettl expects that decisions will be taken in the interest of the euro area and will not be diluted by national interests. *Kotz* mentioned that a banking union as an integral part of a monetary union was discussed as early as 1992. He considered the opinion that central bank money was different from bank deposits an illusion. Therefore, banking union is necessary to complete monetary union. *Treichl* identified loans in foreign currencies as an extremely risky form of lending. Yet it took 25 years for the banking sector and regulators to understand that such a business model generates considerable systemic risk. Currently, mortgage lending constitutes the major systemic risk in his opinion. By way of conclusion, Treichl addressed the consequences of the SSM directly. In his perception, the SSM is a positive, yet highly bureaucratic step forward. The major shortcomings are the missing deposit insurance scheme and the fact that not all EU Member States will participate.

The final session of the conference on "Future Challenges: The Big Picture" was chaired by *Doris Ritzberger-Grünwald,* Director of the Economic Analysis and Research Department, OeNB. According to *Martin Hellwig,* Director of the Max Planck Institute for Research on Collective Goods, European economies suffer from three weaknesses: low growth, enormous debt, and weak financial institutions. These highly interrelated issues together with demographic change are reminiscent of the Japanese experience over the last two decades. The post-Lehmann policy of bailing out most banks prevented what Hellwig considers of utmost importance: an adjustment of the market structure. Excess capacity in any industry leads to gambling. Will banking union solve these problems? It is a step in the right direction. Some of the cross-border externalities within the euro area will be internalized. In Hellwig's perception, the step is too small, however. Much of the relevant EU law takes the form of EU directives

which need to be transposed into national law. As a consequence, the ECB will have to apply different laws. This may affect the viability of the system. If banks with systemically important functions in several Member States were to get into trouble, authorities would be unwilling to enter into a recovery and resolution procedure. The "too big to fail" issue has not been resolved.

The last speaker of the 2014 conference was *Thomas Wieser,* President of the Eurogroup Working Group. He started by outlining the origins of banking union. The legal framework for financial regulation and supervision was based on directives. As a consequence, supervision remained a national issue. Even though the main actors partially understood the risks generated, serious improvements in supervisory coordination were not conceivable until the financial crisis reached unprecedented levels in 2012. The actual trigger for banking union was the need to recapitalize banks directly through the European Stability Mechanism. Such a procedure is only possible if banks are supervised by a common authority. The new regulatory framework will change the environment considerably. An industrial policy approach to the banking sector that is driven by national instead of European interests will no longer be possible. Regulatory forbearance and regulatory capture will be more difficult. Discretionary actions will not be allowed. The new resolution regime will certainly change the incidence of resolution costs. Using taxpayer money to cover losses will be the exception. Wieser expects that in the future, banks' liabilities will be perceived as riskier than nowadays. Thus the cost of funding will go up. The consequences for the real sector are difficult to estimate, as bank financing may be complemented by other means of funding.

Claus Raidl and *Ewald Nowotny* presented the Klaus Liebscher Award, which has been bestowed every year since 2005. The award was established on the occasion of the 65th birthday of former OeNB Governor Klaus Liebscher in recognition of his services to Austria's participation in the European Economic and Monetary Union and for European integration.

The two prize-winning papers in 2014, which were selected from among numerous excellent submissions, address particularly topical economic policy issues and display outstanding academic quality: "Systemic Sovereign Risk: Macroeconomic Implications in the Euro Area" by *Saleem Abubakr Bahaj,* University of Cambridge, and "Information Frictions and the Law of One Price: 'When the States and the Kingdom became United'" by Claudia Steinwender, an Austrian economist currently at the London School of Economics.

In his paper, Bahaj analyzes a question that was a topic of sometimes fierce debate at the height of the European sovereign debt crisis: Are rising risk premia for sovereign borrowing simply a forward-looking signal of the capital market that correctly reflects countries' macroeconomic weakening? Or is the causality reversed, with risk premia rising for reasons that are unrelated to macroeconomic conditions but cause an economic downturn and an increase in public debt? Bahaj finds that factors that are not directly related to a country's macroeconomic situation cause about half the rise in risk premia for sovereign borrowing.

Claudia Steinwender re-examines an old question of international trade theory whose correct resolution has important implications for assessing the social

benefits of new information technologies: Does the acceleration of information flows made possible by technological innovation improve the quality of price signals? Steinwender uses statistical data derived from a historic technological achievement: the construction of the first transatlantic telegraph line in the 19th century. The analysis of cotton prices in New York and Liverpool before and after the completion of the cable shows that the quality of price signals improved, benefiting both consumers and manufacturers.