Axel A. Weber
Chairman of the Board of Directors
UBS

The Role of the European Banking Union in European Integration

Since the beginning of the European debt crisis, the future architecture of the European Economic and Monetary Union has been discussed often and widely. The crisis has shown that an economic and monetary union cannot function well without a further integration of the participating countries' banking sectors.

Monetary union implies that the euro area countries share the same money, the euro. Sharing the same money implies that one euro should be the same across all member countries. If we define money as M1, then money can take two shapes – either it comes in the form of banknotes or in the form of deposits at a commercial bank. If markets start to differentiate between banknotes or between euros deposited at different commercial banks, the monetary union is at risk. A monetary union therefore requires a certain degree of integration and unification of the banking system.

Consequently, I see it as a positive and necessary development that we are now building a banking union, and I am convinced it will contribute to financial stability and economic prosperity. It should mitigate the link between banks and sovereign governments, curb financial fragmentation, enable banks to rebuild trust and focus again on their role in society, that is, supplying credit to the real economy. But it is also a project with many remaining challenges. Also, there is a risk that it may reduce pressure on other items on the political and economic reform agenda.

Three Key Issues

To start with, I would like to focus on three key issues of the banking union that in my view are especially important from an economic perspective. First, the banking union will make monetary policy more effective. Second, the uncertainties regarding implementation of the banking union; this is an exercise with many elements that need to operate cohesively for the whole project to be a success. And third, looking beyond the banking union, further structural reforms are necessary to stabilize Europe.

Let me start with the important relationship between the banking union and monetary policy. The banking union will make monetary policy more effective. Let me add here that effective monetary policy also requires integrated euro area financial markets beyond banking. Both should be top priorities on the political agenda.

To be more specific, a banking union is very much in the interest of monetary policy, for several reasons:

- First of all, it is important to mitigate the link between sovereign governments and banks and thus unburden monetary policy from fiscal concerns, from the responsibilities that have been assumed in the crisis, and from some of the "too big to fail" considerations. The different links between sovereigns and banks during the crisis created a negative feedbackloop that induced financial fragmentation and contributed to impairing the credit channel and the transmission of monetary policy. The need to sever this bank-sovereign nexus was one of the reasons for establishing the banking union. The Single Resolution Mechanism (SRM), in combination with the Single Resolution Fund (SRF), is supposed to address this issue. With the ECB in charge of the resolution of significant banks under the SRM, sovereigns will in the future have less ability to intervene in failing banks, enabling better separation of bank and sovereign risk.

- Please note that I said "mitigating" the link and not "breaking" the link between banks and sovereigns. Breaking the link is, in my view, illusory. Despite the banking union, the link will not be broken entirely. Links between a sovereign and its

banks will always remain. For example, banks are usually the largest buyers of government bonds. Their balance sheets will therefore reflect the quality of their sovereign's bonds. Furthermore, banks and their sovereigns are subject to the same national business cycles. Besides, the deposit insurance remains national, representing another strong link between the sovereign and its banks.

- A second plus for monetary policy is that the banking union will contribute to harmonizing monetary conditions and reducing financial market fragmentation. A single supervisor should enhance transparency and lead to a convergence of rules and standards. The common principles embedded in the comprehensive assessment in preparation for the Single Supervisory Mechanism (SSM) should also create more homogeneity and thus increase trust in cross-border lending.
- And thirdly, a strong banking union can unclog the transmission mechanism of monetary policy. In the euro area, banks have traditionally played an important role in financing the real economy. Bank loans account for most household borrowing and for around 50% of non-financial firms' external financing, in contrast to the U.S.A, where 75% of firms' financing comes from capital markets.
  - The crisis disrupted lending processes in many European countries. The recent ECB report on financial integration in Europe and the ECB survey on the access to finance of SMEs in the euro area, for example, show that today there is still a large divergence in financing conditions and access to finance for SMEs in different parts of the euro area. In countries like Germany and Finland, some 80% of SMEs can fulfill their financing needs through bank loans, whereas in Greece or Ireland, this rate is only 30%. National governments first and foremost have a role to play in improving this situation.
  - The ongoing state of fragmentation in banking has become a serious obstacle to SMEs' access to financing, with implications for the eco-

nomic recovery in distressed countries. Throughout the crisis the ECB tried to repair the transmission of monetary policy and restore the credit channel. And recently, global market developments have also contributed to an inflow of capital into the European periphery, but the problem is not solved yet. Governments need to act decisively to use these tailwinds to improve the situation before markets become more skeptical again.

The steps taken toward the banking union will establish conditions necessary for a transparent, competitive and stable banking sector. And they will help monetary policy to regain traction across the euro area and be more effective. Ultimately, however, it is up to policy makers to ensure that the banking system is restored to health. And, needless to say, the banks themselves play a decisive role in improving the situation.

Remaining Uncertainties

However, I also have some concerns regarding the implementation of the banking union. The set-up and implementation of the banking union is a tremendous undertaking with consequences in many areas. For this exercise to be successful, many building blocks must fit and work together, and conditions must fall in place.

The banks that are going to be supervised directly by the ECB under the SSM from November onwards are currently preparing for the transition of supervision and are undergoing the AQR and the stress test. Like a doctor, the ECB would like to have a full health check of any new patients. A doctor would put new patients on an exercise bike in order to test their resilience to stress. However, if the patient just came back from the intensive care unit, it is less obvious how such an exercise would be health-enhancing.

The Comprehensive Assessment is an important but delicate preparatory exercise. Many people are wondering if the outcome could trigger another crisis. The ECB has recently announced the details of how it expects failing banks to recapitalize.

I also wish to emphasize the importance of clear communication and transparency. Timely and transparent management of the market's understanding of the comprehensive assessment is important, in particular with respect to the impact of its outcome on individual countries and institutions. Where possible, the competent authorities should take mitigating actions.

Any downside surprise could make the capital raising efforts much more difficult for banks that are just implementing their plans to cope with tighter Basel III capital requirements, and therefore potentially trigger further deleveraging with consequences for lending and the economy.

Let me give you just a few examples to illustrate my concerns:

- First of all, to mitigate the bank-sovereign nexus, the SRM and the SRF are important building blocks of the banking union. Looking at the recently approved SRM, I find that the processes are complicated, as there are many parties involved in the decision making, a process that needs to be fast. Also the SRM needs unanimity and the overall concept is not tested.
- Furthermore, the Bank Resolution and Recovery Directive (BRRD), an important partner to the SRM and SRF, will only be enacted in 2016. This time gap may lead to potential complications in 2015 as some countries have no national law or legal ability to implement burden sharing

ahead of the entry into force of the BRRD. Also, the BRRD diverges in several aspects, such as in funding periods and the use of resolution funds, from the SRM and SRF.

- Another concern is the national deposit insurance, which is a weak link in my view. We need to find the optimal balance between national responsibilities and pan-European systems.

- Furthermore, I see potential conflicts of interest between the ECB as the supervisor and the ECB as the monetary policy authority. I am of the opinion that one needs to make a clear separation between supervision and monetary policy and I believe the current set-up, although with the best intentions, is a delicate one. For the 130 largest banks, the ECB is the "lender of last resort", determines deposit and refinancing rates, enforces liquidity and leverage ratios, sets capital buffers, and on top of that it should also ensure price stability in the euro area. Truly a conflict of interest minefield!
- Last, but not least, I would like to add a general note of caution. The banking union will fundamentally alter incentives for many market participants. While regulation is always well-intentioned, it often has unexpected secondary effects. Given the importance and vast size of the European banking sector and the complexity of the project, one needs to be alert to recognize adverse developments and to react in time, if necessary.

So a lot of work remains to be done and further efforts are needed to address the concerns I mentioned. It is important to ensure the success of the banking union. But the banking union alone is not enough to restore stability. Policy makers have a large role to play in the stabilization of Europe.

Further Reforms are Needed

The European countries, in the core and in the periphery, need ongoing efforts at structural reforms to restore stability and return to a solid growth path. For example, labor costs remain high in Europe and 46% of SMEs in the euro area even reported increasing labor costs over the past six months. Unemployment, and especially youth unemployment, is a burning issue in many European countries. Red tape is still abundant and regarding fiscal consolidation, there is still a long way to go.

The banking union is not a financial panacea. Factors such as rigid labor markets, lack of competitiveness or bad fiscal discipline also contribute to the ongoing European problems. A banking union will not address these issues. The current loose monetary policy stance of the ECB may also lead to new imbalances, this time in core euro area countries. Again, a banking union will not prevent this.

The U.S. Federal Reserve System has decided to normalize its monetary policy and gradually taper its asset purchases, because it considers that the U.S. economy is improving and that recovery is sound. But recovery in the euro area is lagging that of the U.S.A. and the impact of the normalization in the U.S.A. is substantial, especially for the European periphery.

One could interpret the recent decline in Spanish, Greek and Italian sovereign rates as an indication that international investors have confidence in the reform dynamics in these countries. I don't consider this to be so – the market is probably too benign. But even if it were not, the current level of these rates would only be justified if the reforms are carried out as planned. And it is here that I have doubts. Therefore, with market pressure for reforms declining, the political pressure on these countries to deliver on their promises needs to stay high. It is the combination of further structural reforms and completion of European initiatives, such as the banking union, that will lead to more stability and trust.

Conclusions

The banking union is a historic, fascinating and ambitious development. It is an important step forward in complementing the Monetary Union. It is also a project with vast consequences for European integration. It is not a silver bullet, however, and more efforts are needed on the national as well as on the European levels to stabilize the financial sector. To put Europe back on a sustainable growth path, structural reforms and more and better cooperation between financial sector and regulatory and political decision makers are needed.