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Opinion and Discussion Group on Political Economy

Launching Europe's banking union: adapting to the unexpected

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1. The banking union: an inopportune launching?

Over the last ten years, the European project –and, in particular the euro project– has had to face the most complicated episodes of its relatively brief history. The financial crisis that broke out in 2007 generated major tensions in the sovereign debt markets and created a highly complex risk feedback loop between the financial system and the bond markets. The launching of the banking union represented both an audacious but, at the same time, somewhat limited response to these and other structural problems that the crisis had served to highlight.

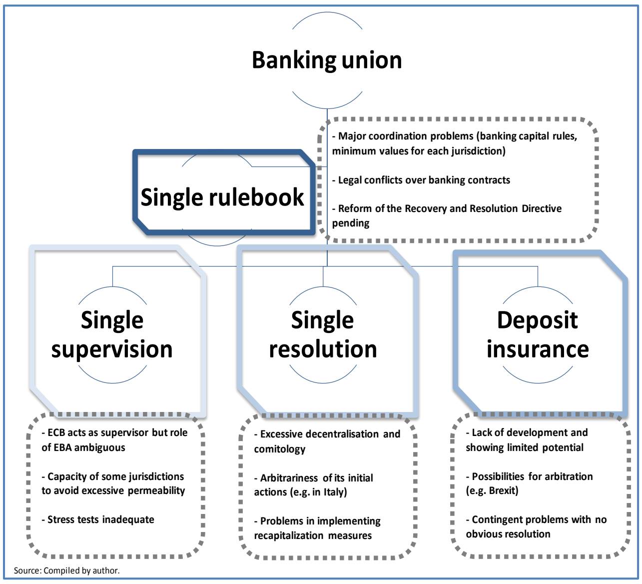
After reaching a large number of highly complicated agreements, the banking union came into being in 2014 with the creation of the Single Supervisory Mechanism (SSM). But, it was not until 2016 that the regulations underpinning the Single Resolution Mechanism (SRM) were introduced and, with them, that the banking union was exposed to its first test of fire. The aim of this brief is to analyse the position that the banking union finds itself in today, following its introduction. Such an analysis seems opportune in the case of a financial system like the one operated in Europe, where the degree of dependence of the financial institutions –its so-called level of 'bankarization', is probably the most intense in the world. And it also seems opportune, if we take into consideration the high default rates (estimated by the European Central Bank at one trillion euros of impaired assets across the euro zone) and the problems of transparency affecting banks in more than one European country, and which, in some cases, most notably Italy, see them heading towards a new banking crisis. Indeed, it is precisely the case of Italy that has highlighted the operational shortcomings of the banking union and which, despite its poor timing, can offer lessons on how the project might be improved in the short term.

It is relatively easy to criticize and to find weaknesses in such a complex setup as Europe's banking union. But, we should also stress the essential role played by its conception, and relatively rapid implementation, in avoiding even more serious threats to the continent's financial stability than those actually experienced in recent years. The debate concerning the political will to advance the European project is often heated, as are discussions regarding evidence that there are no banking unions in the world that are not at the same time tied to fiscal unions, which in turn find themselves tied to political unions. Yet, we should not underestimate the progress that has been made in such a short period of time and, in this regard, we cannot ignore the impetus that has been provided by Europe's political bodies. Indeed, on 28 June 2012, the European Council formalized the creation of a banking union to "guarantee stability and improve credit conditions" and "break the vicious circle between sovereign states and banks". Although discussions had been ongoing for some time, the agreement to create the union came as a welcome surprise –especially, for Spain, which at that time was the prime object of concern given its high levels of financial instability. The banking union, with all its shortcomings and potential for improvement, has enabled the creation of a safety net that not only protects the banking industry but also, to a considerable degree, the euro.

Just a month later, on 26 July 2012, the words of the European Central Bank's President Mario Draghi were the perfect complement for ensuring the long-term credibility of the new banking safety net under design: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

From 2012 until the end of 2015, a banking union began to take shape around the four main pillars illustrated in Diagram 1.

Diagram 1. The structure of the banking union on its creation and the reforms that remain pending. Strengths and weaknesses



Source: Compiled by author.

• The first of these pillars, the Single Rulebook is designed to ensure the consistent application of the regulatory and supervisory banking framework across the EU. The other three pillars can be summarised as follows:

• Single bank supervision: centred above all on the European Central Bank (ECB), with some of its powers being exercised in coordination with the European Banking Authority (EBA) and characterised by a high degree of decentralization. At present, more time needs to elapse before we can evaluate this supervisory role, given that in relation to certain matters some doubts persist –for example, the extent to which its in situ supervision of financial entities is proving effective.

• Single bank resolution: the mechanisms and powers to act in situations that threaten an entity's financial stability. Specifically, to establish the procedures and identify the cases in which bail-in (with shareholders and bondholders suffering a share of the losses) and bail-out (with the participation of the taxpayers) measures can be adopted. This single resolution faces further complexities regrading which there is still room for improvement, as is the case of debt restructuring and insolvency proceedings.

• Single deposit insurance: probably the best-known element of any safety net and yet the pillar towards which least progress has been made. There is a need to take into account the historical differences in the form of these guarantee funds –in some countries they are explicit (and contributory), while in others they are implicit (and contingent)– which makes it very difficult to create a common private mutualisation system.

Some of the practical problems identified with respect to these pillars and pending reforms are described in Diagram 1.

Specifically, problems of coordination have emerged in the most recent steps taken by the banking union prior to the implementation of the Bank Recovery and Resolution Directive in 2016. The ECB referred to these problems in its Financial Stability Review of November 2016, when it affirmed that "the high stock of non-performing loans (NPLs) on the balance sheets of euro area banks continues to be an important cause for concern for policymakers". However, on 23 November 2016, the European Commission announced various reforms to its Recovery and Resolution Directive that included: (i) Measures to increase banking sector resilience and financial stability, in particular in relation to leverage ratios; (ii) Measures to improve the lending capacity of the banking sector; specifically, making it less burdensome for medium and small size banks to comply with certain rules of solvency regulation; iii) Measures to facilitate bank and market liquidity, primarily by reducing the solvency requirements for banks' trading book positions and supporting measures for the creation of a capital markets union.

To some extent, the current design of the banking union reflects the disparate interests involved in its conception or, at least, contradictory views regarding the extent to which risks should be mutualised and how this might be achieved in terms of the budget. As Reichlin and Vallée (2016) suggest, the situation presented by the Italian banks is a particularly delicate one in which to be implementing these pending reforms and for completing the banking union. In particular, they point out how Italy is badly affected by two weaknesses that characterise Europe's banking industry: on the one hand, the operational dysfunctionalities that are strangling the financing mechanisms of production and the generation of profitability; and, on the other, major problems of transparency and asset quality that go unrecognised. Since the conception of the banking union, it was assumed that a centralized resolution framework, and a mutualized deposit-guarantee scheme were necessary for its effective operation. But progress on both fronts is far from complete. And this despite the efforts made by Europe's governments which, since 2007, have provided 675 billion euros in capital and repayable loans to the banks along with 1.3 trillion euros in guarantees. It is these high costs, among other concerns, that have motivated the need to implement a resolution that would limit bail-outs through the introduction of bail-in measures. But cases like that of Italy show that the current system continues to be characterised by decentralization and discretionary decision-making.

With the perspective afforded by time, it may be concluded that the sole existence of the banking union should be judged a success, especially if we reflect on the market conditions and general expectations of the sector in 2011 and 2012. Indeed, the question is no longer whether there should be a banking union or not, but whether it is an efficient union or not. And, to achieve this efficiency, it seems clear that additional elements are required. The current design was sufficient to respond to the immediate problems, but bold steps need to be taken to face the challenges that await Europe on the horizon.

The banking union, moreover, has been launched in a scenario in which other non-banking operators have begun to proliferate (e.g. fintech providers) and it will be largely up to the banking union to guarantee a level playing field.

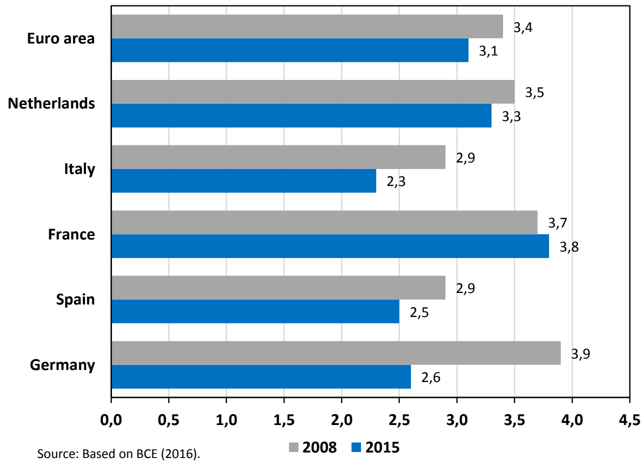
This brief analyses these issues in the five sections that follow on from this introduction. The second section describes the market environment of Europe's banks. Recent structural changes in the sector are analysed in the third section. The fourth examines the realities of bail-in and bail-out mechanisms and the difficulties of implementing them. The problems that might arise in relation to sector regulations and financial stability derived from the new non-banking providers are addressed in section 5. The brief concludes with a set of reflections on bank resolution and supervision policy in Europe over the next few years.

2. The market environment of Europe's banks

At times, there is a tendency to assume that the problems of the European banking sectors are attributable almost exclusively to the financial crisis. However, to a large extent, they are part of a set of circumstances that have been taking shape since the end of the 1990s: the sector's excess capacity and the excess supply in relation to demand.

The need to trim or deleverage the sector has been more than apparent as Europe's banks continue to cut their asset volume many years after the crisis. As Figure 1 shows, the financial institutions' assets in relation to GDP fell across the euro area from 3.4% in 2008 to 3.1% in 2015. This fall has been particularly significant in such countries as Germany (3.9 to 2.6%), Italy (2.9 to 2.3%) and Spain (2.9 to 2.5%).

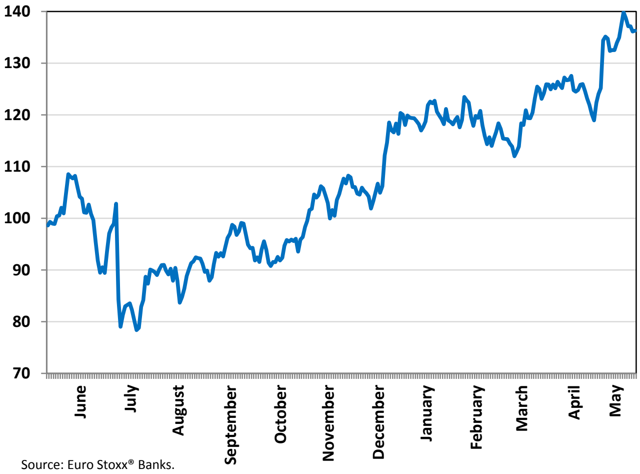
Figure 1. Financial institutions' assets in relation to GDP in Europe (2008-2015)



Source: Based on BCE (2016).

The change in market equilibrium in the banking sector is not, however, exclusively a question of the mismatch between supply and demand, but rather one of having to generate profitability in a complex, almost unprecedented, market environment, of negative real interest rates and an abundant provision of liquidity from the ECB. These are circumstances that, along with a progressive technological change, have ushered in another type of crisis: that of the profitability of banking. The market value of Europe's banks suffered a severe (even excessive) blow during 2015 and the first half of 2016. Figure 2, which shows the market value of this industry (approximated by the Euro Stoxx 600 Banks Index), indicates, however, that since the second half of 2016 there has been a considerable recovery. It might not be coincidental that this coincided with the introduction, in January 2016, of the bail-in mechanisms provided for in the Recovery and Resolution Directive, which mean greater risks of losses for the banks' shareholders, as well as announcements of continuing monetary stimuli by the central banks.

Figure 2. Bank Stock Market Behaviour (May 2016 - May 2017). Euro Stoxx 600 Banks Index

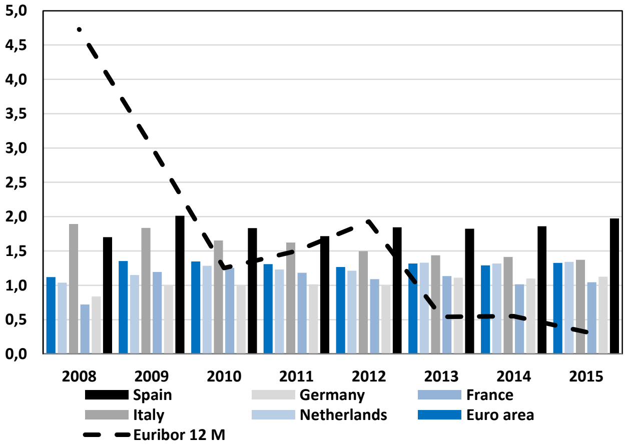


Source: Euro Stoxx® Banks.

The interest rate environment deserves special attention. Standard monetary and banking theory suggests that market interest rates reflect the balance between supply and demand for loanable funds and money. However, negative real interest rates are the direct consequence of an unusually expansive monetary policy. Although banks can obtain liquidity at a low cost, it is difficult to generate margins of intermediation because the demand risk (growth prospects, unemployment levels, etc.) does not correspond to the market interest rates that have been artificially generated by the monetary authority. Moreover, the interbank market is still largely non-existent. Among other matters, this mismatch between market liquidity and risk-adjusted liquidity would explain, as shown in Figure 3, that the fall in interest rates has not resulted in a parallel fall in bank intermediation margins. However, the "price effect" (lower interest rates) has not been accompanied by a quantity effect (greater demand for credit) which, along with other matters, has not allowed Europe's banks to improve their profitability.

Figure 3 also shows that there are still marked differences across Europe in terms of their respective margins of intermediation. The crisis has accentuated the divergence in the price conditions of the European banking sector. Also worth mentioning, although it would require a separate analysis, are the changes in national contractual structures derived from the decisions of the EU Court of Justice, including, for example, mortgage floor clauses in Spain and the impact this has had on the profitability of the country's banking sector.

Figure 3. Interest rates and intermediation margins: evidence of a non-linear relationship



Source: Based on BCE.

Benoit Cœuré (2016), member of the Executive Board of the ECB, even pointed out that we might speak of a taxonomy of relations between banking activity and real interest rates. This taxonomy, including some empirical relationships of interest identified by the ECB, is summarized in Table 1.

Table 1. Implications of negative interest rates for the euro-area banks

Structural factors
Demographic changes
Slowdown in the rate of technological progress
High demand for safe assets relative to their supply
Monetary factors
Real interest rates not necessarily 'natural' equilibrium rate between supply and demand
Forward guidance pledges affected by constantly falling rates of inflation
With inflation on the rise, a lax policy has less justification
Bank asymmetries
Availability of liquidity but not interest rates act as monetary stimulus
Interest rates not adjusted to demand risk or to accumulated debt
Households benefit more than the banks from lower debt charge costs
Positive effects for defaulters
Technical challenges
Computer systems and negative interest rates
Price creation and negative interest rates
Contract security and negative interest rates
Short and long term
Boost to net interst margins in the short run
Decline in margins accompanied by flattening of the yield curve
Banks are reluctant to charge negative rates on retail deposits
Empirical evidence
Euro-area banks: 60% of income comes from net interest income, 25% from fees and commissions and 15% from other sources
Between 2014 and 2016, average deposit rates fell by 0.2%, loan rates fell by 0.8% in the euro area
Greater adoption of risk, more credit to SMEs

Source: Based on ECB and bank loan surveys.

The structural factors (demographic change, population ageing) explain some of the mismatches between supply and demand discussed above. The monetary factors and the asymmetries they cause with respect to the banks' activity explain the mismatch identified between the availability of liquidity and the difficulty of lending to the private sector. The technical challenges of operating with negative prices are also relevant in an environment where it is difficult to develop the market. There is also the risk that this situation of low or negative interest rates will be difficult to reverse in the long run with the prevailing monetary and macroeconomic conditions. Finally, the empirical evidence highlights differences in interest rates by product type that were not apparent in the evolution of the margins depicted in Figure 3. In particular, interest rates on deposits have fallen less than have those applied to loans and, in spite of this, there has been little change in the margins attributable to the "quantity" effects (i.e. greater movement on deposits than on credits).

Another pending question as far as financial stability is concerned, and one that poses a challenge for the banking union, is the persistence of problems of transparency with regard to the quality of the banks' balance sheets. Several examples show that market signalling has not been improved in terms of providing greater transparency. In the first place, equal treatment is not always apparent in the supervision of different types of risk. The priority remains credit risk analysis, while other risks –such as market risk, which can be problematic in some countries, receive less attention. And when these risks are analysed, as occurred with the stress tests conducted in 2016, they are done so only tangentially and without offering a sufficiently informative breakdown. Another of the obvious examples (which we return to later in this brief) is the unequal treatment of episodes of banking crisis, as illustrated for example in the Spanish and Italian cases. But from a merely informative perspective, one of the key problems in relation to transparency is the design and execution of the banks' stress tests. The differences between the European and the US cases –summarized in Table 2– are highly illustrative of this.

In the United States, stress tests examine a greater number of macroeconomic scenarios and treat bank holding companies differently, given that they are more vulnerable to global shocks. Likewise, the US tests simulate the potential losses suffered by certain types of asset and the banks' own resources, while specifying minimum capital requirements, something that is no longer done in the European tests. The importance of the tests is more apparent in the United States, where the results of these or similar tests (such as 'living wills' or resolution plans) can lead to sanctions, such as the prohibition to distribute dividends.

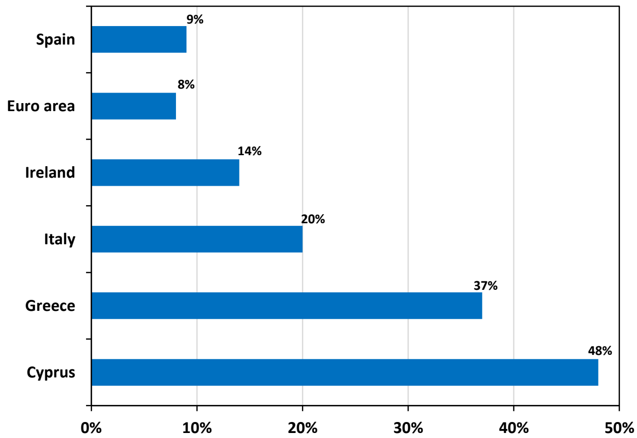
Table 2. Stress tests in Europe and the United States

Europe (EBA)	United States (Federal Reserve)
Scenarios	
Two macroeconomic scenarios: baseline and adverse Incorporation of market risk scenarios Pluriannual approach	Three macroeconomic scenarios: baseline, adverse and severely adverse Two macroeconomic scenarios for bank holding companies (BHCs): baseline and adverse Add-ons for BHCs with significant trading operations: global market shock Add-ons for BHCs with substantial trading operations: global market shock Counterparty credit risk
Models	
EBA develops common methodology covering market risk, counterparty credit risk (CCR) and credit valuation adjustment (CVA) Banks project net interest income Banks themselves estimate the impact of scenarios on risk-weighted assets Balance sheet assets remain unchanged throughout the exercise	Simulations run on credit losses, balance sheet, risk-weighted assets, and capital levels. Credit loss projections do not incorporate bank-specific effects Advanced risk measurement approaches are disallowed (standardized approach used instead).
Requirements	
Capital thresholds not defined Results of the tests used as input for ECB supervision	CET1 4.5% Tier 1: 6% Total risk: 8% Tier 1 leverage ratio: 4% Qualitative assessment of its capital planning

Source: Based on the Clearing House.

The lower degree of monitoring and the lack of transparency of the tests conducted in Europe are also apparent in the fact that the stress tests will not be performed in 2017 and that the next ones are scheduled for 2018. This is difficult to understand, from an information point of view, in what is a sensitive time for leading banking sectors, such as the Italian and Portuguese. In Europe, there are marked inequalities in the credit default rate, which in countries such as Italy or Greece exceeds 20 and 30%, respectively (Figure 4). In the euro area, there are 1 trillion euros worth of impaired assets. Moreover, 60% of this default concerns business loans.

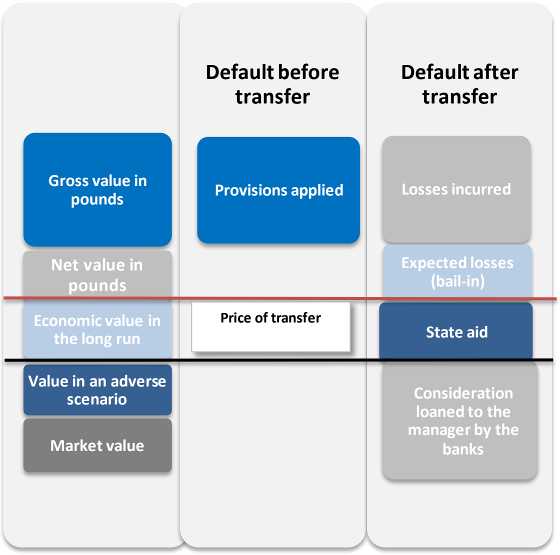
Figure 4. Default rate in the euro area (%)



Source: Based on BCE (2016).

The need for clean transparent balance sheets meant that, at the beginning of 2017, the creation of a European management company for impaired bank assets was considered (see, for example, Constâncio, 2017). Based on the experiences of banking crises in countries such as Ireland and Spain, a certain amount of knowledge has been gained concerning the procedures for transferring impaired assets, as shown in Diagram 2.

Diagram 2. Procedures for transferring impaired assets



Source: Based on the Clearing House.

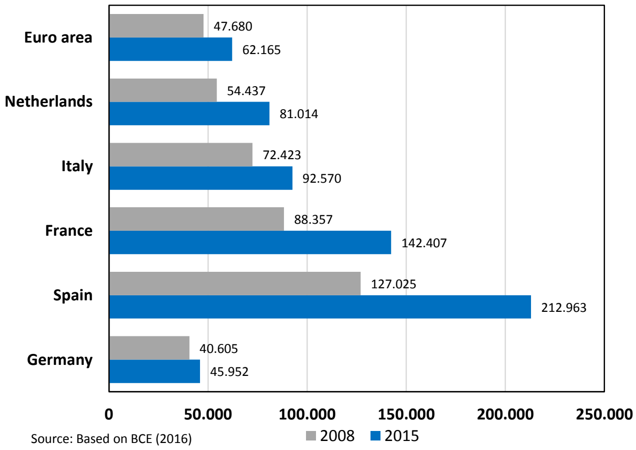
The starting point are the assets' remaining net losses after the application of provisions by the corresponding entity. Of the losses in value incurred, we need to determine which represent capital losses that must be covered by means of bail-in mechanisms. However, perhaps the most delicate process is that of giving a long-term value to the asset (representing a certain recovery of that value), which is essential in determining the extent to which state aid should be provided for its sale and the extent to which this aid is recoverable. In short, determining the price at which the asset should be transferred from the entity to the company or "bad bank". The prudent consideration of adverse scenarios is, as such, a necessary step before determining the asset's final market value.

These asset transfer processes and the proposal to create an asset management company for the euro area are taking place in a context in which governments are under pressure to recover assets and to determine and limit the cost of bank bailouts, which does not make things any easier. It is also worth noting –and it is something that will have to be monitored– that a large market for the securitization of impaired assets has been generated, comprising the principal buyers of this distressed debt, primarily investment funds and hedge funds.

3. Structural changes and the outlook in 2017

The European banking union has been launched in parallel with the restructuring of the banking sector, which has been a long, drawn-out process, adding to the challenges of banking supervision and resolution. It is like having to take a snap shot of a sector and establish the structure for its supervision and resolution while it is undergoing constant change. The changes in the sector are self-evident. In 2008, there were 6,062 credit institutions in the euro area, but by 2015 this number had fallen to 4,769, a cumulative drop of 21%.

Figure 5. New phase in the restructuring of the European banking sector. Population per credit institution



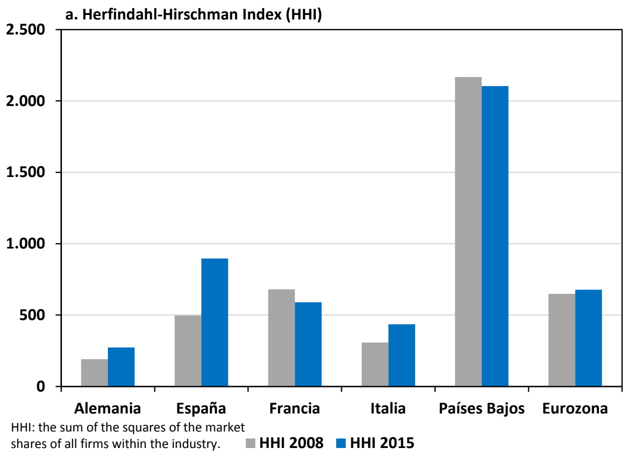
Source: Based on BCE (2016)

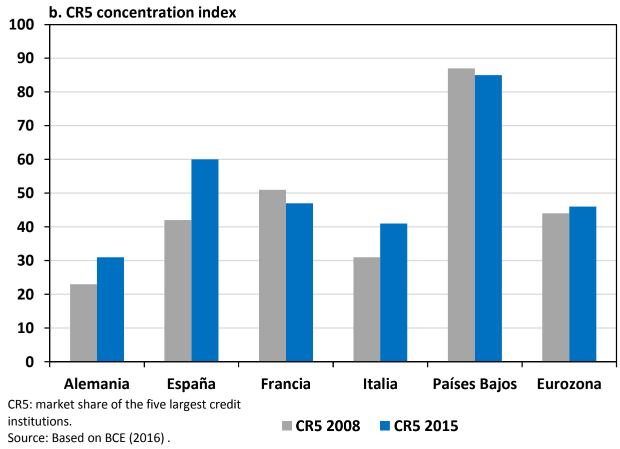
This change is coupled with another in the structure of supply, in which a smaller number of banking institutions serves a larger percentage of the population, as shown in Figure 5. The technology revolution has weakened the relative importance of distance and allows fewer institutions to compete. However, the new non-bank suppliers have emerged as competitors, which represents a further challenge for the regulation and supervision of the sector against the wider backdrop of the banking union. This is analysed in greater detail in section 5.

Whether measured using the Herfindahl-Hirschman Index (HHI) or by the share of total assets held by the five largest credit institutions (CR5), the concentration of the banking sector has increased (Figure 6).

Yet, the difficulty of generating profits and the reduction in margins mean that competition has increased, despite the consolidation of the sector. The widely held (pre-crisis) view that smaller banks could be more efficient and profitable in some cases has even been called into question. The market environment today is very different and the costs of participation in the market and the ability to access it have become key determinants. The European banking sector is characterised by a strong belief in the potential for mergers and acquisitions, but the way in which the problems of asset quality are being resolved, in such countries as Italy and Portugal, suggests that there is still some national resistance to corporate cross-border operations. Transactions of this type are also significantly conditioned by the market environment and the need to increase transparency with respect to the quality of the assets in other European banking sectors, and not only in the Italian case. For the time being, what is notable is that Europe's banks have significantly reduced their cross-border exposures following the crisis. This means less likelihood of contagion, but it also means less integration and a weaker banking union. Or, at least, as the design and implementation of the safety net has advanced, interactions have not only not increased, they have actually fallen in number. Europe has gone backwards in its attempts at creating a pan-European banking market, and events such as Brexit are not going to make things any easier.

Figure 6. Banking concentration in the euro area - HHI (0-10,000) and CR5 (%)





Source: Based on BCE (2016) .

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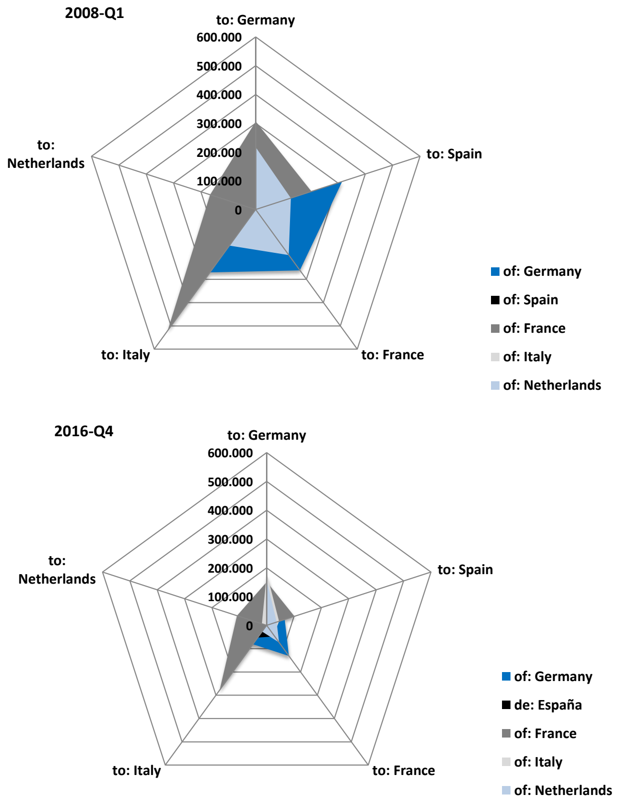
For example, between 2008 and 2016, there has been a marked reduction in the presence of the banks of each of the countries making up the euro area (loans, shareholdings and other rights) in the other countries of the zone (Figure 7). This is a long-term effect of the sovereign debt crisis and bank deleveraging.

Perhaps the clearest evidence of how crises of confidence serve to reduce cross-border activity is provided by Brexit. In the short term, it will be difficult for Brexit not to help improve integration and the banking union. While it is true that the United Kingdom was never integrated into the frameworks that shaped the banking union, there are procedures and coordination mechanisms that now, if not exactly in question, should at least be given some reconsideration. In the medium to long term, we might think that Brexit will have some benefit for the euro area in terms of coordination, as it should allow the development of a more compact continental bloc without the UK. However, there also exist possibilities for regulatory arbitrage with financial institutions attempting to exploit the advantages of each jurisdiction.

Figure 7. Exposures of Europe's banks to other countries of the euro area (loans, shareholdings and other rights in other banks, firms and the public sector)



Source: Based on Bank of International Settlements.

In any case, although exposures to the United Kingdom have been reduced following the Brexit referendum, there had already been a significant reduction after the crisis (Table 3). It is striking, moreover, that Spain is the only country of the large Member States considered whose banks increased their exposures to the United Kingdom in the years before the referendum –at 23.858 billion dollars– but reduced them in the six months following the Brexit vote by 22.047 billion dollars.

Table 3. Exposures of Europe's banks to the United Kingdom, millions of dollars (loans, shareholdings and other rights in other banks, firms and the public sector)

	2008/Q1	2015/Q2	2016/Q2	2016/Q4	Change 2008/Q1-2016/Q4	Change post-*brexit*
Germany	886.240	414.255	406.223	315.337	-570.903	-90.886
Spain	331.384	355.318	377.289	355.242	23.858	-22.047
France	483.751	221.239	215.184	189.800	-293.951	-25.384
Italy	-	46.679	43.663	38.120	-	-5.543
Netherlands	341.864	105.748	83.241	70.912	-270.952	-12.329

Source: based on BIS.

4. Bail-in vs. bail-out: "perverse" private and "imperceptible" public solutions

The Single Resolution Mechanism (SRM) came into effect in January 2016. The architects of the European banking safety net were probably aware that the mechanism would need a certain amount of breaking-in, but the Italian banking crisis has been, and will undoubtedly continue to be, a good test bed for the SRM. Indeed, an overall evaluation of the actions of resolution and supervision in relation to the problems of the trans-Alpine bank points to the conclusion that the SRM has not been applied as was originally planned, which poses three types of problem for the European banking sector:

- It calls into question the strength of the SRM and the ability to enforce it, although there will undoubtedly be a regulatory space in which to reinforce it in the future.
- It gives rise to comparative grievances due to the bail-in and bail-out processes employed before the SRM came into force.
- It represents a source of uncertainty that might have a contagious effect on the European banking sector as a whole.

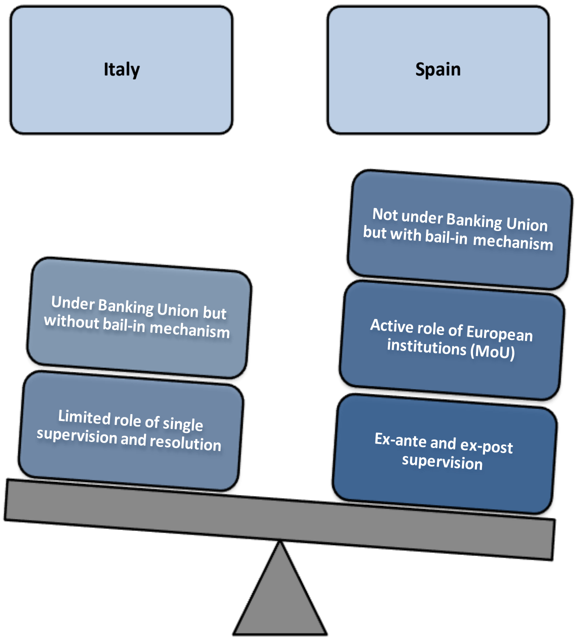
The Italian authorities have been at pains to point out that the bail-out implemented in its banking sector to date complies with European regulations. In reality, it is a final bail-out disguised as a partial and temporary bail-in, as can be concluded from the following sequence of events: first, Monte dei Paschi di Siena (MPS), the bank identified as having the severest problems, launched a private-sector restructuring scheme. However, on December 22, MPS's attempts at increasing its share capital by 5 billion euros failed, forcing the Italian government to sign a bail-out decree the following day for the whole sector that included other banks in need of recapitalisation. The decree provided the State with a 20-billion euro rescue fund to guarantee the liquidity of the troubled banks and to strengthen their equity position. The ECB suggested that this recapitalization was possible, but that it would require 8.8 billion euros alone to meet the capital needs of Monte dei Paschi. The new shareholder structure of MPS will be made up of the State, with a 70% capital holding, and institutional investors, with a further 2 billion euros. Meanwhile, MPS has undertaken to initiate a restructuring plan that will see the laying-off of 2,450 workers over the next three years and the closure of around 500 branches. Where most doubts remain is in the handling of the bank's bondholders, in particular the 40,000 holders of MPS's junior bonds who, in the end, will not have to suffer any losses, in direct contravention of SRM regulations. The Italian State proposes converting these bonds into shares (an apparent bail-in) which can then be sold back to the State in return for new, safer bonds not subject to any penalties, which, to all intents and purposes, constitutes a bailout using the taxpayers' money.

In short, the first part of the rescue –purchase of part of the bank's capital by the Italian State– was conducted in accordance with Article 32 of the Recovery and Resolution Directive, but this directive requires that, for this to be possible, subordinated bonds and low-quality debt be converted into shares. It is here that the Italian rescue plan clearly contravenes community regulations and it does so by engineering a financial operation that ends in a bail-out. In strictly financial terms, it is equivalent to the State buying the debt directly from the bondholders.

The broader problem is that these actions could subsequently be extended to other Italian banks that find themselves in difficulties. Indeed, 35% of the credit portfolio of the trans-Alpine banking sector can be classed as bad loans. The way in which the rescue plan has been put together has been criticized by the German government and by other European authorities. What is called for is an unambiguous application of the Recovery and Resolution Directive and, if deemed pertinent, a recovery of the losses suffered by bondholders through the courts, provided they can demonstrate that they were 'mis-sold' the bonds in the first place.

This was the procedure adopted in Spain in 2012, at a time, moreover, when the SRM had yet to come into force, but the Memorandum of Understanding (MoU) regarding financial assistance required the activation of an impromptu bail-in mechanism, as described in Diagram 3. Similar measures were adopted in other countries, including Cyprus and Greece. Interestingly, Spain's bail-in experience had a considerable influence on the design of the SRM. Indeed, part of the Spanish experience was in fact based on the draft which, at that time, was being drawn up for the SRM.

Diagram 3. The Spanish bail-in vs. the Italian bail-out



Source: Compiled by author.

Arguably, part of the problem in applying the resolution mechanisms in Italy has more to do with the single supervisory mechanism than with that of the single resolution. Thus, it would seem that there is a margin for political negotiation in determining whether a banking entity can continue as a going concern or whether it is close to bankruptcy or is already in default. The case illustrated by MPS clearly falls into this second category and the failure on the part of the single supervisor to act led to the flawed application of the resolution and to potential problems for the future.

5. The challenge posed by non-bank providers under the banking union

As if the difficulties of the macroeconomic environment (that is, those that threaten the financial stability and the deficiencies manifest in the application of existing rules) were not enough, the banking union faces an additional challenge in having to regulate the new non-bank providers, operating in the so-called financial-technology –'fintech'– environment. Most of these competitors offer payment services, which is why the European regulation which, for the time being, has paid them most attention is Directive (EU) 2015/2366, of the European Parliament and of the Council, of November 25 2015, on payment services in the internal market, better known as the second payment services directive, PSD2. This regulation represents an attempt at ensuring that the services rendered by these providers do not threaten Europe's financial stability, and to achieve this, among other things, that a level playing field exists between bank and non-bank providers.

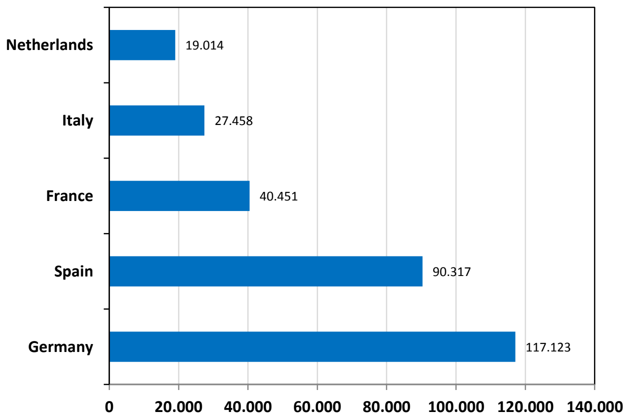
In general, the application of PSD2 has given rise to both positive and not so positive reactions. Among the former, it is worth highlighting the efforts being made to understand just where the new providers of financial services stand under the regulatory umbrella, while offering a sufficient degree of flexibility to ensure that most of their financial innovations do not escape legal control. Among the negative conclusions to have been expressed is that a certain preference has been detected to regulate entities rather than functions. The consequence of the approach adopted is that banks continue to be under an overwhelmingly greater regulatory pressure than are the non-bank providers, and that this level playing field has yet to be achieved.

The regulations contained in PSD2 include strict security requirements for initiating and processing payments and for protecting consumer data. PSD2 also contemplates the opening up of the EU market for companies that offer consumer-oriented payment services or services to firms that require access to the bank accounts of these customers. This means, the banks will have to become necessary collaborators in the development of third-party activities.

However, in the classification of payment service providers what is missing is an explicit consideration of regulatory requirements similar to those that the banks have under the banking union, governing such areas as solvency, liquidity, leverage and resolution. Only the so-called "electronic money entities" need to comply with prudential regulatory requirements (previously provided for under Directive 2009/110); yet, these are much less restrictive than those of the banks. PSD2 introduces approval and prudential requirements for the so-called "payment institutions", but again these are much more limited than those of the banks. In fact, a bank may be an electronic money entity or a payment institution, but it is governed by much broader regulations. The main difficulty lies in delimiting the extent to which the non-bank providers will end up assuming (albeit indirectly, by using their clients' banking services) control over sizable volumes of deposits or credit facilities without being subject to the solvency and deposit requirements necessary to avoid problems of financial stability.

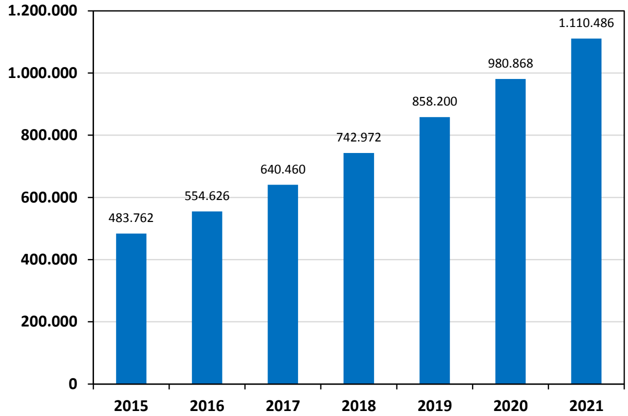
Yet, there remain major differences between fintech firms and banks in terms of their penetration and the strategies they adopt. In fact, the fintech environment is more transversal in nature impacting the banks with its development of digital channels and services, as they compete or collaborate directly with non-bank operators. And there is a large number of areas in which the banks will be able to improve their technological capabilities significantly, including distributed ledger technologies (DLT), where the transmission of data is conducted via blockchains, and in many aspects of the interaction between the banks themselves, and in custody of securities as well as in clearing and settlement services.

Figure 8. Fintech penetration in Europe in 2016
Value of transactions made via fintech channels (payments, business finance and personal finance). Millions of dollars



Source: Based on Statista.

Figure 9. Fintech growth forecasts in Europe
Value of transactions made via fintech channels (payments, business finance and personal finance). European Union. Millions of dollars



Source: Based on Statista.

In the countries of the euro area, Statista's calculations indicate that fintech penetration remains limited. The value of transactions (payments, business and personal finances) carried out via fintech channels in 2016 only exceeded 100 billion dollars in Germany (Figure 8). In Spain, the volume was 90.317 billion dollars, which was well above the figures recorded in France, Italy and the Netherlands.

Yet, the potential for growth is enormous. Forecasts (Figure 9) suggest that fintech could exceed a trillion dollars in the EU in 2021.

As pointed out earlier, it will be the banks that end up taking advantage of most of these advances in financial intermediation linked to digitization, although undeniably there will be greater competition in the field of payment services. Whatever the future, under the banking union, further steps need to be taken towards achieving a level regulatory playing field. If the national authorities retain control of fintech regulation –despite adopting common norms, such as those of PSD2– this playing field and balanced regulatory treatment will be difficult to guarantee in the framework of the European banking union.

6. Final thoughts

This brief has analysed the problems and future prospects of the European banking union following the implementation of the resolution mechanisms in January 2016. Problems of execution and coordination –and the inopportune but inevitable events of the Italian banking crisis– have called into question the actual operation of this union. Yet, the speed with which the Single Resolution Board resolved the Banco Popular crisis shows that it can work. It also shows that Spain cannot be accused of flinching when implementing its bail-in mechanisms (with investors having to suffer the losses rather than deposit holders and taxpayers). These mechanisms were imposed as part of the 2012 financial assistance program –at a time when they were not yet part of European regulations– and they have been reapplied now within the framework of the new single bank resolution.

The European authorities themselves have detected various gaps and weaknesses in the Recovery and Resolution Directive and have undertaken various reforms, above all with the aim of eliminating its rigidities that impede both credit flows and adequate risk assessment based on the type and size of borrower. Problems in the practical application of the single supervision and resolution are also evident, as highlighted by the decisions adopted by Italy as it addressed its banking crisis, in what constitutes a clear example of non-compliance. Under the guise of a complex financial operation, an apparent bail-in has been converted into an eventual bail-out, and it will be the Italian taxpayer who ultimately assumes the costs of the rescue plan. At least as things currently stand.

Neither has the launching of the banking union been helped by the current complexity of the monetary and financial environment and the upheavals to which it has been exposed. The markets have failed to be convinced by the lack of transparency in the banks' balance sheets, and the structure of the union remains incapable of offering convincing responses in the short- and medium-term to improve their image and provide stability.

Nor is it simple to launch a banking union when one of the key elements in its safety net, the common deposit protection scheme, remains largely undeveloped.

Finally, an added obstacle to the structural changes of the sector is the presence of fewer banking operators and an increased number of competitors in the fintech environment. This represents a threat to Europe's financial stability, especially given the absence of a level regulatory playing field for the banks and the new operators. The second European payment services directive (PSD2) has ushered in some advances in this area, but much remains to be done to achieve a level playing field and to prevent systemic problems.

In short, the banking union remains one of the most important and complex ventures in the euro project, and one that will largely determine the future of the single currency. However, its task is far from easy. Indeed, the union will have to be adaptable to the circumstances that arise and inventive in proposing solutions for the multiple fronts on which it will have to operate. After all, against the economic backdrop of the twenty-first century, the union should not lose sight of the fact that absolute realities cannot always be managed, rather that it must strive to adapt to the dynamics of change and the unexpected in the most efficient and socially responsible way possible.

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