8 Banking Union and the ECB

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Since the creation of the euro area, price stability has been the primary objective of the European System of Central Banks (ESCB),[1] with the Eurosystem and the ECB, as its core institutions, being responsible for the implementation of monetary policy.[2] However, the recent financial and euro crises have highlighted a secondary mandate of the ESCB as one of the EU priorities, namely, the prudential supervision of credit institutions and the stability of the financial system.[3] Accordingly, a new legislative wave has endowed the ECB with additional powers regarding banking supervision.[4] In addition, decisive steps have been taken in developing a new set of institutions, embedded in the European Banking Union, to contribute to the fulfilment of this second mandate.

The relationship between the banking Union and the ECB is a key link in the Financial and Monetary Framework of the Economic and Monetary Union (EMU). In this chapter, I briefly review some of the research being done under the ADEMU project related to: i) the weaknesses of the current Banking Union-ECB design and its implementation; ii) the new roles of the ECB, and iii) the possible conflicts between the ECB-Banking Union and the national central banks (NCBs) or the corresponding national competent authorities (NCAs).

1 See Article 127(1) of the Treaty on the Functioning of the European Union (TFEU) (2016/C 202/01) and Article 2 of the Statute of the ESCB and the European Central Bank (ECB) (2012/C 326/230).

2 See Petit (2017) for a discussion of the mandates of the ECB as well as other major central banks.

3 See Article 127(5) of the TFEU.

4 See Article 1 of the Single Supervisory Mechanism Regulation (2013/L 287/63).

On the Banking Union-ECB design

The financial and euro crises made clear the close linkages between the banking sectors of the euro area member states and the high potential for contagion these linkages could create. These crises also highlighted the problems in the institutional design of the euro area associated with the tension between two opposite ideas. On the one hand, a currency area where a single monetary policy is combined with provisions for supervision and resolution of its banking sector managed at the country level could be ill designed. On the other hand, the integration of backstops and safety guards for the banking sector across the euro area could generate the wrong incentives and exacerbate free riding at the member state level.

The creation of the **European Banking Union** (EBU) is supposed to provide the optimal solution to this tension between risk sharing and moral hazard within the EMU. To achieve that goal, the EBU is designed around three pillars.

The Single Resolution Mechanism

First, there is the **Single Resolution Mechanism** (SRM), which centralises the European response to banks facing difficulties. The SRM will make use of the Single Resolution Fund (SRF) financed through contributions by the banking sector. The spirit of the SRM is that, unless there are severe systemic disruptions to the banking system, bank resolutions will make use of this fund and, therefore, there will be no need for bailouts in which public funds are needed. However, Yiatrou (2016) provides a closer look at the design for the use and targets of the fund in these resolutions. She argues that the existing provisions might not deliver adequate funding for every given bank resolution. This state of affairs implies that **the mechanism does not necessarily eliminate implicit government guarantees, which may have important consequences. First, it does not fully eliminate the connection between sovereigns and the banking sector. Second, it could fail to discipline banks' risk-taking incentives**. At the same time, Yiatrou recognises that implementing a fully credible regime would demand the channeling of a massive amount of funds which could significantly harm the profitability of banks. She concludes that the current setup seems to achieve a balance between its effects on risk-taking and the financial costs it imposes to banks.

The Single Supervisory Mechanism

The second pillar is the **Single Supervisory Mechanism** (SSM). This mechanism, granted to the ECB, has the role of monitoring the financial stability of banks. However, Monti and Petit (2016) question the legal basis of this mechanism. At a general level, these authors warn that existing Treaties do not include suitable provisions to empower the EU legislator with the capacity to create the elements of the EBU. Regarding the SSM in particular, the authors detect significant margins of discretion in the interpretation and implementation of supervisory standards both between the ECB and NCAs, and between the NCAs themselves.[5] Other aspects that need a reformulation involve possible overlaps between the regulatory powers of the ECB and the European Banking Authority (EBA) as well as possible asymmetries between euro area and non-euro area participants in the EBU.

Amtenbrink and Markakis~~t~~ (2017) also highlight deficiencies in the design of the SSM. In particular, they point out the lack of clear criteria against which to assess the ECB's performance in the area of banking supervision, as well as a gap in terms of the ability of the European Parliament to assign consequences to the ECB's conduct.

The European Deposit Insurance Scheme

The third pillar is the **European Deposit Insurance Scheme** (EDIS), which is at a standstill – possibly due to fears of it becoming an across-countries transfer system and/or exacerbating the inherent moral hazard problems. However, with the advent of the financial crisis, narrow banking has been proposed as another option to guarantee the value of deposits. This alternative has been heavily criticised as imposing unbearable costs on the banking industry. In Rodríguez Mendizábal (2016), I show how **a 100% reserve requirement could be implemented in our current monetary system.** At a general level, a necessary condition for this implementation not to impose a tax on banks has to do with the remuneration of required reserves at the same rate as the refinancing

5 For example, the *Five Presidents' Report* (Juncker et al. 2015) already recognised the need "to address the significant margin for discretion at the national level" regarding "the quality and composition of banks' capital" and calls for the necessary legal amendments.

operations of the central bank, a policy already followed by the Eurosystem. A second, and more stringent necessary condition is the disposal by banks of enough eligible collateral to pledge on these refinancing operations. Should this collateral constraint be overcome, the implementation of 100% reserve requirement would question the need to design a deposit guarantee scheme at the Banking Union level to prevent self-fulfilling bank runs.

On the new roles of the ECB

Within the Banking Union, **the ECB plays three roles.** The first one, already mentioned, is **as guarantor of the SSM.** Regarding this bank supervision role, Jungherr (2016) analyses the extent to which central banks should require commercial banks to reveal information to the public about their risk exposure. In this sense, starting in 2014, one of the key steps in the creation of the Banking Union was the ECB's *Asset Quality Review*, which published an assessment of capital shortfalls for the 130 most significant euro area banks.[6]

The author seeks to identify the relevant trade-offs in the optimal choice of transparency and to provide arguments for its regulation. On the one hand, transparency is beneficial as it generates market discipline and allows banks to commit to a prudent portfolio choice, which takes into account the potential costs of instability. On the other hand, transparency increases the risk of being exposed as a weak bank in the midst of a sudden downturn. Opacity provides some insurance against this risk. In Jungherr's model, mandatory public disclosure is socially beneficial in the presence of information spillovers between competing banks. Interestingly though, full disclosure maximises neither economic efficiency nor financial stability. Some degree of bank opacity is socially desirable.

6 Results of the *Asset Quality Review* since 2014 and of other supervisory measures can be found at https://www.bankingsupervision.europa.eu/banking/tasks/comprehensive_assessment/html/index.en.html

The second function of the ECB involves **being the authority responsible for monetary stability** – in particular as liquidity provider for the euro area, a role that, as Adao and Silva (2016) have shown, has been strengthened since the euro crisis with the observed increase in firms' cash holdings.[7]

The third role is **as the authority responsible for financial stability**, a mandate which, as mentioned above, has become very relevant, if not predominant, since the financial and euro crises. Following the steps of the Federal Reserve Board and the Bank of England, the ECB has actively pursued quantitative easing (QE) policies. However, it has not employed any credit easing policy such as the Term Asset-Backed Securities Loan Facility (TALF) implemented in 2009 by the Fed, which was a successful response to the freeze of the AAA-ABS market, and responsible for channelling a significant amount of funds for loans to households and small businesses. In fact, with TALF the Fed took a risk which needed to be backed up by the US Treasury, something unfeasible in the euro area.

Gaballo and Marimon (2016) interpret the AAA-ABS freeze as a high-interest, high-risk self-confirming equilibrium and show that a **credit-easing policy that includes a subsidy contingent on** lenders' losses – such **as** TALF – is **an optimal policy** that dissipates (pessimistic) misbeliefs, even when the central bank has the same misbeliefs as private creditors. An interesting feature of such a policy is that it will reveal and implement a low-interest, low-risk rational expectation equilibrium at no cost for the fiscal authority since, in such a case, lenders would not realise losses and no subsidy will actually be given. Of course, if such a low-interest, low-risk equilibrium does not exist, then the policy will bear a cost. But this cost, the authors argue, will be finite, making the social expected value of such experimental policy likely to be positive.

7 See Thiele (2017) for an analysis of the degree of independence of the ECB within its role in implementing monetary policy in the euro area.

On the possibility of conflict with national authorities

The variety of roles played by the ECB within and outside the Banking Union multiplies the possibilities for conflict with its national counterparts, either with NCAs within the SSM or with national central banks within the Eurosystem. Smits (2017) reviews some of these possibilities. An important difference between the two main tasks assigned to the ECB – namely, monetary policy and prudential supervision – is the different degree of reviewability and scope for juridification. Whereas the legal acts produced by the ECB when conducting prudential supervision can potentially be challenged in court, this does not seem to be the case with respect to monetary policy decisions (with some exceptions).

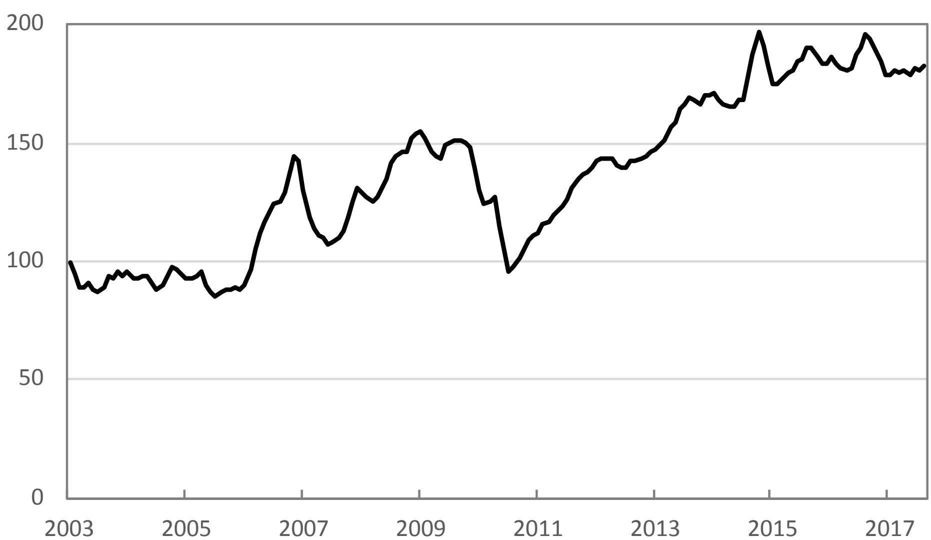
Regarding the sphere of monetary policy, the EMU design of decentralised implementation of centralised decision making may make the system prone to conflict between the ECB and the national central banks. Two such cases are gold and foreign reserves together with the Emergency Liquidity Assistance (ELA). First, while both the Treaty on the Functioning of the European Union (TFEU) and the Statute of the ESCB and ECB make clear that gold and foreign reserves are held and managed by the Eurosystem, statements by NCBs and further agreements within the union seem to suggest that they remain a national competence. Second, the decentralisation of the ELA in favour of the NBCs seems in contradiction with the competences assigned exclusively to the ECB by European law.

Finally, another area of divergence between the ECB and its national counterparts rests on the diverse regimes of supervisory liability. While many national competent authorities explicitly limit supervisory liability to cases of intent or gross negligence, the ECB exhibits full liability pursuant to Article 340 of the TFEU, and therefore contradicts these national regimes. Thus, a clarification and precision of the liability regime of the ECB within the SSM seems of utmost importance to diminish the scope for future conflict.

Conclusions

Arguably, the most obvious risk associated with possible deficiencies in the design of the European Banking Union is the resurgence of a national bias and the fragmentation of financial markets across the EU. In fact, as reminded by Danièle Nouy, the current Chair of the Supervisory Board of the Single Supervisory Mechanism, the recent financial crisis has plainly shown how fragile the apparent financial integration of the euro area was (Nouy 2015). As an example, Figure 1 presents a measure of financial fragmentation in the loan market in the euro area. It shows the dispersion in loan rates applied by credit institutions (also known as monetary financial institutions, or MFIs) to consumers across different countries in the euro area. We can see i) how this dispersion was present even before the financial crisis; ii) how it further increased with the beginning of the financial tensions in 2007; and, above all, iii) how it still remains at relatively high values more than ten years after the disruption in financial markets started. Similar conclusions can be drawn from certain measures of financial fragmentation also in money and bond markets (ECB 2017).

Figure 1 Cross-country standard deviation of MFI interest rates on consumer credit (loans between one and five years)



This apparent high elasticity for fragmentation of the financial landscape of the euro area presents a serious challenge in the design of the Banking Union as the result of the tension mentioned at the beginning of this chapter. The ADEMU research summarised here reviews several areas where progress could be made. In particular:

- care should be taken in designing institutions (i.e. the SRM and SSM) to provide the right incentives both to market participants and states avoiding possible conflicts with national counterparts; and
- possible new measures (i.e. narrow banking and credit easing policies) could contribute to alleviate financial tensions at zero or bearable costs.

The aim would be to improve risk sharing and to ensure a level playing field for all actors involved without promoting free-riding or strengthening the banking-sovereign nexus.

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Professor Rodríguez's main research area is monetary economics. In particular he has worked on the monetary transmission mechanism from two perspectives. On the one hand part of his work deals with understanding how changes in the interest rate affect economic activity. On the other hand he has also analyzed how the way monetary policy is implemented by central banks may influence the behavior of short term interest rates. Another research area is international economics. He has worked on the analysis of exchange rate target zones and on evaluating the gains from monetary unions.