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The Banking Union, under way and here to stay

A report by the PwC and IE Business School Centre for the Financial Sector.

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Introduction

The European Union's progress towards integration has always been marked by firm steps and inconsistent political impulses, guided to a large extent by developments in the international economic environment. The implementation of the Economic and Monetary Union (EMU) and the creation of the euro constitute a key – and fortunately irreversible – advancement, as the European Central Bank reiterated at the height of the sovereign debt crisis in 2012. But the recent financial and fiscal crisis has revealed serious weaknesses in the European financial system's architecture. Financial fragmentation has been proved to play a crucial role in the vicious cycle that connects banking systems with sovereign debt. At times of economic difficulty, their mutual effect is compounded, potentially leading to acutely critical situations, as was the case in mid 2012.

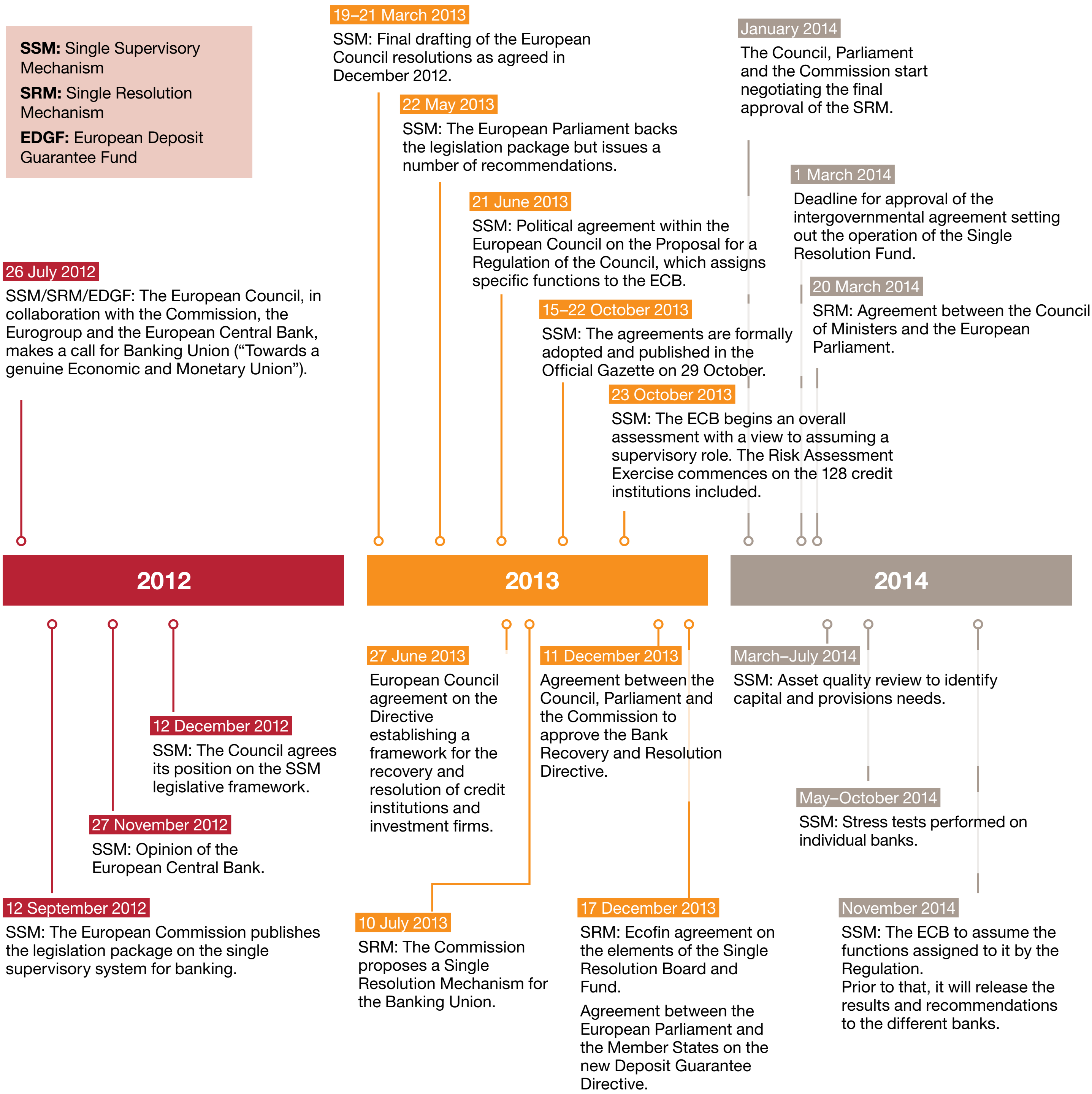
European leaders had already warned at the turn of the century that adoption of the euro did not mean the end of the the EMU process. Yet no further progress would be made in the area of monetary until the following crisis, as the then president of the European Commission rightly predicted in 2001, when the single currency came into being: "I am certain that the euro will require the introduction of new economic policy instruments. Today it is politically impossible to propose such instruments. But some day there will be a crisis and then they will be created." Arguably, the turning point came with the European Council of 29 June 2012, which gave political approval to the establishment of a Banking Union and instructed the European Commission to submit a concrete proposal (Chart 1).

Since then, spectacular progress has been achieved in a little more than a year and a half. Today there is considerable consensus on the components that should constitute the banking union: a Single Supervisory Mechanism (SSM) for the entire euro area; a Single Resolution Mechanism (SRM), with a single European authority able to take over a bank's management, restructure it and even wind up its operations if necessary, and a Single Resolution Fund; a Safety Net for bank deposits that does not distort competition but prevents fragmentation, and a Single Rulebook to serve as the legal basis or framework for the entire process.

Not all of these components have reached the same degree of development, though. The supervisory system, which is due to enter into effect in November 2014, is almost completed, and the institutions involved are working round the clock on the necessary preparations. The resolution mechanism, which will start operating in 2015, is backed by an initial agreement that was confirmed in early 2014.

The Safety Net is the slowest in the group, with no expectation of any progress being made in the short term towards establishing a common deposit guarantee fund. Significant progress has been achieved, nonetheless, in harmonising the existing individual deposit guarantee funds. The Single Rulebook is largely laid out, although certain important aspects also remain to be resolved.

Chart 1. **Banking Union key milestones.**



Source: Prepared in-house.

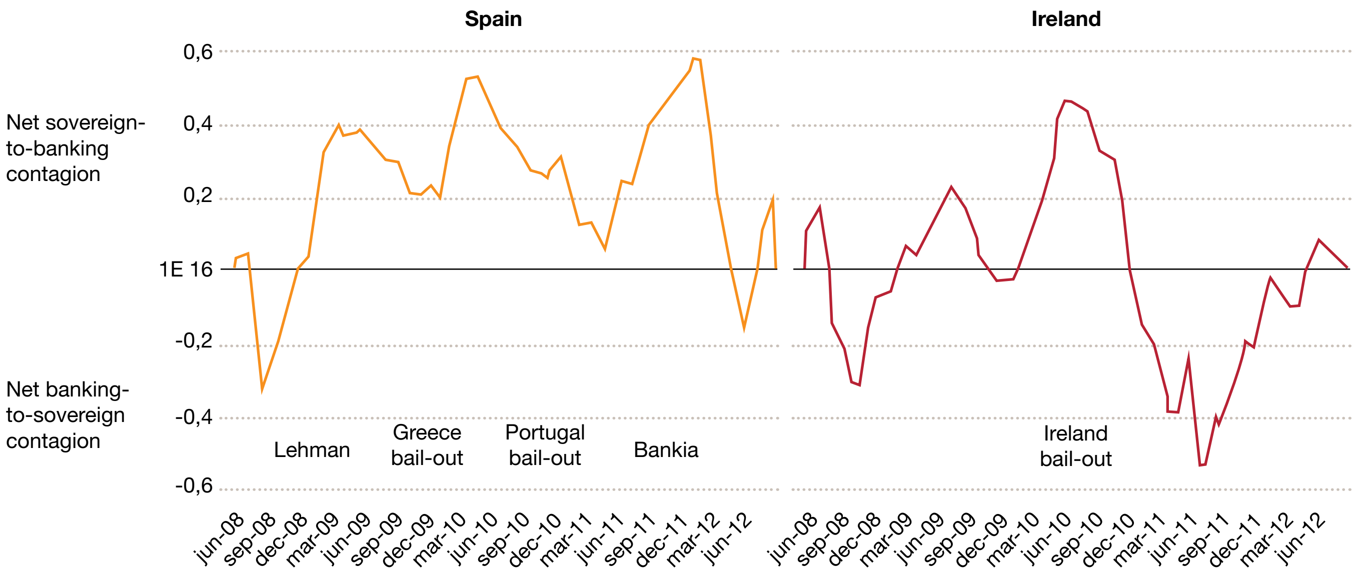
Before we go into an in-depth analysis of each of these components and their implications for financial institutions, we will give a brief account of the reasons that justify the establishment of a Banking Union.

The crisis has revealed that the architecture of the European financial system, built on national supervisors and national resolution mechanisms, is unable to guarantee financial stability in an area that uses a single currency. The connection between sovereign risk and banking risk has demonstrated its clearly procyclical nature, causing situations in which damage to the financial system has far exceeded a country's fiscal capacity (the case of Ireland), or where imbalance in public finances and its attending increase in sovereign spread have contributed to a rise in borrowing costs and even prevented the soundest banks from having access to the markets. All this has had a negative effect on European economies' potential for growth and job creation, including Spain.

Home bias – the tendency for a country's savings to finance investment preferably in that same country – is one of the most markedly direct consequences of financial fragmentation. Affecting interbank lending and public debt alike, home bias is exacerbated during a crisis and therefore accelerates its effects.

All the above have also contributed to the malfunctioning of the European monetary policy transmission mechanism during the crisis. Since late 2010, interest rates on lending to families and businesses have dropped in some large European economies, but risen in peripheral countries (Greece, Portugal, Ireland, Italy and Spain).

Chart 2. **Mutual contagion between sovereign risk and banking risk.**

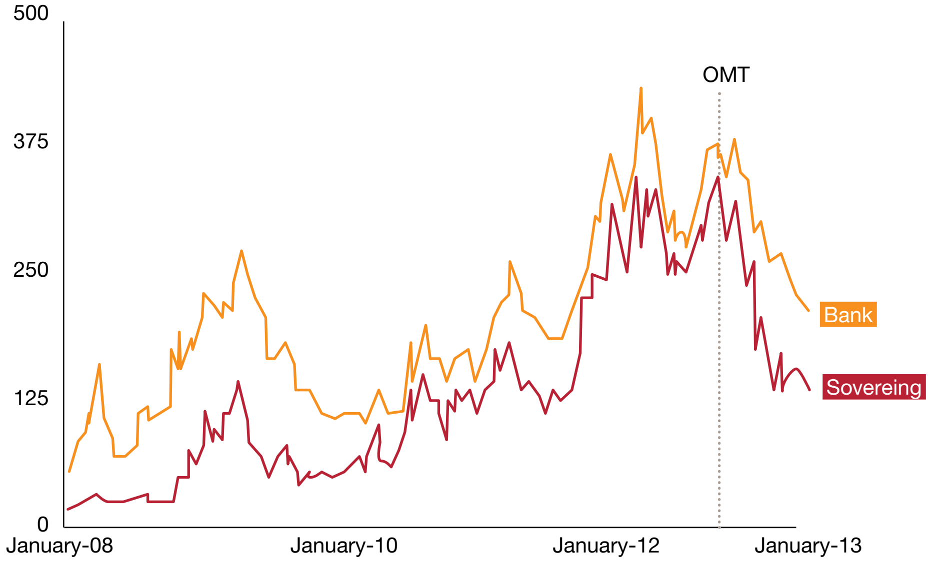


Note on methodology: This indicator represents the difference between the net variation percentage for an equal-weighted index of leading banks' CDS prices (which is not due to the CDSs' historical record but to contemporary shocks on sovereign credit risks) and the opposite net variation, i.e. the variation that reflects the impact of shocks affecting financial risk levels on sovereign risk. The indicator is positive when the shocks' impact on sovereign credit risk levels in relation to financial risk is higher than the opposite effect. The value of this indicator on any given day is estimated based on the information available for the preceding sixty days. The series is also modulated using a sixty-day moving average.
Source: O. Arce & S. Mayordomo, 2012, "Credit risk contagion between sectors", work document.

A further issue worth noting is fragmentation generated by the reaction to the crisis, which has added its effects to the existing financial fragmentation. In the absence of a single resolution authority, the authorities of the Member States have reacted on the basis of national mandates that pursue the interests of their respective States and do not necessarily contribute to the financial stability of the whole. National supervisors have set limits on the loan-to-deposits ratios of their banks' branches and subsidiaries in other countries. Regulations have been introduced restricting foreign banks' freedom of action in a given market. New constraints have been put in place on subsidiary-to-parent cash flows.

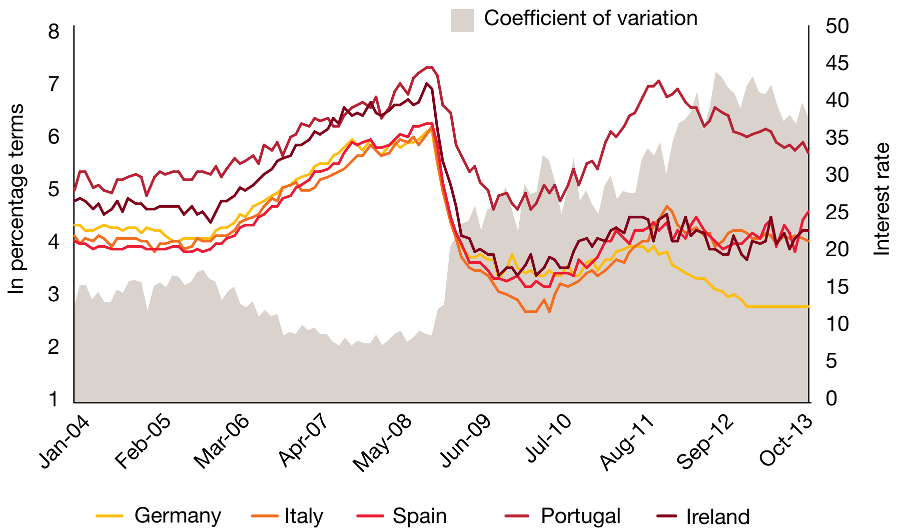
Since the onset of the crisis, the EU has instituted measures that were clearly designed to break the link between sovereign risk and banking risk and to

Chart 3. **Changes in sovereign debt and bank funding 2008–2013 (CDS, basis points as a percentage of debt).**



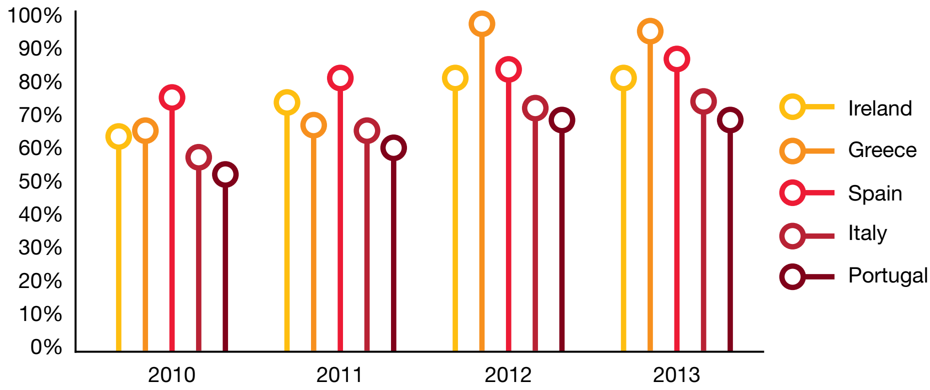
Source: International Monetary Fund. A Banking Union for the Euro Area 2013.

Chart 4. **Interest rates in loans to businesses in Germany, Italy, Spain, Portugal and Ireland.**



Source: Funcas. Papeles de la Economía Española. Construir una Unión Bancaria. November 2013

Chart 5. **Sovereign debt of Ireland, Greece, Spain, Italy and Portugal held by national banks, in percentage terms.**



Source: European Banking Authority (EBA). Report on 2013 EU-wide Transparency exercise.

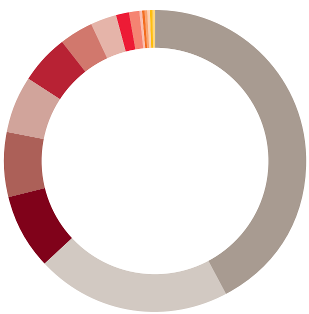
ensure the proper operation of monetary policy. In particular, it is worth noting the ECB's long-term refinancing operations (LTROs), implemented in late 2011 and early 2012 to provide unlimited finance to the European banking system, and its Outright Monetary Transactions (OMTs).

Although OMTs have so far not been resorted to, the mere announcement of the scheme has already produced the effects sought.

The EU's institutional fabric has also seen measures designed to improve the European framework for

Chart 6. **State capital aid to banks in the EU-27.**

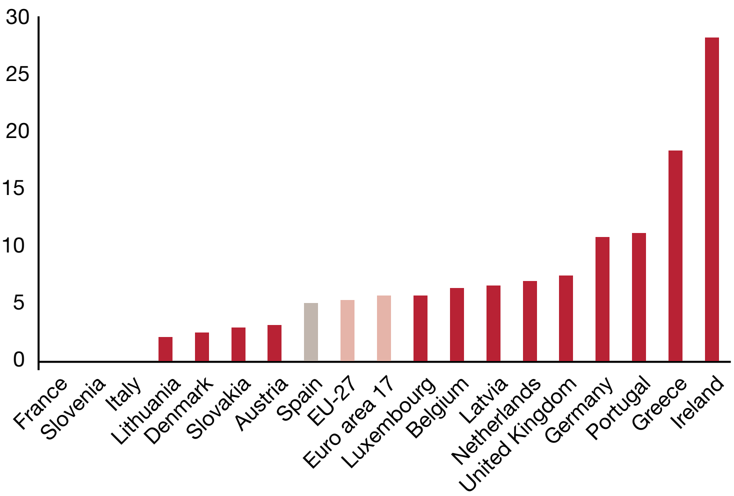
Distribution by country (in percentage terms)



In EUR billions

Germany	285,46
United Kingdom	140,11
Spain	54,17
Ireland	46,41
Netherlands	41,44
Greece	35,71
Belgium	24,03
Portugal	18,39
Austria	9,83
Denmark	6,38
Italy	2,60
Luxembourg	2,50
France	2,20
Latvia	1,46
Slovenia	1,04
Lithuania	0,69
Sweden	0,65
EU 27	**672,89**

As a percentage of GDP



Source: Aid provided to the Spanish financial sector in the context of the European Union. Joaquín Maudes. Funcas Spanish Economic and Financial Outlook. October 2013.

macroprudential supervision, including the creation of the European Systemic Risk Board (ESRB), the European System of Financial Supervisors (ESFS) and the European Supervision Authorities (ESAs), whose area of responsibility extends to banking, insurance and securities.

However, these are merely stopgap measures. The Banking Union must tackle the root of the problem by implementing the necessary institutional and operational reforms to enable European integration to be completed.

Significant headway has been made in establishing a Banking Union to round off and put real sense into the monetary union, but several challenges still lie ahead. Firstly, uneven progress in the development of the different components that make up the process poses the risk of an unfinished Banking Union, unable to defeat the prevailing fragmentation. Secondly, one consequence of the Banking Union will be speedier consolidation of the banking sector, so particular attention will need to be paid to the increase in systemic risk this may entail. Thirdly, there is considerable uncertainty surrounding how supervision will be coordinated and what resolution mechanisms will apply to financial institutions not directly supervised by the ECB. These include banks from non-euro area Member States that have not sought to take part in the Banking Union, but also small banks falling under the jurisdiction of national supervisory authorities on account of their size.

As the Banking Union is irreversibly set in motion, the role of the European Banking Authority becomes clearer. It is also becoming apparent that other ESAs (insurance and, above all, markets and securities) should likewise play a key part in the new financial map of Europe.

Lastly, it is worth raising the question of whether this is the end of the road that leads to European integration, and when will the time be right for further advances towards political and fiscal union. The “Four Presidents’ Report” (signed in 2012 by Herman Van Rompuy, president of the European Council, in collaboration with Jose Manuel Durao Barroso, president of the European Commission, Jean Claude Juncker, president of the Eurogroup, and Mario Draghi, president of the European Central Bank) states that the Banking Union is part of a far more ambitious project that proposes new measures for budgetary harmonisation and common decision-making.

Executive summary

"It is better to take small steps in the right direction than to take a great step in the wrong direction" (Chinese proverb)

"Once we accept our limits, we go beyond them" (Albert Einstein)

The Banking Union is under way. The project, which has been referred to as the EU's most ambitious initiative since the euro was introduced, enters into operation this year. Its prime purpose is to remedy the problems detected in the European banking system during the financial crisis (e.g. market fragmentation, distortion of lending circuits, impaired monetary policy transmission, uncoordinated responses at the national level, etc.), and in particular to break the link between sovereign risk and banking risk, which has proved to have the potential to generate a vicious cycle. The aim is to suppress or limit the drain on the public purse caused by crisis episodes in the banking sector, which have cost huge amounts of taxpayers' money in recent years.

Will the Banking Union succeed in solving all these problems? In its current state, its design is complex and incomplete, with some gaps still showing through. A look at the bigger picture, however, reveals that the Banking Union represents a definite contribution to stability and consistency in the financial system, particularly in the medium-to-long term and therefore marks a major advancement in the process of European integration.

The project is based on the following four pillars:

1) **The Single Supervisory Mechanism (SSM).** The SSM is the key to the entire process. The crisis taught us that financial regulation alone is not enough, and that supervisory mechanisms must be harmonised to deliver certainty to the markets about the real condition banks are in and the policies being adopted to correct potential imbalances. Its set-up, which is almost completed (the SSM will enter into operation in November 2014) guarantees harmonised supervision criteria for all banks in the euro area and any other EU Member States that wish to be included. However, supervisory action will function under a two-level scheme: the ECB will directly supervise the largest banks (some 130), and the national authorities will handle smaller institutions. Given that the SSM's operating principles have been adopted from the English-speaking world, they will be in sharp contrast to the supervisory models currently existing in several European countries, including Spain. Before the system enters into operation in 2014, a number of tests and assessments will be performed to ensure that the largest banks are in good solvency conditions and thus dispel any doubts on the part of investors.

2) **The Single Resolution Mechanism (SRM).** A vital

complement to the Single Supervisory Mechanism, the SRM represents a considerable advancement in the process towards risk mutualisation among EU banks. Though expected to enter into operation in 2015, implementation of its key functions will begin in 2016. The SRM will have strong powers to decide on how to deal with non-viable banks, albeit subject to a complex decision-making process. The mechanism provides a bail-in procedure whereby creditors and shareholders assume losses in what amounts to a first line of defence in the event of difficulties. If that buffer proves insufficient, the Single Resolution Fund will step in, with the financial industry bearing the cost. Having secured the risk-sharing commitment required to set up this fund is one of the Banking Union's chief breakthroughs. But the SRF will not be established in full from the start. It will be built up from contributions provided by the national funds over a period of eight years up to a total of EUR 55 billion in 2024. Risk mutualisation will also be a gradual process, spanning ten years. One point of uncertainty in this respect is what will happen if all the available resources are depleted. A number of public-funded financing schemes have been provided for this extreme scenario, but the creation of an instance of last resort has been postponed until 2024.

3) **The Safety Net.** The third pillar of the Banking Union is the creation of a Safety Net, which will be chiefly – though not exclusively – aimed at safeguarding bank deposits, a key element of system stability. The natural objective would be to establish a Single Deposit Guarantee Fund to supplement the Single Resolution Fund, but this option has been ruled out by a group of core euro area countries firmly opposed to sharing bank deposit risks with other Member States. The Safety Net therefore relies on national deposit guarantee funds. The harmonising impulse, which crystallised into a directive in 2009, standardised the minimum required coverage for guaranteed deposits at 100,000 euros. It also succeeded in setting a series of time-bound objectives for maximum payment periods and fund financing. However, there are still differences among the protection schemes of the individual Member States with the potential to generate competitive advantages and disadvantages that are independent of an institution's solvency. Moreover, the resources contributed by national funds could prove insufficient to tackle systemic crises.

4) **The Single Rulebook.** A set of harmonised prudential rules created as an effort to correct the fragmented adaptation of the Basel III criteria (international banking supervision recommendations) into national legislations. To achieve this, a directly applicable regulation has been introduced (the Capital Requirements Regulation, which entered into force on 1 January 2014) setting out the procedure for adaptation of the criteria. As the provisions of such regulations do not need to be implemented into domestic law, the discretionary scope of national authorities is minimal. The

Regulation governs critical aspects of supervisory standardisation, including levels of capital, liquidity and leverage. Some matters, however, still resist regulatory harmonisation. Authorisation procedures, capital buffers and sanctions are among the areas where national lawmakers have liberty to manoeuvre. This increases the difficulty of establishing a set of common rules for all EU Member States.

Given this combination of advances and difficulties, will the Banking Union actually work? So far, the markets appear to believe it will. At the time of completing this report, the cost of insuring bank debt has fallen since an agreement on the Bank Resolution Mechanism was concluded last December, as has the risk premium of insuring bank debt compared with non-bank debt. Both these indicators correlate with bank solvency. The CDS index for Europe's 25 leading banks, which gauges their credit risk, in January 2014 reached its lowest point since March 2010. Sovereign debt costs from peripheral countries have also dropped significantly, including Spanish debt, although recent turmoil in emerging countries' currency markets has distorted that trend.

However, the short timespan examined and the abundance of details to be settled in 2014 make this a strictly provisional assessment. Any forecast on the project's success must take into consideration a number of variables and determinants.

- Firstly, time. The Banking Union needs time to mature and resolve

its innate inefficiencies. Risk mutualisation is a gradual process that will only become fully effective after eight years. In addition, the entry into effect of the Single Resolution Mechanism in 2016 will mark the beginning of an almost two-year period in which the Banking Union's basic structure will not be fully deployed.

- Secondly, results will depend on how the economy performs over the next few years. If growth is reasonable, the system's initial faults will dilute themselves and the Banking Union will be sufficient to protect the financial system from potential strain in individual banks and prevent contagion to the rest of the sector. But if growth fails, banks' problems would spread across the board and the Banking Union would not be fully prepared to absorb the impact of a systemic crisis, particularly during the initial stages of the process.

- The third decisive factor for the project's outcome is staff selection, as it will determine the extent to which the people managing the Banking Union are able to take decisions swiftly, independently and free from any national interests. Though the decision-making procedure is quite complex, in the event of an emergency, the necessary steps would presumably be taken by the most competent and best informed officials.

The Single Supervisory Mechanism, the key to the entire process

The Single Supervisory Mechanism (SSM) is a European system of financial supervision that encompasses the ECB and the competent national authorities of the participating Member States. Due to become effective in November 2014, it is the key component that will open the door to the EU's Banking Union. Its importance lies not so much in its supervisory role – which is generally in line with the classical scheme of authorisation, monitoring and correction – as in its uniformity across the whole euro area. A single mechanism is less susceptible to the interests of individual countries or banks, and is therefore crucial to restore confidence and ensure taxpayers' funds are properly managed.

As pointed out in the introduction, one of the triggers of the financial crisis was investors' distrust of the information released by banks, whether on account of transparency issues or inconsistencies in key indicators and criteria (e.g. risk-weighted assets). The purpose of the SSM is to deliver certainty on banks' real condition and predictability on the mechanisms available to correct potential non-compliance.

One system, two levels. The SSM will have jurisdiction over all financial institutions from euro area countries and from non-euro-area EU countries that have agreed to take part in the project. However, supervisory action will function under a two-level scheme:

1. The ECB will supervise the largest or most relevant banks (defined as "significant credit institutions") directly and continuously. To be classified as significant, an institution must meet any of the following conditions: (i) the total value of its assets exceeds EUR 30 billion, (ii) the ratio of its total assets over national GDP exceeds 20%, unless their total value is less than EUR 5 billion, or (iii)

the ECB or the national authorities consider the institution to be of significant relevance to the domestic economy. Institutions that have received funds from the EU's financial assistance bodies will also be directly supervised, regardless of their size. In all cases, a minimum of three banks from each participating country will be included in this group. Some 130 institutions (accounting for almost 85% of consolidated bank assets in the euro area) meet at least one of these conditions and will therefore be subject to the ECB's direct oversight. More than 90% of Spanish banks will be placed under direct ECB supervision based on quantification of their consolidated assets. In Germany, this proportion amounts to 65% (see Chart 8).

2. Non-significant institutions (some 6,000) will be supervised by the national authorities, subject to the harmonised criteria that apply to all credit institutions. Nonetheless, the ECB can at any time decide to exercise direct supervision of any non-significant institution if it deems it necessary to ensure the consistent application of general supervisory criteria. Rather than a supervisor, the ECB might best be seen as a supervisors' supervisor where this group of banks is concerned.

Why this two-level approach to supervision? The reasons are both practical and political. Firstly, the ECB will concentrate its supervisory efforts on the largest banks, as it is physically impossible to handle all of the euro area's great quantity of banks directly. Added to this, national central banks have extensive experience supervising their own institutions, which constitutes an assurance of efficient performance. Secondly, this arrangement satisfies a group of countries that prefer to keep their smaller, non-significant banks under the supervision of national central banks. Their stance is predicated on the idea that smaller banks are not systemic and therefore do not need the ECB's direct supervision.

Ultimately, the purpose sought by two-level supervision is not to have two separate models or approaches, but to apply different degrees of centralisation to the two bank categories. Supervision criteria must be the same for all banks included in the the SSM's scope. This guarantees what we might call the system's "singleness", even at the cost of adding complexity to its operation.

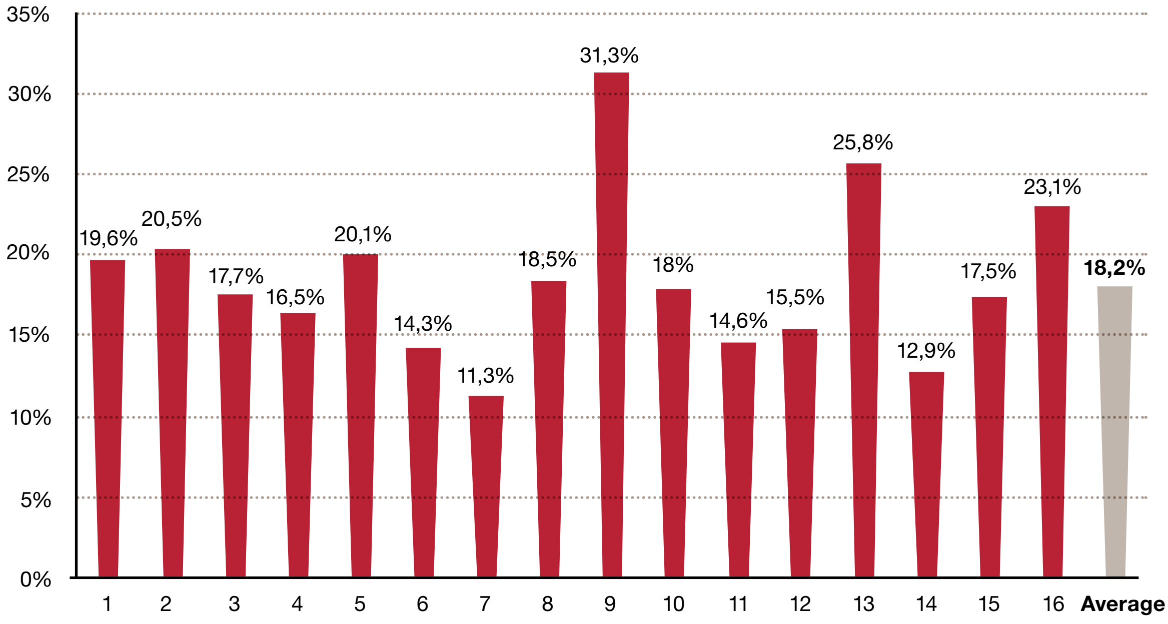
Based in Frankfurt, the SSM's workforce will be approximately one-thousand strong. Professionals from the euro area's central banks will make up a large proportion of the new team, with the remaining positions being covered by outside staff.

The change of model. Institution of the SSM constitutes a shift from a decentralised supervisory model to a system where planning is centralised and execution is partially decentralised. At the present time, credit institutions in the EU are supervised at the national level by the competent authorities of the individual Member States.

The ECB will take on its supervisory role on 4 November, with the national authorities providing support and assistance in the performance of this role.

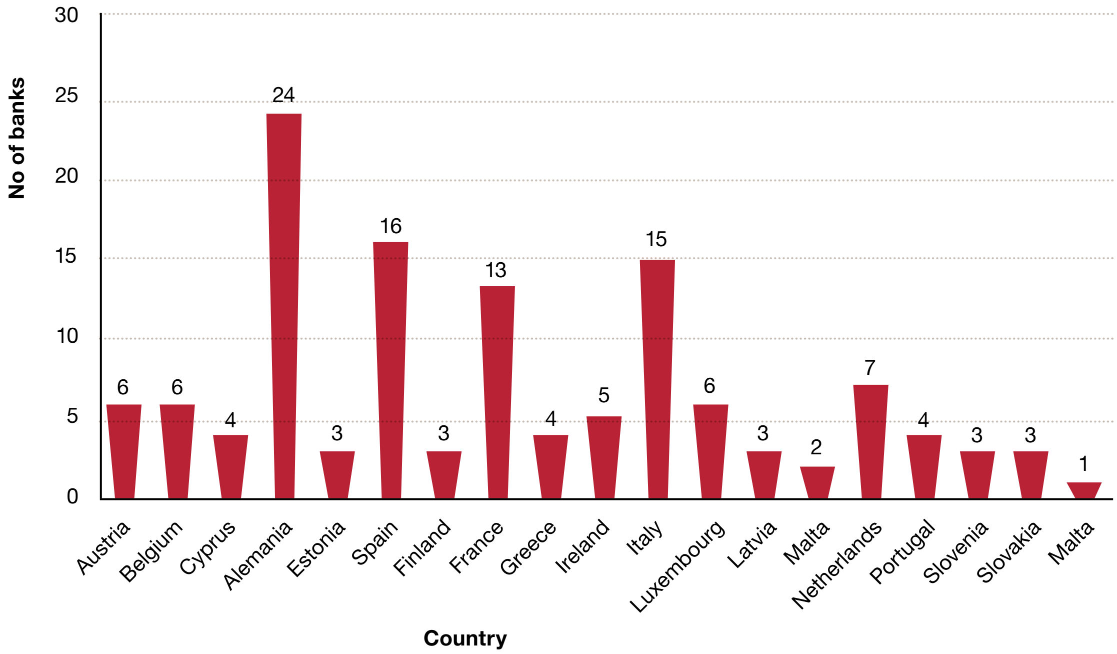
The change is momentous, not only for the new supervisor but also for the banks under its jurisdiction. It should be borne in mind that the SSM will be supervising a wide range of business models, and institutions using equally diverging measurement and valuation criteria (e.g. risk-weighted assets, as mentioned above, or the treatment of impaired loans). Equally relevant is the fact that the new supervisory model is not built from scratch, but based on the supervisory practices of all euro area countries and other developed countries.

Chart 7. **Eligible deposits over total assets for the 16 largest banking groups in the EU, in percentage terms.**



Source: Bankscope Impact Assessment BBR.

Chart 8. **Number of institutions to be supervised by the European Central Bank, by country.**



Source: European Central Bank.

In view of the above, the new model faces the great challenge of overcoming all those differences, laying down common operational principles, and developing a harmonised assessment methodology.

As part of this effort for standardisation, the ECB is currently engaged in devising its own supervisory rating system. This will provide a uniform, structured framework with which to grade financial institutions on the basis of their risks, in much the same way as most national supervisory authorities around the world do. In Spain, this methodology is referred to as SABER (risk-focused supervision of banking activities, according to its initials in Spanish).

The importance of DG IV. From an operational standpoint, it is worth highlighting the particularly prominent role that has been assigned to the Directorate-General for Micro-Prudential Supervision IV, one of the four DGs that will carry out the SSM's operations (see Box 2).In contrast to the other three DGs, each of which deals exclusively with one type of institution, the remit of DG IV cuts across all bank categories. Its responsibilities cover key aspects of supervisory activity, including authorisation, methodology, supervision quality, risk analysis, crisis management and the use of sanctions.

DG IV therefore has an overall view of the model, which enables it to identify non-compliances more easily and to offset any influence supervised institutions might exert over the DGs responsible for monitoring specific bank categories. DG IV will have substantial human and technological resources at its disposal, as befits its central role within the SSM.

A more independent team. Where supervision instruments are concerned, new joint inspections of significant institutions are the most distinctive element the new model will introduce. Instead of ongoing on-site inspections (where supervisory staff are permanently present inside banks), which are a key part of the oversight model in several countries including Spain, the SSM favours joint supervisory teams, where local supervisors will provide approximately 80% of inspection staff and the ECB will provide 20%. Each team will be headed by a coordinator appointed by the ECB's central authority, who will report to the Supervisory Board, and a deputy coordinator representing the national supervision authority.

This combination firstly ensures that the national central banks' first-hand knowledge of the situation on the ground will not go unused. Secondly, it strengthens the inspection team's independence, as the presence of Frankfurt-based supervisors provides assurance that no undue influence will be exercised by the supervised institutions.

A panoramic picture. Inspections having a primarily thematic or horizontal focus will also play an important role in the new model, providing comparative analyses of certain aspects of the financial system, such as interest rate risk, capital adequacy, earnings predictability, governance standards, etc. This approach to inspection enables supervisors to obtain something akin to a panoramic picture of a bank's performance and the weaknesses that affect specific aspects of its management. It is therefore a tool to smooth the path of harmonisation.

Inspiration from the English-speaking world. What do all the elements of the new supervisory model add up to? Any complex system lends itself to many interpretations on its design, but experts tend to agree that this is an operational, preventive, strategic supervisory model that relies to a greater extent on examination of internal control and governance than on accounts auditing.

The new model is thus more akin to the practices of English-speaking countries, such as the UK and the US, than to those applied for instance in Spain and Italy. It is interestingly paradoxical that the new supervisory model, which has been designed in the euro area, is largely inspired by the principles that guide supervisory systems in non-euro countries, even if some central European countries (most notably, Germany) apply broadly the same practices as the US and the UK.

Side by side, not intertwined. Another significant feature of the SSM is its independence. Although the new supervisory system lies within the operational orbit of the ECB, the new model clearly establishes that it will function separately and independently from the ECB's own monetary policy. This separation is intended to prevent conflicts of interests emerging between the two spheres of decision-making, which often feed back on each other. For example, a change in euro area interest rates – the main instrument of monetary policy – will necessarily affect European banks' interest rate risk and, consequently, their supervision. There are also examples of the reverse: if a bank that has received ECB loans is classified as non-viable and is therefore made subject to the resolution mechanism, the ECB could find itself having to absorb losses as part of its own monetary policy operations.

How will the separation between the two policies be ensured? The most relevant provision states that the Supervisory Board (see Box 2), which is the management body of the SSM, will operate separately from the ECB's Governing Council, and it will even have the autonomy to report to the European Parliament. Additionally, if the Governing Council has to discuss matters pertaining to supervision, it will be required to do so with a separate agenda in a meeting specifically focusing on those issues. In the event of any disagreements, the SSMs Mediation Panel will be called on to resolve them. Separation is also physical, with the staff responsible for the two policies working in two different buildings.

According to the Vice-President of the ECB, Vitor Constancio, the ultimate goal is to build a “more advanced system” using “all modern methods” to design a “forward-looking risk-based model”.

A new scene in the industry. The new supervisory mechanism is not the only piece in the puzzle, and its effects on the European financial system will only come into their own when the other two pillars of the Banking Union are in motion and have been fine-tuned to some extent. Having said this, the financial sector tends to agree that the consequences that are integral to unified supervision (i.e. harmonised criteria, greater transparency for investors, improved reliability of banks’ internal models, no barriers for cross-border transactions, no competitive disadvantages, etc.) will naturally set a whole new scene in the industry, with two major trends expected to emerge:

1. Restructuring and consolidation in the banking sector, particularly via mergers and acquisitions. Over the last five years, corporate deals have been few and far between in Europe, partly as a result of institutions’ mistrust of one another. Single supervision will presumably restore trust in the financial sector, encourage banks to consider consolidation as a way to become more profitable businesses and shed off excess capacity in the industry as a whole. Additionally, the Single Resolution Mechanism, which is a vital complement of unified supervision, will create an institutional framework where non-viable banks will be more likely to be resolved through sale of their operations to other banks, as has been the case in the US.

2. Gradual reduction of the industry’s size and its influence on the European economic fabric. The crisis has shown that the industry suffers from excess capacity (assets have dropped by 12% since 2008). Unified supervision will encourage banks to adjust their balance sheets and reduce their risk exposure in order to make their business models more secure and sustainable over time. A smaller financial industry could lessen its weight in financing the economy at large. Currently, 50% of lending to European businesses comes from banks, compared with only 25% in the US.

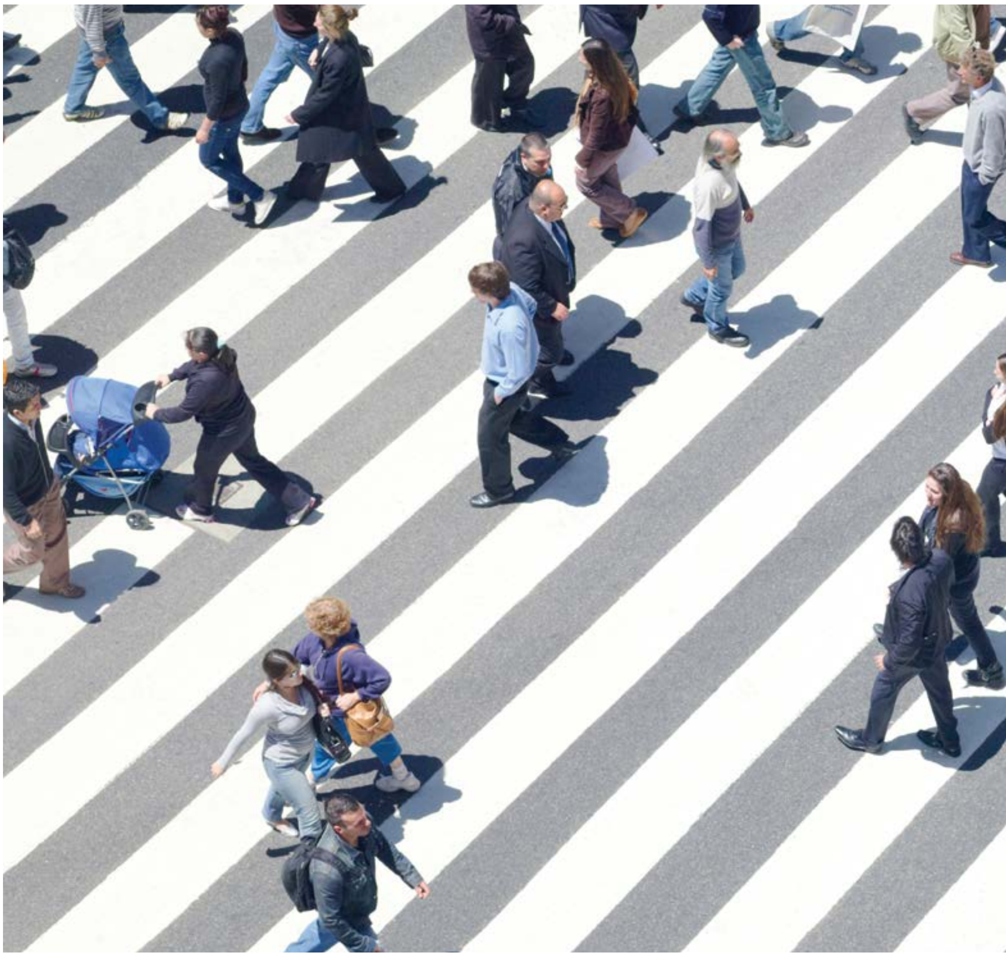
Instruction manual for banks: start with a clean slate. The new supervisory model is, first and foremost, new. This means financial institutions must make a fresh start in their relations with the SSM. The following is a list of practical recommendations for adapting to the new state of affairs:

- Decide which is the best way to channel the bank’s relationship with the new supervisor and act accordingly. This may involve qualified personnel travelling to Frankfurt to mitigate the “long-distance syndrome” caused by the new set-up, without neglecting the national authorities.

- Change the bank’s organisational structure. The new supervisory model requires all banks to develop a clear risk-appetite framework and have it approved by the Board of Directors. The framework will set the bank’s policies on capital planning, risk management and control and internal auditing. Banks will also need to renew their vision on aspects including corporate organisation transparency, responsibilities and accountability of the Board of Directors, approach to conflicts of interest, appointments, audit commissions and the compliance function.

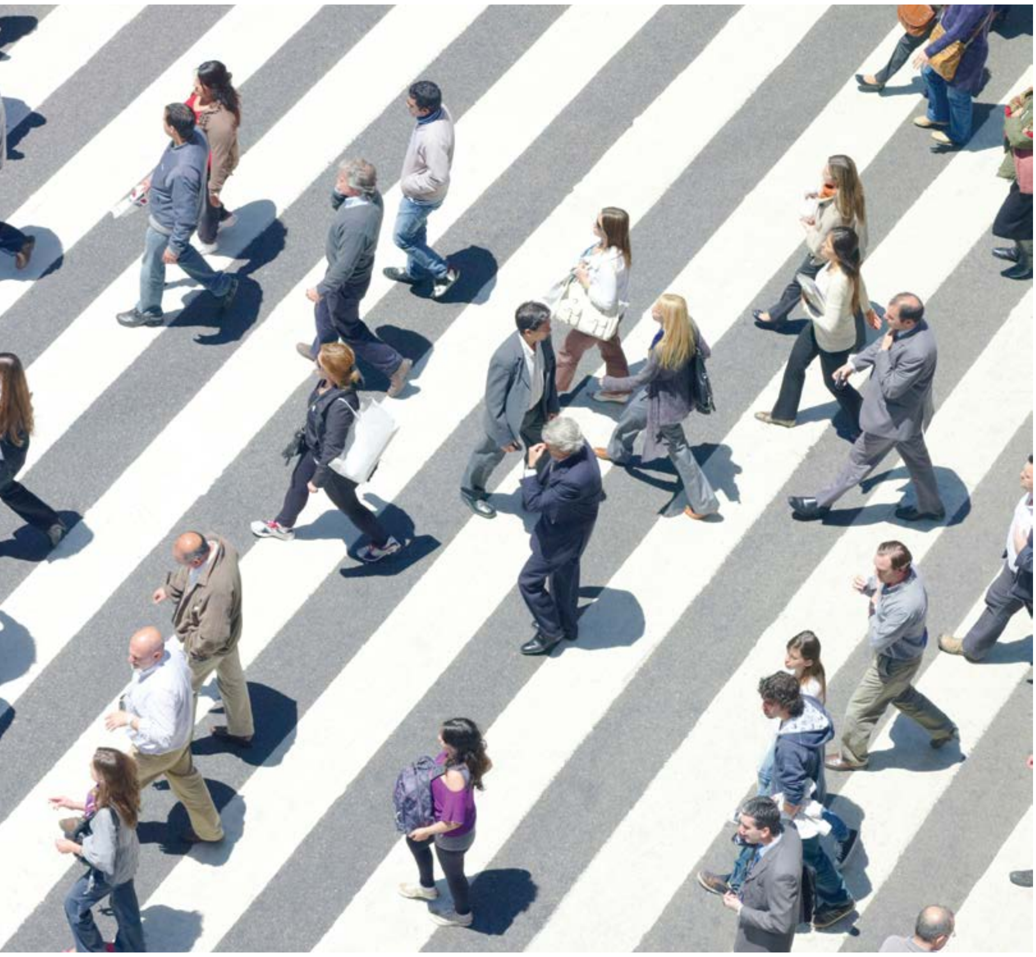
- Explain the bank's business model exhaustively. Do not assume any part of it is already known or unimportant. Past practices and experiences are now irrelevant.

- Invest in human and technological resources. The new supervision model focuses on ongoing evaluation, and every bank will have to establish a



function dedicated to dynamic solvency. Increased resources will also have to be assigned to internal auditing, and risk assessment will have a greater role than verification.

- Maximise attention to planning capital and liquidity (the criteria that will be used to measure European banks against one another) according to a dynamic perspective. This requires banks to develop complex models that include capital objectives for different risk scenarios. Each bank must also develop its own benchmarking process to better understand the global situation and have the information needed to interact with the supervisor.



The entrance exam: crossing the gorge

Before the Single Supervisory Mechanism becomes effective on 4 November 2014, all the institutions placed under the direct supervision of the European Central Bank, i.e. some 130 banks classified as significant, including 16 Spanish banks, will have their balance sheets subjected to a comprehensive assessment. The aim is to dispel any doubts investors may have on the soundness of the leading banks in the euro area by carrying out an exercise in transparency and comparability.

This process, which is considered decisive for the European financial system's stability, comprises three clearly distinct parts. They are, in chronological order:

1. An assessment of risk from a supervisory perspective. This will focus on aspects such as liquidity, leverage and funding. Specifically, it will include a quantitative and qualitative analysis based on backward- and forward-looking information aimed at assessing a bank's intrinsic risk profile, its position in relation to peers and its vulnerability to a number of exogenous factors.

2. An asset quality review (AQR). This broad review of banks' balance sheets as of 31 December 2013 will focus on credit and market exposures, on- and off-balance sheet positions and domestic and non-domestic exposures. In this phase, 8% is the magic number, as it is the minimum threshold for top quality capital. The AQR is expected to be completed by next June.

3. A stress test, performed in cooperation with the European Banking Authority. This will provide a view of the future in terms of institutions' capacity to absorb losses in two different scenarios (baseline and adverse) based on a three-year horizon. Two common equity tier 1 capital thresholds have been set: 8% for the baseline scenario and, most importantly, 5.5% for the adverse scenario. How sovereign debt portfolios are treated is a key aspect of this stress test. The ECB has finally decided to subject sovereign debt to stress (at credit or market risk, depending on the portfolio concerned). Level 3 – i.e. non-liquid – assets will also be valued. This stress test will be the great thermometer that ultimately decides which institutions need to recapitalise, as it would be possible for a bank to meet the minimum solvency requirements but fail the stress test, in which case it would have to find more capital. The stress test will be performed in October 2014 at the latest, with data as of 31 December 2013.

The purpose of the comprehensive assessment – data collection for which is already well under way – is to appraise each bank by combining the results of the three parts of the review. This appraisal will lead to supervisory action, including additional capital requirements (and/or other reparative measures) for banks that fail to meet the specifications.

It is easy to see why the process is regarded as a gorge that must be traversed on the road to Banking Union. On the one hand, the assessment must be strict. Otherwise, the process would lose credibility as a whole and the Single Supervisory Mechanism would be wrong-footed from the start. On the other hand, if the exam is too stringent, some banks could end up in a difficult position, which would erode the system's reputation and increase the risk of instability.

Another risk facing the comprehensive assessment is the absence of an instrument specifically designed to restore capital and restructure banks that fail to meet solvency requirements and are unable to do so themselves. If it becomes necessary to inject public money, the regulatory reference must inevitably be the new European Commission rules on state aid to banks, which came into force last August and are partly based on the Spanish bank restructuring experience. The rules provide a restructuring procedure that includes burden sharing by shareholders and creditors. However, the fact that it is a general procedure, rather than one expressly designed for the comprehensive assessment, could create distrust among investors and undermine its own credibility.

During the months in which the assessment is being performed, we may see some adverse effects, such as credit tightening. Banks will tend to clean up their balance sheets and sell off assets as they prime themselves for the exam, causing lending to contract. If this risk actually materialises, the ECB will have to take action to boost liquidity in the markets.

The SSM from the inside

Internal organisation

Supervisory Board. The internal body responsible for planning and implementing supervisory policy. It will be formed by a chair (Daniele Nouy, from France), a vice-chair (Sabine Lautenschläger, a German member of the ECB Executive Committee), four ECB representatives and one representative from the national competent authority of each participating Member State. Decisions will be taken by simple majority.

Steering Committee. This smaller body will support the Supervisory Board. Its chair will be the chair of the Supervisory Board and it will have a maximum of ten members, including a vice-chair and an ECB representative.

Mediation Panel. The body responsible for ensuring separation between monetary policy and supervisory tasks, resolving differences between the Supervisory Board and the ECB's Governing Council. It will be composed of one member from each participating Member State.

Directorates-general. There will be four DGs, with the following responsibilities:

I. Supervise the operations of the largest banks (approximately 30 in number).
II. Supervise all other significant banks (approximately 100).
III. Oversee non-significant banks in the system, which the ECB has responsibility over even though it does not supervise them directly.
IV. Supervision standards, methodology and quality control.

Each DG will have a director-general (Ramón Quintana, from Spain, has been chosen for that role at DG II) and there will also be six deputy directors-general (Margarita Delgado, also from Spain, will be at DG I) and several division and section heads.

The supervisory model

Harmonised assessment methodology. The methodology, which is currently at the design stage, will contain a mix of technical characteristics taken from different supervisory models. The result will take account of the supervisory rating system (many national supervisors have unique methods in place to rate their banks), its consequences (intensity of supervision and early corrective measures) and the stress placed on quantitative models, among other aspects. The model being developed by the ECB encompasses:

- Supervised aspects. Ten categories of risks, controls and financial fundamentals will be assessed: business and profitability, credit, market, operational, interest rate, internal governance, capital position, liquidity, concentration and insurance.

- Metrics for assessment of the different risk categories. Supervisory rating will be determined by a combination of standard quantitative ratios with thresholds.

- Scale. Four risk levels will be established (low, low-medium, medium-high and high), along with their corresponding control ratings (strong, adequate, inadequate and weak).

- Expert judgement. The extent to which the SSM's judgement can alter the results of a bank's semi-automatic assessment will be established. There will be some scope for discretion, particularly to downgrade ratings.

- The SSM's risk appetite. The consequences for banks of having a given rating will be determined. There will be different types of consequences: intensity of supervision, capital and liquidity requirements, internal control and corporate governance measures, etc. Top rating institutions will be subject to a lower intensity of inspection.

- Sources of information. Supervision will draw on the system of financial reporting and own resources which banks are required to put in place in 2012, on the capital self-assessment report, on the solvency and liquidity projections, and on data collected in the performance of supervision (e.g. inspections, meetings, etc.).

Supervisory mechanisms and tools. The SSM will use conventional supervision instruments (in situ inspections, remote monitoring, briefing sessions, etc.), although they will be combined differently from other models.

The new concept of joint inspections will be introduced, which involves both professionals from the national supervisory authorities (approximately 80%) and from the central authority in Frankfurt (20%) taking part in the inspections. Greater emphasis will also be placed on primarily thematic or horizontal inspections, i.e. those designed to evaluate specific aspects of all institutions in the system.

Inspection will be preventive, focusing assessing potential risks ex ante in preference to those that have actually materialised.

Capital adequacy projections and self-assessment reports will also be used as part of the inspections.

Funding. The SSM's costs will be covered by the supervised institutions by paying a yearly fee. Institutions from non-participating Member States that have branches in participating Member States will also be required to pay this fee.

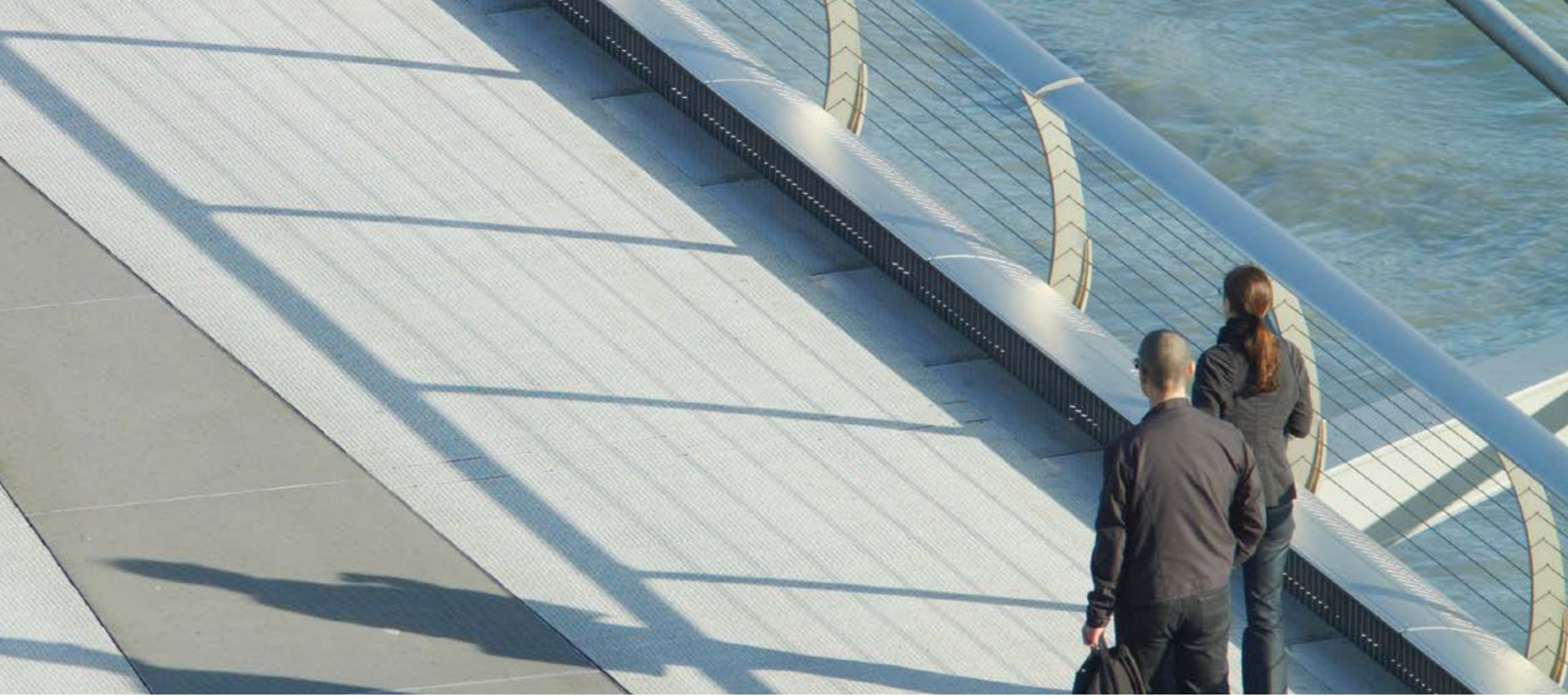
The Single Resolution Mechanism, a crucial component

The agreement in principle to create a Single Resolution Mechanism (SRM) institutes a common architecture for restructuring troubled and non-viable banks. Whereas in this sense the SRM is genuinely a single mechanism, it is not so clear whether its two constituents also are: the Single Resolution Board, which would better be described as multiple given its composition and decision-making process, and the Single Resolution Fund, which will exist alongside the national funds for a transitional period of eight years (see information attached).

The SRM will have the same scope of application as the Single Supervisory Mechanism (SSM), with the same structure. The system will have jurisdiction over all banks in the participating countries (euro area countries and any other EU Member States that request to be included), although a two-level scheme will be used, as in the SSM. Banks classified as significant (some 130), which are directly supervised by the ECB, will be subject to the Single Resolution Board, while all other banks will remain under the jurisdiction of national resolution authorities. However, the Board will take over any resolution process if use of the Single Resolution Fund is needed, regardless of the bank.

This operating scheme is crucial to ensure consistency with the SSM. Moreover, it provides an incentive to non-euro area EU countries to join the Banking Union process, as all banks from participating countries can benefit from the Single Resolution Fund's assistance.

It is not the purpose of the common resolution framework to salvage a non-viable bank that has failed as institution – an ambition that has cost taxpayers dearly in the past. Neither is it



the point to wind up such banks in a disorderly way, as this often causes a strong systemic impact. The aim is rather to streamline the bank, isolate the diseased parts to protect the healthy while enabling it to maintain its essential functions, including the payment system, in order to preclude contagion and preserve stability in the financial system.

Who will fund the restructuring process? As we will see below, the common procedure includes a model where shareholders and creditors constitute the first loss-absorbing buffer. As a second line of defence, the banking industry will cover the cost of the process through its contributions to the resolution fund. Support from public funds will only be available as a last resort, which will significantly reduce the cost of bank bail-outs to the taxpayer. The goal is to improve market discipline, ensure those who appropriate large profits in times of boom take responsibility for the losses when things start going badly, and give the managers of financial institutions the right incentives for sound running of their operations.

The SRM will have strong powers and competences, as legally provided in the Bank Recovery and Resolution Directive, which is now in the final stage of its approval.

The SRM relies on four basic instruments to pursue its aims:

- Sale of assets. The Resolution Board has the power to sell part of a business without the shareholders' consent.

- Transfer to a bridge bank. A business may be transferred in part or in full to a bank controlled by the authorities, which will continue to offer essential financial services while the situation is resolved.

- Segregation of assets. Toxic assets may be transferred to an independent vehicle or bad bank.

- "Bail-in". A process whereby a failing or non-viable bank's shareholders and creditors assume losses.

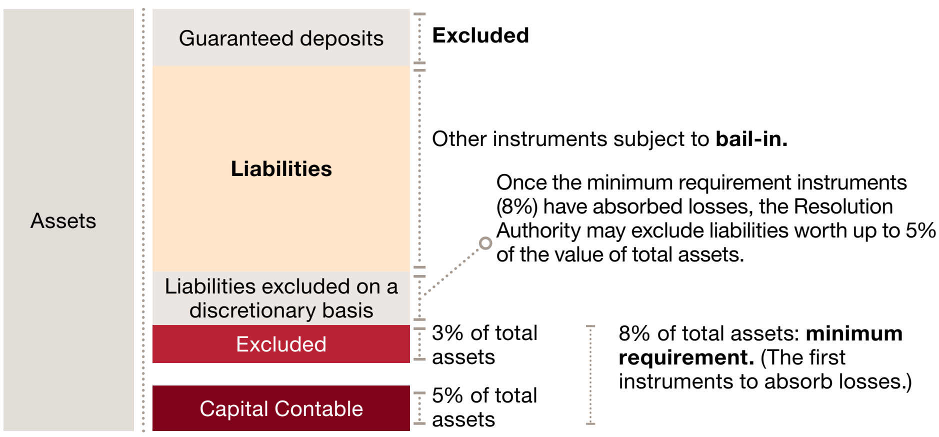
Bail-in is the key to the restructuring process. By imposing a scale of seniority to decide which shareholders and creditors will assume the costs and in what order, it creates a clear perception of the risks attached to an institution's liabilities. Under the Bank Recovery and Resolution Directive, shareholders will be the first in line to bear losses (equity is wiped out or diluted to assume the first losses). Next, debt held by creditors is converted to shares or written down, including bonds and hybrids (e.g. preferred stock). Lastly, deposits worth more than 100,000 euros, with those held by individuals and SMEs having seniority over those held by large companies. In any event, shareholders and creditors will have to assume a minimum loss of 8% of the bank's liabilities or 20% of its risk-weighted assets (known as the minimum requirement) before the resolution fund steps in.

Guaranteed deposits (up to 100,000 euros) and some liabilities (e.g. employees' fixed salaries and pension funds, items related to critical goods and services, and debt instruments with a remaining maturity of less than seven days) are excluded from the bail-in and are therefore untouchable. The SRM can also at its own discretion exclude 5% of total liabilities from bail-in to preserve financial stability.

This scheme ensures investors will be first hit in any restructuring process, thus avoiding or limiting bail-outs, which have been frequently resorted to in the banking crises of recent decades, usually at the expense of the taxpayer.

A further distinctive feature of the new resolution framework, which is also inspired by the Recovery and Resolution Directive, is that all banks will be required to draw up recovery plans on how to deal with emergency situations. The leading banks are already preparing these recovery plans, which will be updated on a yearly basis. Institutions

Chart 9. **Operation of the bank resolution and recovery scheme**



This scheme is based on an example bank with a capital amounting to 5% of its total assets.

Source: Prepared in-house.

will have to provide full details of their internal structure, specify which parts of their businesses are not essential, and establish a system of firewalls that can be quickly activated if its financial position deteriorates significantly. This process of preparing for the worst is based on the principle that any bank, however robust and solvent it may seem, is exposed to crisis situations (we have seen some recent examples of this) and therefore may have to be restructured. If necessary, the recovery plan would serve as a guide for the Single Resolution Mechanism, providing the information it needs to act swiftly and decisively. As a complement to the recovery plan, the SRM will prepare a resolution plan, which it would implement if an institution were to meet the conditions for resolution. Both plans together constitute a bank's "living will".

A major conceptual advance. Will this system resolve future banking crises? The mere talk of creating a Single Resolution Mechanism is already a major advance in the Banking Union process, in so far as it constitutes the essential crowning complement of the Single Supervisory Mechanism. The agreement is also particularly valuable given the difficult circumstances in which it has been reached, with some Member States expressing misgivings about committing to such a risk-sharing structure. This complex and imperfect – yet common – system provides the system with a single set of rules that all troubled and non-viable banks can receive similar treatment. The case of Cyprus, where the EU had to improvise a late response to the problems affecting its financial system, is a good example of the drawbacks of not having a uniform resolution framework. The SRM's creation will send a message to the markets about the euro area countries' determination to put an end to the culture of using public money to bail out banks. The best way to fully appreciate the importance of this agreement is to imagine what would have happened if no deal had been reached. A further positive aspect of the agreement is the acknowledgement of the need for common backstops to act as an element of last resort if the instruments put into place by the SRM fail to deliver the expected results. Although no actual effective measures have as yet ensued, the commitment is nonetheless real and will presumably eventually materialise to complete the resolution framework.

Two challenges. While considerable progress has been achieved, the new mechanism also offers significant challenges:

1. The decision-making process is the first challenge posed by the agreement, as its complexity may prove a hindrance in difficult situations requiring a rational, impartial, confidential and urgent response. The final layout, which involves the Single Resolution Board, the ECB and the European Council, gives the participating countries the last word in certain cases. This may generate interference in the process and reinforce – rather than break – the link between sovereign risk and bank risk. There is also some uncertainty surrounding the decision-making timeframe. Decisions issued by the resolution authority theoretically become effective within a maximum of 24 hours. However, the Council of Ministers can oppose decisions or propose amendments, subject to a previous proposal from the Commission. Implementation can therefore be delayed for longer than one weekend, which is the period considered reasonable to avoid market disturbances. This high-speed mechanism may have its drawbacks if the Council, in agreement with the Commission, uses its veto rights preventively, bearing in mind that it only has one day to analyse a decision by the Single Resolution Board.

2. The second challenge is the absence of an appropriate backstop to handle a scenario in which the resources available become exhausted during the course of the restructuring process. Three avenues for additional funding will be available during the eight-year transitional period in which the Single Resolution Fund will gradually be built up with contributions from the individual national funds. Firstly, a national fund may borrow money from its own government. Secondly, it may borrow from another European fund. Thirdly, the European Stability Mechanism (ESM) may inject money into the country concerned subject to certain conditions, as was the case in Spain in 2012. The efficiency of these mechanisms has been called into question, particularly recourse to the ESM, which is already a possibility and reinforces the link between sovereign risk and banking risk. An explicit commitment has been made, however, to establish a backstop in 2024, although its specifications have not been negotiated. It is now a blank page that will have to be written over the next few years. The markets have also voiced doubts about whether the Single Resolution Fund, which is expected to reach 55 billion euros in 2024, will be sufficiently endowed.

300 looking for a place to work. The Single Resolution Mechanism will need sufficient resources to work efficiently, autonomously and proactively. In principle it is envisaged to have a workforce of 300 professionals, sourced from the national resolution authorities, including the Fund for Orderly Bank Restructuring (FROB) in Spain. Where the new body will have its head office has not yet been decided. The key debate is whether it should be based in Germany – with the guarantee of effective communication with the Frankfurt-based ECB and SSM on the upside, and a highly concentrated financial power on the downside – or elsewhere, which would result in less interaction but more independent judgement and a certain degree of decentralisation. Neither has an agreement been reached on who will be executive director, although there is some consensus among member countries that the position should be held by a prominent personality in European politics. It does seem clear that the SRM will have agency status (the administrative rank of independent bodies established to help implement European institution policies concerned with specific areas), and will thus share the same standing as the European Banking Authority, the agency created in 2011 to coordinate local supervisors.

The impact on banks: more than just money. Credit institutions in the euro area will finance the Single Resolution Fund as it is gradually built up. But bearing in mind that the transitional period will last for ten years and that the ultimate goal is not too ambitious (1% of guaranteed deposits, i.e. some 55 billion euros), the contributions paid will not destabilise the industry's balance sheets, although they do require an effort. In any event, the expected improvement in financial stability and investor confidence would, if they finally materialise, more than repay the industry's contributions. But the SRM means something more than money for financial institutions. Firstly, all participating banks are required to draw up a comprehensive recovery plan, which must be examined and approved by the supervision authority. Secondly, the seniority order established by the bail-in mechanism is a key factor in determining the structure of a bank's liabilities, which may even affect its composition and cost. Furthermore, bail-in criteria also influence investors' decisions, as they will avoid putting money into the 8% minimum requirement, which is a bank's first loss-absorption buffer.

Operations. This is how the SRM will work

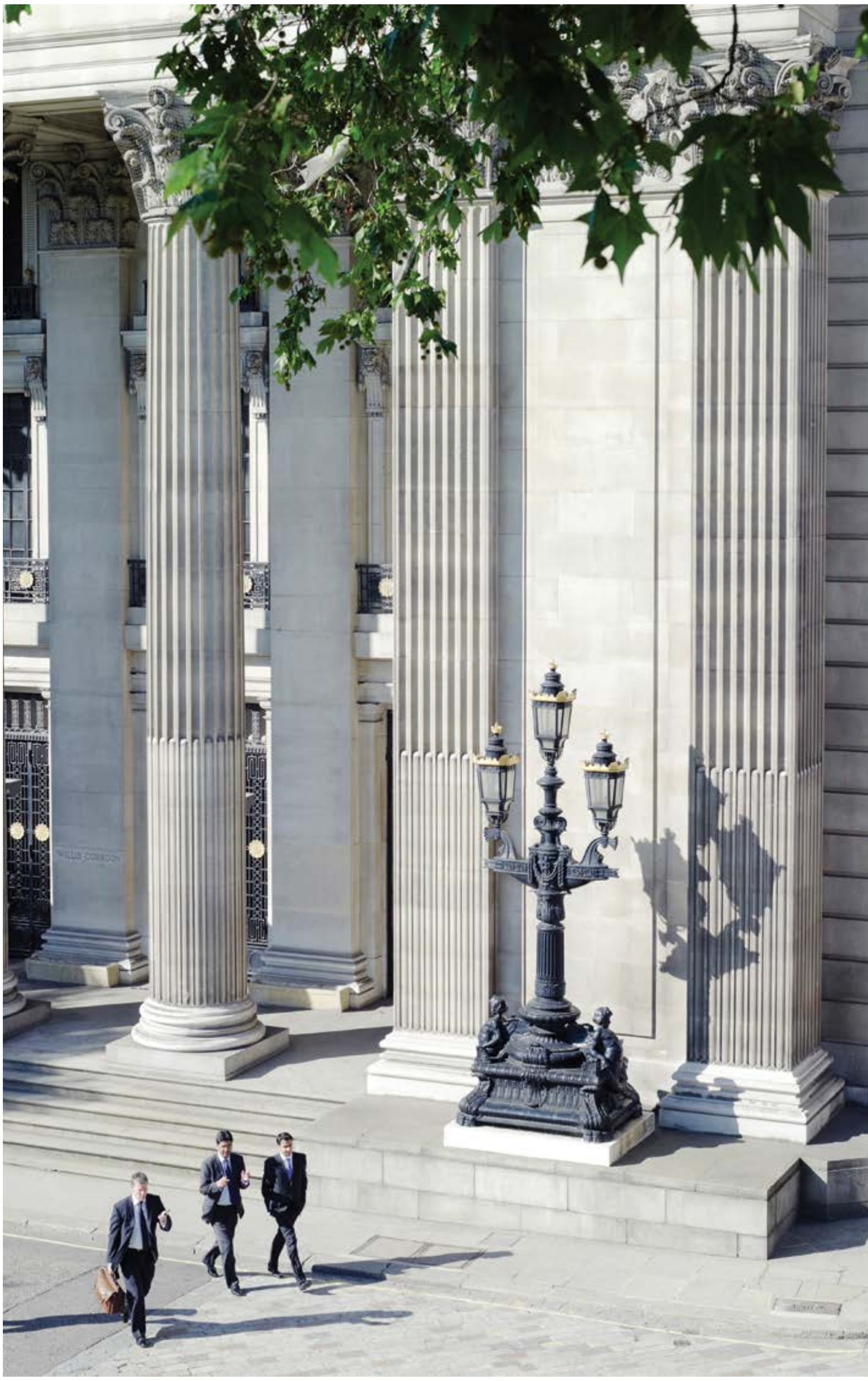
The Single Resolution Mechanism (SRM) will become operational on 1 January 2015 and its main powers will come into force on 1 January 2016. The SRM, whose scope of action encompasses all the countries covered by the Single Supervisory Mechanism (SSM), is composed of:

- **The Single Resolution Board (SRB).** This will have wide-reaching powers to restructure banks. At the request of the ECB or at its own initiative, it will be able to subject a bank in difficulty to a restructuring programme, ascertain which tools need to be used in each case and avail of the Single Resolution Fund, of which it is the owner and administrator. The decisions of the SRB will come into force within 24 hours after their approval, unless the Council of Ministers, at the proposal of the European Commission, rejects them or proposes amendments. The SRB will be composed of an executive director, four directors and the representatives of the national resolution authorities of the participating countries. It will operate with two formats: executive and plenary. In the executive format, where decisions shall be taken with regard to individual banks, the executive director, the four directors and the representatives of the affected countries will intervene; the ECB and the European Commission will participate as permanent observers. During the plenary session, the Board will take the general decisions, those involving liquidity support exceeding 20% of the capital of the Single Resolution Fund, those affecting recapitalisations exceeding 10% of the funds or when more than EUR 5,000 million has been used in a calendar year. In these cases, a double majority will be required: two thirds of the board members representing at least 50% of the contributions. The plenary session is also entitled to oppose the resolutions of the executive session in certain important decisions, in this case by simple majority.

- **The Single Resolution Fund (SRF).** The commitment establishes that the fund will initially consist of national compartments (the funds already constituted in the participating countries), which will mutualise (merge into the common fund) gradually over a transition period of eight years until they completely disappear. In the first year, 40% of the funds from national compartments will mutualise: in the second year 20% and the remainder over the following six years. The objective is that at the end of this phase, the single fund will represent an amount equal to 1% of the guaranteed deposits, i.e. approximately EUR 55,000 million. The fund will be financed by the banking industry at national level.

The agreement also includes the design of a backstop in the event the available financing runs out. During the transition phase the funds will be able to obtain bridge financing from national sources (backed by bank contributions) or the European Stability Mechanism (ESM)). In the latter case, the current procedure will apply, i.e. the countries and not the banks will request assistance from the ESM, like in the case of Spain. The possibility of lending also exists between different national compartments. Once the eight-year transition phase has concluded, a common support mechanism will come into force, which will be able to lend to the common fund and whose costs will be reimbursed by the banks through levies. The nature and characteristics of this common support mechanism will be developed during the transition phase.

In order to guarantee the member states' budgetary sovereignty, the Single Resolution Mechanism will be unable to take decisions requiring extraordinary contributions from the States without its prior approval.



A Safety Net with Loopholes

Banking Union was theoretically conceived following the creation of three new decision-making structures: a Single Supervisory Mechanism, a Single Resolution Mechanism and a Safety Net, the mainstay of which is the protection of bank deposits through deposit guarantee funds. The first two structures are duly on course and we are familiar with their schedule and main characteristics.

Conversely, the third pillar (using classic EU terminology), is further from becoming a reality. Although progress has been made in harmonising the national funds to guarantee bank deposits, the objective of creating a single deposit guarantee fund has gradually fallen off the agenda. The reason for its exclusion from debate is the firm refusal by a group of Central Eurozone countries to share bank deposit risk with other member states.

However, the fact that the creation of a single deposit guarantee fund has vanished from the political agenda does not mean that it is inappropriate for the completion of Banking Union. Deposit guarantees are a key factor for the stability of the financial system, since they largely prevent or limit banking panics that are typical of banking crises. National deposit guarantee funds currently exist, financed by banks that carry out that function, but the creation of single supervisory and resolution mechanisms in the eurozone calls for this singularity to also apply naturally to asset protection schemes.

In this respect, a hypothetical Single Deposit Guarantee Fund, supported by national funds, would act as a sponge to absorb the losses incurred in a banking crisis, irrespective of the solvency of the country in which they occurred. Also, in combination with the Single Resolution Fund, which will also be financed

through contributions from the finance industry, it would help create a dense fabric of guarantees, thereby affording credibility and strength to the Banking Union project.

However, it is also true that the creation of a European Deposit Guarantee Fund, albeit desirable, is not absolutely vital for the Safety Net. Once the guaranteed deposits have been excluded from the bail-in process and the cornerstone of the Single Resolution Fund has been laid down, resorting to the deposit guarantee funds will be more unlikely, thereby curbing the need for mutualisation.

In addition to the lack of a single deposit guarantee fund, the creation of a backstop has also been poorly resolved, which could be used if the costs of the crisis exceed the funds envisaged in the mechanisms (see previous chapter on Single Resolution Mechanism).

The conclusion from the foregoing is that the Safety Net on which Banking Union lies contains certain loopholes that can blur the final outcome of the project and, in particular, it does not support the objective of breaking the cycle that feeds back to sovereign and bank risk.

Where we are: half way there. If we assume that the creation of a Single Deposit Guarantee Fund is now a political utopia, we must ask to what extent can the current asset protection schemes in force in the eurozone (although limited or incomplete), support the Banking Union project. The national deposit guarantee funds are currently half way between fragmentation and harmonisation. The 2009 Directive unified the minimum coverage level of guaranteed deposits, which is probably the most sensitive criteria in the event of a banking crisis. Therefore, at present, all national funds must guarantee minimum deposits of EUR 100,000 per saver and bank.

Also, in December 2013 the European Council and the European Parliament reached an agreement to review the Directive and establish harmonised deadline and financing objectives. The agreement reduces the maximum deadline in which depositors can receive their money from 20 to 7 working days, in three stages: 15 days from 2019, 10 days from 2021 and 7 days from 2024. The review also establishes an ex ante contribution target (periodic preventive financing) of 0.8% of the covered deposits, to be carried out in ten years, with contributions weighted by the risk of each bank. In its 2010 Directive proposal, the European Commission had suggested a contribution of 1.5%.

Despite these harmonisation achievements, there are approximately forty different protection schemes throughout the European Union (countries like Germany or Austria have more than one), with significant differences, especially with regard to their financing. Most of the countries (including Spain) are constituted using ex ante contributions, whereas a small group of members (including the UK and Italy) operate ex post and contributions are requested when the fund runs low. There are also considerable differences with regard to the percentages of coverage, eligible deposits, contributions and obligations of the banks and size of the funds.

This biodiversity of national funds creates an asymmetrical network, with coexisting systems that have a resistance capacity against very different situations of risk, giving banks in certain countries competitive advantages or disadvantages regardless of their level of solvency.

Aside from fragmentation and its negative corollary with respect to the link between sovereign and banking risk, perhaps the most noteworthy matter regarding the current situation of protection schemes in Europe is that appropriation to them might not be enough in order to deal with systemic crises. In general, national funds are prepared to cushion the impact of the demise of a medium-sized bank, but no more than that. This suggests the need to create adequate cross-financing instruments that can resolve generalised crisis situations in a member state.

What we need: robust financing and a containment barrier. Given that there is dual evidence to support that the creation of a single deposit guarantee system does not currently appear on the agenda and that the appropriation to national funds might not be enough, a pragmatic approach would be to try to strengthen the Safety Net through the establishment of a powerful backstop, which would act as a larger containment barrier and which would be activated when the fund or national funds have completely run dry. In 2013 the International Monetary Fund IMF) proposed the possibility of making the EUR 500,000 million European Stability Mechanism (ESM) available in emergency situations to finance national funds in trouble. The ESM would therefore adopt the role of last port of call in the event of systemic shock.

The banks feel every single pinch. The obvious impact on the banks, which finance the deposit guarantee funds, is that the strengthening of the asset protection mechanisms will presumably involve an increase in their contributions to the system, with the concomitant adverse effect on their profits. In the current situation of the Spanish and European industry, marred by a decline in profitability, any pinch of profits is painful, but it will not have a significant impact on their income statement.

Emergency liquidity assistance, the taboo last resort

One of the levers of the financial system's safety net is emergency liquidity assistance (ELA), which has become, de facto, the banks' lender of last resort during difficult times. It involves loans given by national central banks to banks that cannot resort to the ECB in order to obtain liquidity because they lack adequate collateral and, therefore, find themselves in a complicated financial situation.

The national central banks provide lifelines in situations of extreme difficulty. However, emergency liquidity assistance may not fit in with the main objective of Banking Union, which is to break the bond between sovereign and

Figure 10. **EU eurosystem exposure of 17 countries. September 2012**

	Eurosystem loans in euros	ELA to credit institutions	SMP trends	Eurosystem exposure	Bundesbank exposure	Bundesbank exposure (% of GDP)
Austria	17.4	0.0	0.0	17.4	4.7	0.2
Belgium	39.7	2.1	0.0	41.9	11.3	0.4
Cyprus	3.7	10.2	0.0	13.9	3.8	0.1
Estonia	0.0	0.0	0.0	0.0	0.0	0.0
Finland	3.7	0.0	0.0	3.7	1.0	0.0
France	176.5	0.0	0.0	176.5	47.8	1.8
Germany	76.8	0.0	0.0	76.8	20.8	0.8
Greece	30.3	100.6	35.8	166.6	45.1	1.7
Ireland	79.1	40.0	17.0	136.1	36.8	1.4
Italy	276.7	0.0	96.2	372.9	100.9	3.8
Luxembourg	5.0	0.0	0.0	5.0	1.4	0.1
Malta	0.6	0.0	0.0	0.6	0.2	0.0
Netherlands	27.7	0.0	0.0	27.7	7.5	0.3
Portugal	54.9	0.0	21.5	76.3	20.7	0.8
Slovakia	2.6	0.0	0.0	2.6	0.7	0.0
Slovenia	3.9	0.0	0.0	3.9	1.0	0.0
Spain	399.9	0.7	39.7	440.3	119.2	4.5
Total	1.198.6	153.7	210.2	1.562.5	422.9	15,9

Source: European Central Bank, national banks and Citi Research estimates banking risk. To the extent that such liquidity is provided by national central banks (and appears on their balance sheets) and in certain cases also has a State guarantee, what is happening is exactly the opposite: the bond between country and banking risk is being strengthened. This impact, together with the fact that it is not obligatory to publish information on how it is instrumented, has almost made emergency liquidity assistance become a taboo issue in negotiations for the implementation and development of Banking Union.

These disadvantages have led to a debate in the European Union on the possibility that these operations might cease to be performed by national central banks and be performed exclusively by the ECB. Consequently, regulations for granting liquidity would need to be modified, as well as changes to guarantees requested from banks.

Figure 10 shows the concentration of emergency liquidity assistance operations in three countries (Greece, Ireland and Cyprus), as a reflection of the weakness of their respective financial systems in September 2012.

The ESM, a cannon of limited use

The European Stability Mechanism (ESM) is an intergovernmental organisation created by the European Council in March 2011, which operates as a permanent mechanism to safeguard financial stability in the eurozone. This mechanism came into force on 1 July 2012, has a budget of EUR 500,000 million and is Monetary Union's most powerful weapon to assist countries in financial crisis. ESM support is conditional upon the assumption of a number of financial and economic policy commitments by the country receiving assistance.

Bearing those objectives in mind, at the close of the edition of this report, the EMS and its predecessor, the European Financial Stability Facility (EFSF) had paid out EUR 320,000 million, EUR 41,300 of which was received by Spain to recapitalise its banks (see figure 11).

In June 2012 the eurozone heads of State or Government approved the use of the ESM as a direct recapitalisation instrument for troubled banks, up to a maximum of EUR 60,000 million, thereby considerably broadening its scope of action.

However, political debate in the European Union (negotiations are currently underway) has so far prevented that possibility from materialising, which would significantly strengthen the eurozone's financial safety net. One group of central countries blocked its application because it considers that if the ESM assists specific banks, its financial position (and rating) would weaken, given that providing money to a State, which in most cases have mechanisms to guarantee its return, is not the same as providing money to a bank in crisis.

Figure 11. **ESM, EFSF and IMF financial assistance programme (in thousands of millions of euros).**

Country	Greece	Ireland	Portugal	Spain	Cyprus
Type	Balance of payments	Economic adjustment programme	Economic adjustment programme	Financial assistance to recapitalise banks	Economic adjustment programme
Supervised by	EC, ECB and IMF	EC, ECB and IMF	EC, ECB and IMF	EC, ECB and IMF	EC, ECB and IMF
Amount committed	246,3	85	78	100	10
Paid	215,4 (ESM/EFSF: 185,5 IMF: 28,9)	62,7 (ESM/EFSF: 40,2 FMI: 28,9)	71,0 (ESM/EFSF: 46,9 FMI: 24,1)	41,3 (ESM/EFSF:41,3)	4,9 (ESM/EFSF: 4,6 FMI: 0,3)
Assistance as a % of GDP	110,3%	39,2%	42,3%	4,3%	27,8%

Source: Economic Governance Support Unit of the European Parliament and proprietary preparation.

The difficulties in extending the ESM's assistance function to banks were revealed during the Minsters of Economy and Finance meeting held in Brussels on 18 December, which laid down the pillars for the constitution of the Single Resolution Mechanism (SRM). During this meeting, no agreement was reached regarding the use of the ESM as a backstop, failing all other bank restructuring options. The ESM will not be used to directly recapitalise the banks deemed weak during the tests performed in 2014, prior to the entry into force of the Single Supervisory Mechanism, or after that date, upon constitution of the Bank Resolution Fund.

A loan may be requested from the ESM as a solidarity fund when all other options have failed, but only as a mechanism to assist countries, not banks, i.e. under the same conditions as before Banking Union was approved.

However, the ESM could potentially be the last port of call in 2024, when the Bank Resolution Fund fully becomes a common instrument. However, that assumption will be discussed by eurozone member states in coming years, and it will remain to be seen how it is finally articulated. At the December meeting, the Economy and Finance ministers only undertook to develop a backstop over the next eight years which, if needed, will lend money to the Resolution Fund and will be reimbursed by the banking sector and they did not indicate whether the ESM will intervene in this assistance programme, as seems logical.

Figure 12. **Capital contribution from ESM members, in thousands of millions of euros.**

Member	% ESM participation	Paid capital in thousands of millions of euros	Capital subscription in thousands of millions of euros	ESM contribution/ GDP
Austria	2,78%	19,48	2,22	0,006%
Belgium	3,48%	24,34	2,77	0,007%
Cyprus	0,20%	1,37	0,16	0,008%
Estonia	0,19%	1,3	0,15	0,008%
Finland	1,80%	12,58	1,43	0,007%
France	20,39%	142,7	16,31	0,007%
Germany	27,15%	190,02	21,72	0,007%
Greece	2,82%	19,71	2,25	0,010%
Ireland	1,59%	11,14	1,27	0,007%
Italy	17,91%	125,39	14,33	0,008%
Luxembourg	0,25%	1,75	0,2	0,004%
Malta	0,73%	0,51	0,06	0,008%
Netherlands	5,72%	40,02	4,57	0,007%
Portugal	2,51	17,5	2	0,011%
Slovakia	0,82%	5,77	0,66	0,008%
Slovenia	0,43%	2,99	0,34	0,008%
Spain	11,90%	83,32	9,52	0,008%
Eurozone	100%	700	80	0,007%

Source: ESM

A Single Rulebook to prevent fragmentation

Another pillar of Banking Union is the Single Rulebook, although its importance is frequently underestimated in the process as a whole. The single rulebook is a group of harmonised prudential rules that the European Union institutions must respect, in order to ensure uniform compliance with Basel III criteria (global capital standard agreements) throughout all member states.

This regulatory uniformity, which seems basic in any harmonisation process, as proposed by Monetary Union, has been frequently breached in the past. The underlying difficulty with European regulations, whose application is based on the transposition of directives to national legislation (in certain cases quite discreetly) has enabled many countries to interpret the common regulatory body of banking supervision as they see fit. This has led to a different playing field (see accompanying information). The greater or lesser rigour of national regulations affects bank solvency and can create competitive advantages and disadvantages and uncertainties among investors, especially during times of crisis.

The Single Rulebook fills in these gaps and largely resolves regulatory fragmentation. It has instrumented the adaptation of Basel III to European regulations through rules that can be applied directly, without the need of transposition or intervention of member state authorities. This has the advantage of significantly reducing the number of options of national discretion. Also, a regulation is subject to the same European process of approval as a directive, which ensures that the decision is fully democratically controlled. Consequently, the Capital Requirements Regulation (CRR) came into being, which supplements the

fourth version of the Capital Requirements Directive (CRD IV) and which is applicable from 1 January 2014. This new approach is a key factor in the banking union process, since it favours market discipline and competition between banks by establishing a more uniform and clear regulatory framework. Thus, the Single Rulebook will enable the banking sector to be:

- More resistant. The uniform application of prudential measures will strengthen banks' solvency.

- More transparent. European banks will be more comparable among each other, which will favour the decisions of supervisors, depositors and investors.

- More efficient. Banks will not have to adapt to 28 different types of legislation.

Progress with exceptions. Despite this progress, the Capital Requirements Directive contains some European regulatory areas, where national legislators still have a margin of discretion to impose different criteria. These areas, where the prescription capacity for countries is low, relate to the powers and responsibilities of national authorities, such as authorisation procedures, the establishment of capital buffers, supervision and sanctions. The directive also contains risk control requirements associated with national corporate laws and corporate governance laws.

Conversely, the Capital Requirements Regulation, which applies directly to member states, regulates regulatory decisions regarding capital, liquidity and leverage requirements. Figure 13 summarises this distribution of powers:

The Single Supervisory Mechanism (SSM) must split hairs in order to

Chart 13. **Distribution of national and community powers of the new regulation.**

Directive (Provisions associated with national laws, scantly prescriptive)	**Regulation** (Detailed and highly-prescriptive provisions that create a Single Rulebook)
Access and development of banking activities	Capital
Exercise of freedom of establishment and free movement of services	Liquidity
Prudential supervision	Leverage
Capital buffers	Counterparty credit risk
Corporate governance	High-risk operations
Sanctions	Dissemination and disclosure requirements

Source: European Commission anf proprietary preparation.

manage this distribution of powers, especially in areas where the regulation leaves national authorities with a very high margin of discretion. In Spain, for example, the banks apply different provisioning criteria to other EU members.

The most significant case relates to the generic provision, which is an instrument with a countercyclical component that does not exist in other member states, as it arises not as a result of non-payment already observed in relation to loans, but rather it is based on the historical experience of arrears and losses in previous crises. In 2007 these provisions totalled EUR 25,836 million. The single supervisor must decide whether to maintain these provisions or, conversely, eliminate or modify them in a certain manner, which would free up a significant volume of resources which, up until now, were accumulated to cover future losses. Although to date, this amount has been reduced to EUR 3,292 million, it is obvious that any decision regarding these provisions can have a very significant impact.

The same phenomenon occurs in relation to the risks covered by the so-called Pillar II measures, i.e. circumstances that are not regulated by European legislation and whose coverage must be determined by national supervisors to prevent contingencies in the country. One specific example is sector concentration risk which, in Spain, is measured in accordance with specific ratios and requires an additional capital buffer.

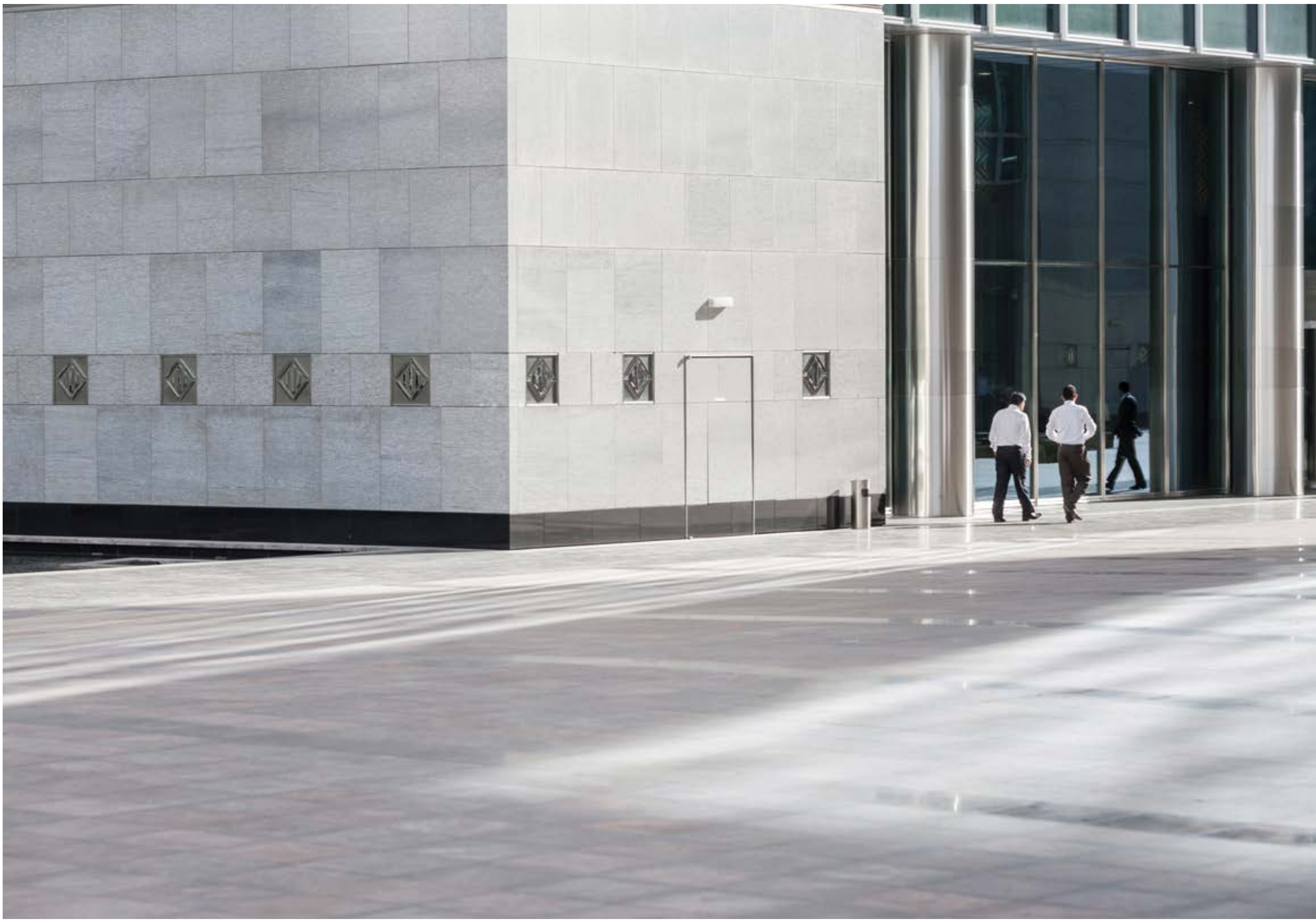
These national provisions, which entail exceptions or flexibility in the framework of the single rulebook, have reason to exist in a scenario in which economic cycles are not fully synchronised. In order to address such asymmetries, EU countries retain the possibility of establishing certain requirements that enable prudential supervisory criteria to be adapted to the reality of each one.

The Single Supervisory Mechanism (SSM) must also tackle the difficult task of combining historical national supervision models that differ greatly in terms of characteristics and levels of requirements. In the case of Spain, for example, banks are subjected to stricter valuation with regard to the density of assets compared to other countries (the relationship between risk-weighted assets and the total balance sheet), which is key in measuring capital adequacy and, in short, bank solvency.

With regard to supervisory tasks, the SSM will be faced with the challenge of harmonising practices without relaxing them in countries with stricter regulations. Also, the new mechanism is faced with the initial difficulty of coordinating, with limited resources, the supervision of a very large number of banks in many countries, which can lead to the risk of a decrease in supervision intensity during the transition phase.

Overall, we can affirm that the new legal framework on which the European banks' supervisory requirements are based addresses some of the weaknesses shown by the banks during the financial crisis, particularly those relating to capital inadequacy, both in terms of quantity and quality. The new prudential rules, inspired by the Basel III agreements, impose stricter criteria on capital reserves and liquidity levels and also strengthen the banks' ability to manage the risks associated with their activities.

Other basic regulations. If the legislative package that composes the Capital Requirements Directive and the Capital Requirements Regulation forms the spinal cord of the Single Rulebook, the Banking Union process is also supported by two other main basic regulations:



- The Bank Recovery and Resolution Directive (BRRD). This is at the final phase of definitive approval and is used as a legal basis for certain fundamental Single Resolution Mechanism instruments, such as the bail-in, a recapitalisation system based on the orderly assumption of losses by shareholders and creditors, except for deposits of less than EUR 100,000. The bail-in is the first backstop to prevent a troubled or unviable bank from requiring public fund assistance. In any case, any public assistance given to a bank will be subject to European Union state aid regulations. In August 2013 the European Commission updated its rules for the granting of public aid to banks.

- The Safety Net, based on the protection of bank deposits, which is a key factor in the stability of the financial system. The net is currently composed of highly diverse national funds that also share the criteria of guaranteeing deposits under EUR 100,000. Progress has also been made in harmonising financing and the payment period of national funds. However, political differences in the European Union have halted the progression of the creation of a single deposit guarantee fund, which is not expected to change in the short term.

Learning from mistakes

The problems arising from the lack of regulatory uniformity in the European Union came under the spotlight during the financial crisis. This occurred, for example, in the case of asset securitisation transactions (a mechanism allowing illiquid receivables to be transformed into marketable securities), which played a decisive role in the explosion of the crisis. Although the framework of the Basel II agreements and Capital Requirements Directive 1 (CRD I) envisaged the risks associated with these transactions and imposed specific capital requirements on banks, many member states availed of temporary opt-out clauses, thus preventing the transposition of the general regulations. In a globalised market such as the securitisation market, the cross-border groups did not have any major problems in taking advantage of this regulatory loophole and issuing their securities in the countries that had not adopted the new requirements. In the light of that discrimination, the European authorities strengthened the second version of the directive in order to sanction the countries with low capital requirements, but some member states postponed la application of the new regulations and benefitted from that competitive advantage in the capital markets for many months.

Situations of inequality also arose in relation to the definition of capital established in Basel III and replicated in the European directive. Transposition to the respective national legislation led to a wide variety of interpretations, some of which were clearly wrong, obliging the European Commission to initiate infringement proceedings for certain countries extended over several years, in order to force compliance with the directive's criteria. A similar case refers to the requirements for implementing internal risk models, whose importance for anticipating situations of stress and maintaining appropriate capital levels was another lesson we learned from the financial crisis. Their adaptation also led to situations of inequality among various member states and, as a result, similar exposure levels had very different capital requirements assigned to them.

This is precisely one of the issues that the ECB will shortly address.

Conclusions and recommendations

The Banking Union project potentially has a huge positive impact on the Economic and Monetary Union project, with which it will gain in terms of density and depth. Also, its appropriate implementation will ideally serve as a vaccine against future banking crises, by limiting the contagion effect typical of episodes of instability and minimising its impact on the taxpayers' pockets, who have recently witnessed in astonishment bailouts of European banks that have required massive public assistance.

The project will also help transfer monetary policy in a better manner and, in particular, interest rate policy to the actual economy, which in recent years has been affected by distortion caused by fragmentation of financial systems, giving rise to situations of discrimination in credit-granting circuits. However, Banking Union will also have significant consequences for the banks themselves, paving the way for a brand new phase in which they will probably have to modify their strategy, resources, internal organisation and even their business models, which could lead to an in-depth restructuring of the European financial map. These repercussions can be summarised and grouped into two short-term scenarios, in accordance with the project's operating schedule.

Short-term repercussions (up until 2016). This is undoubtedly the critical phase for banks, which must immediately face important challenges:

- The first challenge will be the exhaustive assessment of the main European banks, including three different consecutive tests that will be conducted before November 2014. This assessment will provide an overall valuation of each bank's degree of solvency, which could require capital replenishment or other measures for restructuring purposes. In this respect, the decisions adopted in respect of the banks' government debt securities is vital, which will ultimately be subjected to stress tests.

- Furthermore, the banks will have to adapt to an operative, preventive and strategic supervision model that is more reliant on internal control, governance and solvency reviews from a dynamic standpoint, rather than on accounting reviews. The new model will require substantial changes in the bank's internal organisation and, in particular, will make it obligatory to establish a clear risk appetite framework. This framework will include capital planning, risk management and control and internal audit policies. The banks will also have to take into account that supervision criteria will emanate directly from Frankfurt, causing national authorities to remain in the shadow during the process.

- The banks must pay utmost attention to capital and liquidity criteria planning (and not just compliance), which will determine comparisons with other European banks. Accordingly, the banks will have to develop complex models that include capital objectives in various risk scenarios.

- The adaptation process will demand investment in human and technology resources. The location of such resources is also subject to debate. The banks must decide whether it is convenient to relocate executive employees to Frankfurt in order to curtail the effects of being remotely distanced from the supervisor. In the very short-term, the banks face a serious problem involving the drain of qualified professionals. Not only do the banks have to fight among themselves in order to attract talent in a skewed labour market, where demand clearly outweighs supply, they also compete with the supervisory authorities themselves, which also need to extend and enhance their teams.

Medium- and long-term repercussions (from 2016 onwards). The entry into force of the new resolution framework largely determines the medium and long-term effects. The consequences for banks are as follows:

- Creditor seniority established in the bail-in, which will be activated in 2016, is a key component in each bank's liabilities structure and can affect its composition and cost. The bail-in criteria will also most likely influence investor decisions, which will attempt to avoid risking money per the 8% minimum requirements, which is a bank's first loss absorbency buffer.

- All the banks must prepare recovery plans, revisable each year, in order to cater for hypothetical emergency situations. Such plans oblige banks to provide an exhaustive detail of their internal structure, to identify which parts of their businesses are essential and establish a firewall system should their position significantly deteriorate. If this occurs, the recovery plan would serve as a guide for the Single Resolution Mechanism, which would be equipped with the necessary information to restructure the bank in an urgent and decisive manner.

- In the medium term, the banking sector is expected to undergo a process of restructuring and concentration, especially through mergers and acquisitions. Over the past five years, corporate transactions in Europe have been very scarce, partly as a result of mistrust among banks. If Banking Union succeeds in rebuilding trust in the finance industry, as expected, this will enable the banks to propose consolidation formulas in order to boost their profitability levels.

- In the long term, we should bear in mind that the European finance industry is heading towards a gradual reduction in terms of its size and influence on the economic fabric.

  The crisis has shown us that the sector has excess capacity and the unification of supervision will urge banks to adjust their balance sheets and reduce their risk exposure in order to develop business models that are safer and more sustainable over time.

  This reduction in the size of the European finance industry could mean that its activities might lose sway in the financing of the economy.

Economic effort. A problem affecting all the phases of the system's financing process. Single supervisory activities, centred at the ECB will be funded by the banks, which will pay a levy for the service. However, the finance industry will also fund the new Single Resolution Fund (which will be foreseeably constituted gradually between 2016 and 2024, up to a total of EUR 55,000 million), the bridging loans for national funds, as well as the future and still undetermined backstop, which will be created in 2024, as well as the deposit protection scheme network. Although they have been deferred, these contributions imply that significant efforts must be made by European banks.

However, we should not think that such efforts will alter the balance of the industry's income statement. We must take into account that during the 2008-2012 period, the annual profit from operations of European banks amounted to an average of approximately EUR 270,000 million (0.76% of their assets). In any case, the potential benefits of Banking Union will foreseeably and easily offset the industry's contributions to the system overall, in terms of stability, robustness and efficiency.

A more ambitious project. Banking Union will probably change the face of the European finance industry. It could also act as a driver in the long integration process of Economic and Monetary Union. Will it stop there or will it form part of a more ambitious harmonisation project progressing towards fiscal and political union? The debate, emanating from the deepest notion of Europe, is on.

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