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Last Call for a Banking Union in the Euro Area

By Diego Valiante*

Abstract

The current monetary policy framework to avert the ongoing financial disintegration in the eurozone and to break the vicious circle that ties up banks and governments in a death grip (liquidity ring-fencing) does not allow effective policies to deal properly with the problems affecting interbank cross-border money market lending or merger and acquisition activities of banks. To promote a real "banking union," this paper proposes two complementary interventions: a monetary policy intervention and an institutional set-up coupled with common recovery and liquidation procedures. The monetary policy operations, whether through unconventional open market operations or indirect funding of ad hoc vehicles, would need to stabilise the sovereign debt market to break the link between counterparty and country risk, which has boosted adverse selection and frozen the interbank market. Common EU recovery and liquidation procedures, on the other hand, would further promote banks' business integration and international diversification. An independent authority would implement these rules, with access to a resolution fund or a common deposit guarantee scheme.

Keywords: Banking union, EMU, eurozone, crisis management, ECB, monetary policy, collective action problem, interbank market

JEL Classification: E58, E65, G28, G33

The last European Council meeting at the end of June, with the "banking union" proposal (European Council 2012a) and the report on "a genuine economic and monetary union" (European Council 2012b), moved the issue of a "banking union" to the top of the EU agenda for the Economic and Monetary Union, which could potentially embrace countries that have not adopted the euro currency but have opt-in or opt-out clauses (the United Kingdom and Denmark). Besides this general agreement, the definition of what a banking union is and the steps towards a fully integrated financial framework are still open to interpretations about the prudential supervisory tasks to be assigned to the ECB, which are strongly influenced by national views. The general feeling is that "this time will be different," which means that it will be something that goes beyond the minimum harmonization principle in

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banking regulation and supervision. However, non-eurozone countries may find this approach too radical, even though a full-scale banking union might be the only way to re-establish a well-functioning financial framework, which has been severely impaired by the continuing eurozone debt crisis. As a result, the final outcome is directly influenced by the intensity of the problems experienced in the banking sector across the euro area and the extent to which the current Treaty can be stretched to achieve a common supervisory framework. In the end, banking union may mean something different for euro area countries than it does for non-euro area countries. To avert financial disintegration, a mixture of monetary policy interventions and a new institutional and regulatory framework would be required.

1. The Reasons for a Banking Union

The financial crisis in the eurozone has intensified dramatically in the last year. The crisis has intensified the funding problems in the banking sector, which led the European Central Bank to intervene with a massive lending facility of roughly €524 billion (net lending).[1] Instability in the banking system in the Eurozone is mainly caused by moral hazard and adverse selection problems. The moral hazard issue fosters liquidity ring-fencing in national boundaries (Draghi 2012), while adverse selection impedes the restart of cross-border interbank activities for the risk aversion of northern Eurozone banks. This situation hampers the transmission channels of monetary policy, as liquidity injections by the ECB have not been able to restart a well-functioning interbank market.

2. Moral Hazard

Moral hazard is a long-standing issue in banking but fairly unexplored when linked to financial stability issues in the monetary policy transmission channels. Blundell-Wignall and Atkinson (2011) have recently tried to establish a clear link between profitability (return-on-equity) and size of the bank, in particular in times of crisis. As banks lose profitability, they generate returns by simply exploiting their scale through additional leverage and the implications of becoming 'too-big-to-fail'. The current crisis has shown the same problem with a slightly different flavour but more aberrant implications. Banks have gradually acquired huge stakes in the debt and activities of national governments using mainly Eurosystem funds, so de facto tying further their end to the default of governments and vice versa (see Figure 1 and Table 1; see also Merler and Pisani-Ferry 2012). This carry trade has therefore enhanced "home bias" in banking, which is a fairly explored issue in investment portfolio theories.

[1] Author's calculation from ECB data warehouse.

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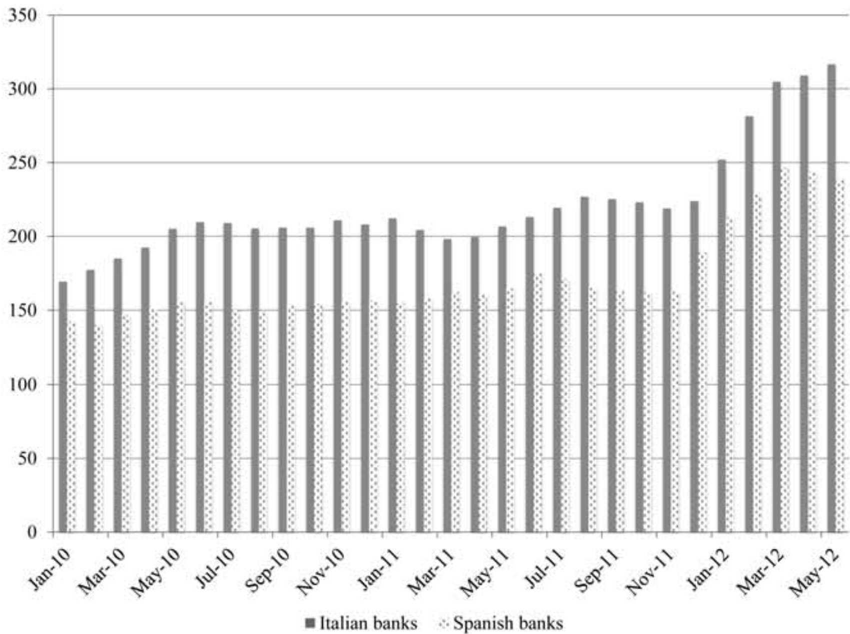

Sources: Bank of Italy and Bank of Spain.

Figure 1: Government Debt Securities Holdings by Spanish and Italian Banks

The link is even more evident if we sum the securities holdings of national government bonds to the total loans given to the public sector (see Table 1).

Table 1

Total Holdings of Securities and Loans to the Public Sector (€bn)

	Italy			**Spain**			**Germany**		
	Securities	Loans	% Total assets	Securities	Loans	% Total assets	Securities	Loans	% Total assets
2010	207.03	258.87	12.39%	156.70	164.72	9.89%	213.85	418.45	7.57%
2011	295.00	257.47	13.67%	190.20	198.02	11.42%	199.51	359.83	6.61%
2012 (May)	346.05	266.13	14.55%	239.00	245.63	13.74%	204.86	359.85	6.32%

Sources: National central banks.

Spanish and Italian banks have respectively 13.74% and 14.55% of their total assets invested in the domestic public sector, double the amounts that German banks have invested in their own government's activities, which adds up to a banking sector already lacking international diversification (see Figure 2).

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Despite public statements, the ECB has used long-term refinancing operations (LTROs) to stabilise the sovereign debt market as well, but evidence unfortunately shows that the effects of LTROs have been temporary and generated side effects, such as moral hazard and the inability to disentangle counterparty risk from country risk in the risk assessment of financial institutions.

In effect, this first "moral hazard" loop is difficult to tackle by policy-makers. Due to their massive holdings of public debt and loans to public institutions, governments struggle to let their national banks to default or to undergo intra or cross-border hard restructuring, as it could result in a massive sale of public debt on the market and liquidity withdraw for public authorities (besides layoffs and the liquidation costs for the economy), which would then send interest rates through the roof and perhaps push the member state to lose market access or to carry on costly bailouts. As a result, the eurozone is experiencing a deep retrenchment behind national boundaries to preserve liquidity ("liquidity ring-fencing"), also when dealing with proposals to get tougher with banks. The discussion on capital requirements in some respect epitomizes this structural problem. Both banks and governments have been free riding on ECB intervention, which makes monetary policies even further ineffective.

3. Adverse Selection

Early signs of adverse selection and risk aversion problems emerged in the interbank market already in 2010. The difficulty for viable financial institutions to finance themselves at acceptable interest rates due to the inability of the lender to distinguish between good and bad borrowers has led to a gradual breakdown of the interbank market, especially for southern eurozone area banks (Akerlof 1970, Stiglitz and Weiss 1981). The difficult situation became worse once markets began to discount the Greek debt restructuring and the uncertainty surrounding the terms of the private sector involvement in mid-2011 (boosting contagion effects). Due to the strong links of banks with public finances and a lack of international diversification in the banking sector of southern European banks (see Figure 2), country risk has been the main component in the evaluation of counterparty risk in the interbank market. The inability to price counterparty risk properly, due to uncertainty on the effects of country risk on exposures, has indiscriminately pushed interest rates up for southern eurozone banks and then crowded out good-quality borrowers.

Instability in the sovereign debt markets therefore increases country risk problems and risk aversion by northern EMU banks towards southern EMU banks suffering from troubles in government finances and national accounts, boosted by their lack of international diversification.

As a result, northern eurozone financial institutions have drastically reduced flows of funds to institutions in the southern eurozone, even though most of them still run a viable business. ECB president has explicitly called it, a "collective action problem", due to "liquidity ring fencing" by member states (Draghi 2012).

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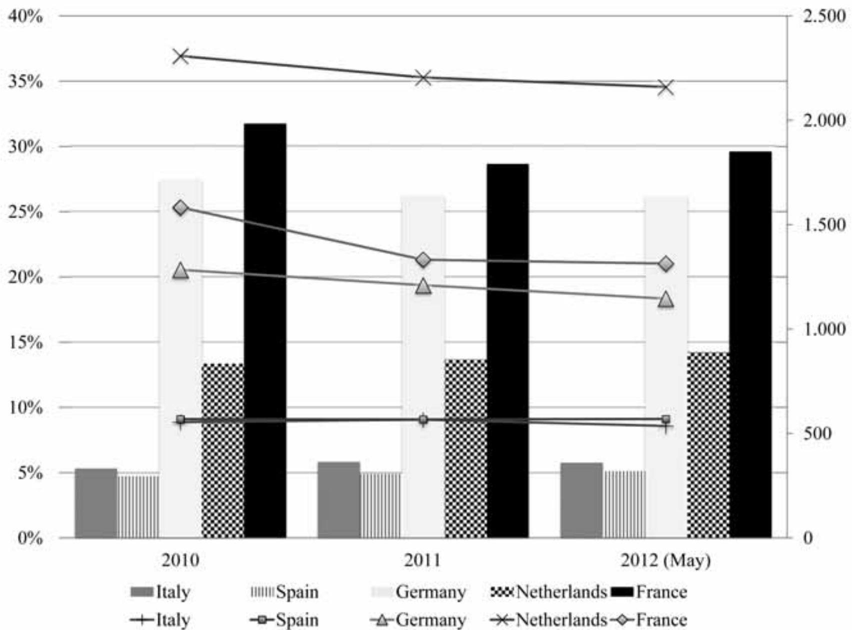

Sources: National central banks.

Figure 2: Foreign Assets (bars, rhs; €bn) and Foreign over Total Assets (%)

Figure 3 above shows the spread between Euribor 6-months and 1-month, and compares it with the spread between Euribor 6-months and EONIA (Euro Over-Night Index Average) interest rates. Since the beginning of the sovereign debt crisis, i.e., when the Greek government in 2010 requested financial assistance from the euro area, differentials began to move in opposite directions, showing that banks were not willing to lend more than overnight. Since then, the interbank market has not really recovered, and the attempt by the ECB to raise interest rates in 2011 has aggravated the market distress (see Figure 3). Markets struggled, despite the relaxation of collateral requirements for sovereign debt of Greece, Ireland and Portugal, and the acceptance of debt instruments not listed on regulated markets as collateral for refinancing operations at the height of the interbank market crisis (ECB 2011). As a result, at the end of last year, the ECB had to reverse its policy by lowering interest rates to 2010 levels and start a massive lending operation to re-establish equilibrium in the interbank market. The situation is currently very weak and, as a result, the ECB has lowered even further the nominal interest rates (now at 0.75%) and the rate on deposits to 0%. The last move has caused a drop in the deposit facilities and an equivalent jump in current account holdings to the ECB (see Figure 4), as financial institutions fear that the ECB may soon turn interest rates on deposits negative to push banks to use liquidity in the interbank market or directly to support the economy. Despite these interventions, the interbank

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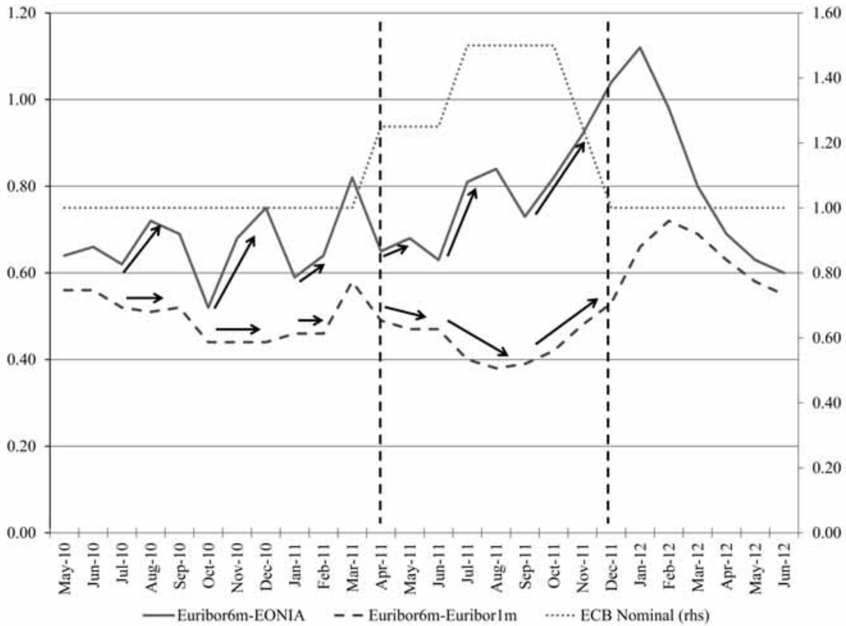
market is still not functioning properly, particularly in a "cross-border" context (Draghi 2012).



Source: ECB data warehouse and monthly bulletins.

Figure 3: Interbank Market Distress (%)

The ECB has de facto become the central counterparty of the Eurosystem, taking on counterparty risk, fed by soaring country risk that has impaired the interbank market. As the figure below suggests, the ECB's attempt to replace the interbank market for southern eurozone banks is reflected in the Target 2 net claims.

50% of Eurosystem total lending has been so far given to Spanish (26.81%) and Italian (23.19%) banks through their respective central banks, especially after the interbank market began to break down after July 2011. In 2012, the funding from the Eurosystem has increased with the long-term refinancing operations to roughly 6% of Italian banks' total assets and 8.4% of Spanish banks' total assets.

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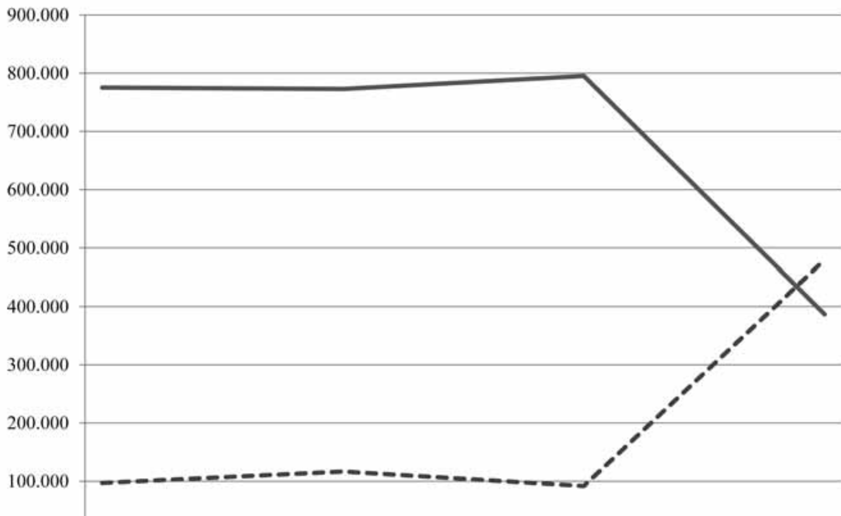
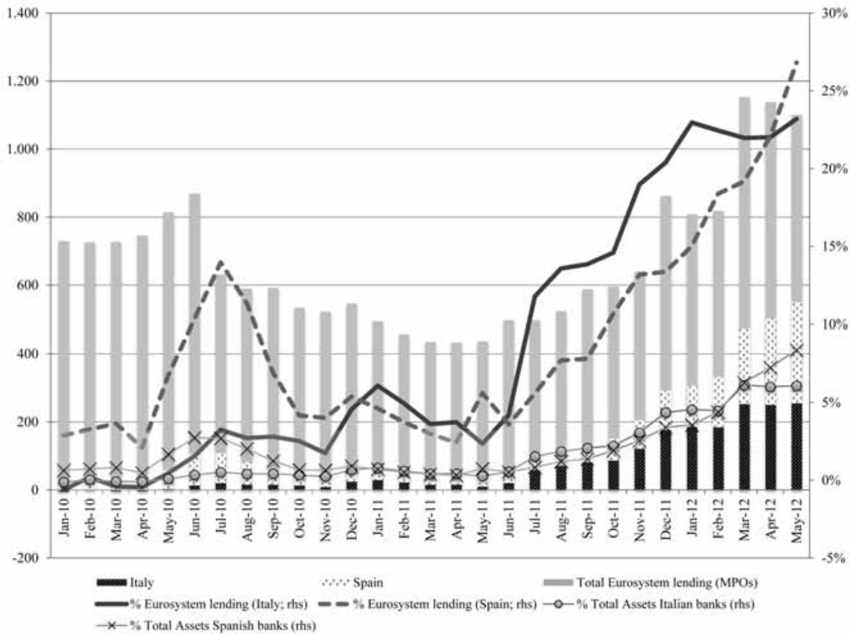


Source: ECB data warehouse.

Figure 4: Deposit Facility versus Current Accounts (€mn)



Sources: ECB data warehouse, Bank of Italy and Bank of Spain.

Figure 5: ECB as a Central Counterparty

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4. Adverse Selection Problems: Avoiding the "End Game"

Breaking the interdependence between banks and governments would restart the interbank market and restore a well-functioning financial framework. A mechanism to signal the quality of counterparty risk can effectively minimize adverse selection. This mechanism would only be effective if massive monetary policy interventions to provide liquidity to monetary financial institutions with limited discretion are confined to exceptional circumstances. These actions may only dilute the effectiveness of risk signalling mechanisms.

To break the first part of the link between banks and governments and restart the interbank market, the ECB needs to stabilise the sovereign bond market. Unlimited liquidity funding to banks has proved costly and ultimately damaging for the banking system itself. The ECB can instead intervene directly with its purchase programme, which could then become a more efficient form of quantitative easing (rather than the inefficient Securities Markets Programme; see Valiante 2011), or through unlimited credit lines to the European Stability Mechanism (see Gros and Mayer 2011). A more stable sovereign debt market would give banks greater ability to price country risk that has impaired their risk evaluation function so far. Unconventional monetary policy actions to stabilise the interbank market would fall under the responsibilities given the ECB by the Treaty. Financial flows would then gradually move again from northern to southern peer banks. By repairing the connective tissue of the whole euro area banking system, rather than addressing the problem as confined to national boundaries, the financial framework could rapidly stabilise and give space to more fundamental political discussions to take place in the fiscal policy area.

With a limited intervention to stabilize the sovereign bond markets, adverse selection issues would continue to break down the interbank market, but also to impair the financial institutions' trust in the stability of the entire system, and more precisely the credibility of ECB actions in being effective and truly independent from fiscal policy objectives of national governments. In effect, all measures pursued by the ECB so far have been ineffective, and have rather increased the damaging link between banks and governments (and so financial disintegration). Stabilizing the sovereign debt market through ECB direct or indirect intervention can help the interbank market in the short-term and create the necessary conditions for liquidation and restructuring of non-viable banks, ergo promoting greater financial stability over the medium term. If financial institutions feel that the ECB's actions are ineffective and, despite its main task to stabilize the financial system given by the Treaty (art. 3.3, ESCB Statute), for political reasons the ECB would not be allowed to use all available tools in its power (in violation of art. 7 of the ECB statute), including non-conventional monetary policies, its credibility would then be seriously in danger. Even the International Monetary Fund (IMF 2012) has recently called for new monetary policy interventions in the euro area, which could also include "non-conventional" monetary policy operations, such as a quantitative easing. In effect,

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the loss of credibility could produce a run on ECB deposits, which will be transferred into a safer currency or asset. This scenario would spell the end of the euro, before governments can even decide whether to save or not the common currency. In general, we refer to the ECB's credibility as its political independence. However, ECB's inability to take actions that can materially repair the broken transmission channel of monetary policies is the other side of the "credibility" medal. For this reason, the ECB announced the Outright Monetary Transactions (OMT) programme, which involves the purchase of short-term government bonds (up to 3 years) for countries that have requested support to the European Stability Mechanism (ESM). The implications of this intervention are manifold and it essentially binds an intervention of monetary policy to the implementation of strong fiscal policy conditions, required by the application to the ESM.

5. Restraining Moral Hazard from Operations: A Common Recovery and Liquidation Authority

Monetary policy intervention, especially in this case, would only be a temporary fix for the banking system. The euro area also needs to deal with the moral hazard problem in banking. Unlimited protection of otherwise no longer viable national banks and lack of international business diversification endanger the financial system and euro area public finances consequently. Since the sovereign crisis erupted in 2010, and despite worsening economic conditions, the number of MFIs in the euro area and their total assets have remained pretty much the same, whether you are in Germany, Spain or even Greece (see Figure 6).

Very limited restructuring and liquidations of banks running almost-bankrupt businesses across the euro area have become a growing concern for the integrity of the banking system. However, the ability to deal with this situation can only emerge once a more integrated prudential supervision has been put in place. Besides monetary policies, prudential supervision relies on two main tools of intervention to be effective: capital requirements to fine-tune banks' behaviour in cyclical market conditions and a common recovery and liquidation procedure, run by an independent authority that can access funds of a common deposit guarantee scheme (or resolution fund) to protect depositors in the liquidation process of the bank, to avoid risks of contagion and bank runs (so called "knock-on effects"; De Larosiere 2009). The US experience with the Federal Deposit Insurance Corporation (FDIC) can be a good example to begin discussions in Europe.[2] On the one hand, common capital requirements, regularly adjusted against the business cycle by an institution like the ECB or the European Banking Authority rather than by a lengthy legislative process, could be a flexible tool to control banks' misbehaviour as market conditions evolve. The systematic failure over the years of capital requirements set through a

2 For an interesting overview of the subject, please see Tett 2012.

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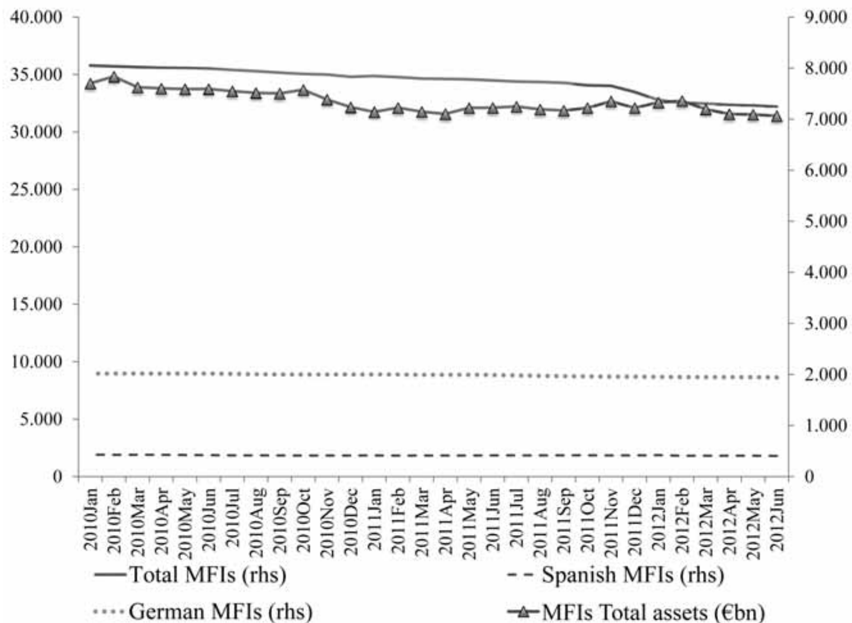

Source: ECB data warehouse.

Figure 6: Number of MFIs in the Euro Area (rhs) and Total Assets (€bn)

legislative process subject to strong regulatory capture stands today as a widely recognized policy failure that should not be promoted further. On the other hand, a common recovery and liquidation set of rules, governed by a eurozone-wide authority, would potentially complete the process of banking reunification. The authority would be assigned the task to implement these rules and decide about the recapitalization of banks that still have a "going concern," but with the application of strong conditions, such as restructuring (with the removal of the management and executive directors) or split of viable (good assets) from non-viable business (bad assets), the latter of which would then be liquidated. In effect, this would open the possibility for cross-border mergers and acquisitions and for other banks to price counterparty risk and be able to take over businesses that can be still successful. This situation also allows governments to free ride ECB intervention, by not forcing banks to wind down businesses, as this would impose additional costs on national budgets if they would need to use the national deposit guarantee scheme.

The recovery and liquidation authority (RLA) would need to be endowed with three elements to be effective:

1. Eurozone-wide common recovery and liquidation procedures;
2. Eurozone-wide deposit guarantee scheme; and
3. Independence.

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A euro area common recovery and liquidation procedure would be implemented in derogation of national bankruptcy laws. Current powers given by the Treaty for the prudential supervision of financial institutions do not allow EU institutions to implement EU-wide liquidation procedures. Even the recent Commission proposal for a "Directive" relies on member states to create a liquidation authority and to start liquidation under the national deposit guarantee scheme, following common guidelines on bank recovery and resolution (European Commission 2012). With specific Treaty changes, proposed under a "banking union" initiative, a EU common recovery and liquidation framework implemented by the common authority would only apply to credit institutions that meet a minimum criterion, which could imply, for instance, that their business activities have an impact on cross-border euro area financial flows. The authority would assess this "cross-border" impact by looking at a minimum holding of foreign assets or at strong financial linkages with banks running a business that meets the foreign assets condition. The enforcement of recovery and liquidation rules would then be limited only to situations in which banks do not comply with capital requirements for a pre-determined time period or if they ask direct (equity) or indirect (loans) capital injections to governments or any other governmental or European body (at the exception of the Eurosystem). An exemption for the Eurosystem, in effect, would preserve the ECB from the influence of the RLA on monetary policy operations, in case the resolution of the bank could create more systemic issues for financial stability. The authority should then be invested of investigatory powers and the authority to impose restructuring and losses on shareholders and creditors with no advance notice, as well as the possibility even to press criminal charges under national legal systems in case of negligence. It could also impose a change of top management and directors and exercise control over remuneration policies. The European Court of First Instance, which sentences in this area could be appealed in very specific cases to the European Court of Justice, would deal with disputes arising from the liquidation process.

A second key element to set an effective recovery and liquidation authority is the flexible access to a resolution fund, which would become a eurozone-wide common deposit guarantee scheme (as supported by Van Rompuy report 2012). This fund can be financed directly by contributions from banks (for instance, based on their leverage ratio[3]), with additional resources provided by the ECB in case initial resources prove inadequate to guarantee a sufficiently high level of protection to depositors to avoid a disorderly bank run (the limit of €100,000 may need to be revised upwards). If member states decide to give the European Stability Mechanism (ESM) a banking license or the ECB decides to buy ESM debt on primary and secondary markets to intervene more boldly in sovereign debt markets, there would be an even more concrete possibility for the ESM to run this authority and the deposit guarantee scheme, perhaps with the support of the ECB for initial staffing. Beyond

[3] The ability to lever gives to bank additional benefits and ability to free-ride and contribute to costly financial stability interventions.

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the start-up endowment of the fund, additional money needed to protect depositors could be raised in debt markets (also with ECB support) and repaid by all euro area banks with a predefined burden sharing. Finally, the ESM can also deal with the recapitalisation of the bank.

The third essential condition is the independence of the authority. A recovery and liquidation authority must act independently from the influence of monetary and fiscal policy institutions. It could report to the European Parliament from time to time or when explicitly requested to keep democratic control over its activities, but only European courts would control the merits of its decisions. If the authority would be run by the ESM, the Managing Director and its staff under the supervision of the Board of Directors would directly apply the common liquidation rules and procedures, and decide on the use of the guarantee fund in the resolution of a bank. The Board of Governors itself would have limited or no control over the implementation of liquidation procedures in order to avoid conflicts of interest between the activities of the authority and the fiscal interest of the national governments to keep non-viable national banks alive. Full control on decision to recapitalise banks will be kept intact. To make this independence even more real, an information-sharing obligation for the Eurosystem and national financial authorities must be put in place. Reliable and immediate information flows are essential to complete a restructuring, reorganization or liquidation of a financial institution's business unit at any time. Finally, to keep its independence, the authority will be funded by the resolution fund (or deposit guarantee scheme), which will need to be kept at a pre-defined level over time.

6. Some Legal Issues

Despite the support expressed for a banking union at the last European Council, certain legal interpretations of the Treaty need to be clarified in relation to the use of art 127.6 of the EU Treaty (EUT) in order to give powers to the ECB on prudential supervision that are able to really establish a banking union as described above. In effect, changes to the Treaty may need to be implemented even if member states decide to go only for a light version of banking union, where the ECB gets only supervisory control over macro-prudential aspects, but not over the implementation of capital requirements. Under this article, the European Council can give "specific tasks" on prudential supervision of financial institutions through a special procedure and unanimous vote to the ECB (after consulting the European Parliament and the ECB itself). Despite this possibility, art. 65 EUT (to be read together with art. 25, ECB Statute[4]) clarifies that prudential supervision (with fiscal policy matters) is a prerogative of member states, and in particular the article says that member states

[4] ECB can only offer advice on the implementation of the Union legislation relating to prudential supervision of financial institutions.

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can "take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions […]" (art. 65.1b, EUT).

So, can the European Council give meaningful prudential supervisory powers (as a "specific task" that is not "ancillary") to the European Central Bank if, under art. 65 EUT, European institutions do not have these powers in the first place? A preliminary interpretation could say that, under art. 127.6 EUT, the European Council can only shift to the ECB specific task (powers) on prudential supervision that are already under the umbrella of the Treaty assigned to EU institutions and that art. 65 EUT does not leave much space to derogate from the subsidiarity principle that is indirectly called in, even though this crisis shows how dangerous is for the financial system to keep prudential supervision at national level while the financial system become even more strongly integrated at Eurozone level (even if supra-national decisions may have an impact on fiscal policies). However, the uncertainty on how to best interpret the Treaty may require a further discussions and ultimately a Treaty change, also to avoid long litigations in European courts.

In any case, the creation of the RLA and common recovery and liquidation procedures across the euro area (or the EMU, for countries that did not participate to the euro, or the European Union as a whole) through the actions mentioned above would certainly need a change of the Treaty to be ratified by all EU members or a separate Treaty only ratified by eurozone countries.

7. Boosting International Diversification in Banking Business Models

Recovery and resolution procedures coupled with a more stable sovereign debt market may prove essential steps to build a banking union. However, lack of international diversification of southern EMU banks and liquidity issues is another element that accelerates the downward spiral in the banking sector. Let us look at the three largest banks in Italy and Spain. Their financials are very depressed (see Table 2), which is generally attributed to an effect of the ongoing financial crisis in the euro area region and to the difficulties of the overall sector.

However, there are specific differences that may tell us a different story. First, the market capitalization of the three biggest Italian banks is just around €27 billion (see Table 2), which is the full market capitalisation only of the second Spanish bank. This situation opens many questions, and in particular why is this so, if the business of Italian banks is still considered viable and the Italian economy is considered more solid and diversified than Spain. Why are these banks unable to attract investors' appetite to gain control? The level of international diversification of their businesses may be a reason that protects these three specific Spanish banks, as they are more international players, but this aspect alone would not explain such big difference (Unicredit has also a partial international business diversification). Another

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Table 2

Top 3 Italian and Spanish Banks' Key Financials

	Domestic Market Capitalisation (€bn; 20 July 2012)	Total assets (€bn; end 2011)	P/E[5]	ROE[6]	EPS[7]	Last 52–week stock market price return	Debt to equity	ROA
Italy								
Unicredit	14.12	926.77	7.61	–12.95	–5.8	–71.98%	189.2	–0.85%
Intesa Sanpaolo	15.23	639.22	6.99	5.89	0.13	–69.13%	–	0.47%
Monte dei Paschi	1.95	240.72	10.23	–31.58	–0.59	–70.34%	213.71	–2.05%
Spain								
Santander	43.54	1,251.53	6.26/8.35	8.74	0.72	–40.95%	303.23	0.59%
BBVA	26.92	597.69	8.3	7.56	0.6	–36.90%	44.01	0.58%
La Caixa	8.87	282.41	10.04	3.87	0.23	–44.80%	17.75	0.29%
Tot. industry	–	**34,211.82***	**18.98**	**8.51**	–	–	**188.68**	**0.56%**

Source: Bloomberg, Reuters, Annual reports and ECB data warehouse. *Euro area MFIs.

reason would be the presence of mechanisms of governance in Italy that may increase the costs of acquiring control over these banks (such as bilateral agreements among shareholders and other control-enhancing mechanisms). For instance, let us assume that there is a northern euro area bank with excess deposits that could be potentially interested in taking over control over one of these banks or over part of their business. The acquiring bank faces tough challenges in dealing with ex-ante evaluation of cross-border operations, due first to the important country risk linked directly to the holdings of public debt, loans and domestic assets that these banks have on their balance sheet (as mentioned above in the section on adverse selection). Country risk is further enhanced by a broader financial crisis in the area. Liquidity and loan performance indicators are suffering from the deepening of the financial crisis (see Table 3).

In addition to this underlying indicators, there is also a lack of incentives by current member states to help the acquiring bank that does not have a strong home bias, for obvious reasons linked to their own funding needs. This situation points, among other things, to the importance of the independence of recovery and resolution procedures from fiscal policies. There is additional uncertainty that interpretation of national liquidation procedures by national judges may impose restrictions to the reorganization of the company that could be rather costly (legal uncertainty).

5 Share market price over earnings per share.

6 Returns on equity, i.e., net income over shareholder's equity (no preferred shares).

7 Net income, minus dividends, over average outstanding shares.

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Table 3

Some Liquidity and Capital Indicators

End 2011 – €bn	Cash over non-performing loans %	Cash and equivalents (% assets)	Financial assets available for sale (% assets)	Total Capital (% assets)	Tier 1 ratio (Total Capital Ratio)	Non-performing loans* (% Tot. Loans)	Impaired loans" (% Tot. loans)	Total loans (% assets)
Italy								
Unicredit	53.68%	9.73 (1.05%)	57.92 (6.25%)	52.48 (5.66%)	8.4% (12.37%)	18.13 (3.24%)	40.18 (7.18%)	559.56 (60.38%)
Intesa Sanpaolo	18.91%	4.06 (0.64%)	68.77 (10.76%)	97.8 (15.3%)	10.1% (14.3%)	21.47 (5.7%)	1.13 (0.3%)	376.74 (58.94%)
Monte dei Paschi	13.63%	0.878 (0.37%)	22.91 (9.52%)	10.77 (4.47%)	11.1% (15.7%)	6.44 (4.39%)	7.04 (4.8%)	146.61 (60.9%)
Spain								
Santander	331%	96.52 (7.71%)	86.61 (6.9%)	82.86 (6.62%)	11.01% (13.56%)^	29.18 (3.89%)`	na	750.1 (59.94%)
BBVA	215%	30.94 (5.18%)	58.14 (9.73%)	40.06 (6.7%)	10.3% (12.9%)	14.39 (4%)	na	359.86 (60.21%)
La Caixa	29.6%	2.71 (0.96%)	35.12 (12.44%)	23.2 (8.22%)	11.8% (16.6%)	9.15 (4.98%)`	na	183.74 (65.06%)
Dexia (end 2010)	120%	3.26 (0.58%)	2.93 (0.52%)	10.18 (1.77%)	13.1% (14.7%)	2.72 (1.03%)	na	264.3 (46.64%)

Source: Annual reports. *Net amounts over total loans. "Past due loans or other deteriorating factor. `It may include past due loans. ^BIS II ratio

A past example of the implicit costs of not having a common recovery and resolution regime enforced by a common supranational authority is the Dexia case, which received state capital in 2008. The Belgian government, after the recapitalisation, did not pursue an effective reorganisation of the bank and protect depositors in a broader operation of liquidation of business units that were clearly struggling to fund operations. The interest was in keeping the whole business alive, thanks to the short-term funding of the ECB via the Belgian central bank and government guarantees (De Groen 2011), for the sake of avoiding knock-on effects on key assets and funding operations of the Belgian government and so additional layoffs. The table below above clearly show the bad liquidity conditions of the bank already at the end of 2010. An effective prudential supervisor would have forced the bank to find alternative forms of restructuring or liquidation before getting into an irreversible situation that, with no liquidation authority and guarantee fund, has been indirectly paid once again by taxpayers' money.

As shown in Table 3, The Italian Monte dei Paschi (the oldest bank in the world) is in a similar situation with very low liquidity available (at the end of 2011 cash was only 0.37% of total assets or around € 800 million) and, despite the ECB liquidity interventions with long-term funding earlier this year (for over € 33 billion),

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the bank has asked for additional liquidity support from the government through the so-called Tremonti bond scheme, which is not so different from a request for a direct capital injection. However, the capital injection will not force the bank to undergo a major restructuring and, in particular, to a change of its governance, which relies on an invasive control by a mixture of strong private and political interests with serious conflicts of interest. In effect, the bond scheme allows the bank to issue debt securities that are then purchased by the Treasury. The debt is fully subordinated to all other debt, besides shares. These securities do not have maturity and can be refunded by the bank at any time. It leaves the possibility to the bank to request conversion of debt into equity. The Treasury only gets paid the interests (with a rate from 7.5%) when the bank is in the position to distribute income to shareholders. The Treasury, however, requires conditions to the approval of the operation, which are not linked to the business of the bank (restructuring, etc), but merely promises about increasing lending to small and medium businesses or suspend the mortgage instalments for workers with specific job-related issues. The bank, after three years, can convert the debt into equity. This debt is recognised as core tier 1, which gives to the bank additional possibility to leverage and expand the business. Due to the financial conditions applied to the capital injection and conditions that do not force the bank to a major restructuring, the European Commission would need to make a thorough assessment of the programme under State aids rules.

These two cases are just examples of the distortions that exist in the banking system of the euro area, with no harmonised prudential supervisory framework. If the recovery and liquidation procedure system proposed above were put in place, after the request for recapitalisation to the government or to the ESM/RLA itself, the RLA would have stepped in and decided which part of the business should have been resolved and which part of it should have been recapitalised, perhaps giving the possibility for a potential acquirer to step in as it has been done in few other cases such as for Fortis Bank. Depositors would have been protected by the deposit guarantee scheme and the sale of assets. The government would have not particularly suffered, as the ECB would have kept control over the stability of the sovereign debt market in case a sale of public debt would have been required.

8. Conclusions

At the heart of the current banking crisis, there is the inability of the policy framework to break the vicious circle that binds banks to governments and vice versa, and impedes cross-border interaction, such as lending or mergers and acquisition activities.

To break this circle and create a real 'banking union', this paper proposes a set of measures that can be split in two complementary interventions:

1. Monetary policy intervention; and
2. Common recovery and liquidation procedures.

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Monetary policy operations, whether through unconventional direct operations (e.g., OMT) or indirect funding through ad hoc vehicles (such as the ESM), would need to stabilise the sovereign debt market to break the link between counterparty and country risk, which has increased adverse selection especially in the interbank market. It would reduce the adverse effects of the adverse selection problem described above.

The second set of measures would aim at increasing international diversification in the banking business through a common recovery and liquidation procedure that would supersede national bankruptcy laws and would be implemented by an independent authority with its own deposit guarantee scheme, funded by banks' contribution and ECB support if insufficient. These measures would reduce adverse selection and the banks' home bias that feeds the vicious circle between banks and governments, i.e., the moral hazard of banks and governments that free ride the role of the ECB as central counterparty. It would then promote cross-border integration and major restructuring to support the ongoing deleveraging process in the private sector.

Opponents of a monetary policy intervention in the sovereign debt markets argue that with a solid banking system in place, banking-sector losses would no longer threaten the solvency of solid sovereigns, and the bail-out of less reliable sovereigns would no longer be necessary (Belke 2012). This statement does not find support from empirical evidence. In developed economies, there is no solid banking system with a bankrupt national or federal government. The opponents' argument may be partially true if euro area countries continue their effort to build federal democratic institutions that will create a political union, which cannot be achieved through a banking union. A banking union cannot make up for the lack of fiscal integration in a common currency area. Without a strong federal government that is able to support the deleveraging in the private sector and the structural imbalances in the Eurozone, the worsening of market conditions, that even member states like Germany are starting to experience, will inexorably continue.

This proposal outlines a roadmap to achieve a banking union in the euro area, which is only the initial step of a broader long-term exit strategy. This roadmap, however, may be insufficient if not accompanied by member states' political support for the effective implementation of these measures into national systems and the institutional set-up to break the link between national banks and national governments. New common democratic institutions may offer to citizens these needed reforms, but this would be the subject of another story.

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