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The European Banking Union and its impact on the solution to the Italian banking crisis

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INTRODUCTION

The Global Financial Crisis of 2007-2009 was confronted with dissimilar instruments in the United States and the European Union, partially due to the different means of intermediation in the two economies, but mainly because EU Member States did not manage to react in a homogeneous and unified way as occurred, instead, across the US.

The much slower recovery resulting from the incapacity of EU participating countries to act as a single body emphasized the urgent need to set up a Banking Union that would provide unique supervision across all Member States, ensuring the respect of uniform capital requirements rules, homogeneous resolution measures to allow for the orderly restructuring of failing banks all over Europe and, eventually, a sole Deposit Insurance Scheme that would consent risk-sharing among the individual banking systems, enhancing depositors' confidence.

In the specific case of Italy, thanks to the fact that Italian banks were still based on a business model mostly focused on traditional commercial banking activities and their domestic market, they initially had limited exposure to international markets and they were only indirectly affected by the spread of the financial instability coming from the US. Subsequently, however, Italy represented one of those countries of peripheral Europe that were heavily hit by the delayed effects of the Global Financial Crisis; as a consequence, the Italian solvency-type banking crisis was deferred compared to the rest of Europe – in contrast with the liquidity-driven crises that the majority of other countries had experienced –, which implied an even more serious retard on the recovery of the Italian economy.

Due to its delay, when the Italian banking crisis emerged, the European rules adopted in the context of the newly established Banking Union were already in place and Italian failing banks were one of the first experiments of the practical functioning of the new resolution measures. The Italian experience, together with the opinion expressed by experts of the field in relation to a first assessment of the functioning of the Banking Union, gives a preview of the benefits brought about by this new institution, but also highlights its major current imperfections and the necessity of further improvements.

This work aims at qualifying the constitution of the Banking Union as a reaction to the last Global Financial Crisis, describing its main bodies and analysing their impact specifically on the Italian banking crisis, ultimately providing a first assessment of these new mechanisms.

The first chapter gives an overview of the development of the 2007-2009 financial crisis through its main phases, from its underlying causes to the different measures put in place in reaction, making a comparison between the US and EU countries.

The second chapter describes all European reactions to the crisis besides monetary policy intervention, including demand and supply side policies – namely, the Juncker Plan and the Capital Markets Union, in response to the consequences of the shortage of risk-free assets on corporate financial behaviour and financial assets allocation respectively – and bank regulatory responses. In this context, section 2.2 provides a sketch of the legacy underlying the Banking Union and a delineation of the working of its three pillars – SSM, SRM, EDIS.

The third chapter analyses banking crises in general and then specifies the characteristics of the Italian one compared to other EU nations, presenting examples of how banking failures were managed in Italy in the light of the newly established measures in the context of the Banking Union; section 3.2 focuses on the particular case of Veneto Banca, as it provides quite a complete overview of the actual application of the Banking Union functioning and for its resounding media echo.

Finally, the fourth chapter discusses the main issues that need to be faced to reach a complete and well-functioning Banking Union, taking into account the single imperfections of each pillar and what consequences they may imply on the effectiveness of the whole system.

CHAPTER 1: THE GENERAL CONTEXT

1.1 The Financial Crisis of 2007-2009

1.1.1 The Safety Trap Mechanism and the shortage of risk-free assets

As explained by Nava[1] and Marchesi in their article "The EU response to the financial crisis and the economic recession"[2], the first cause of the unfavourable conditions that led to the international financial crisis of 2007-2009 can probably be identified in the Safety Trap Mechanism, which was triggered in the years preceding the crisis due to the coincidence of two phenomena.

Firstly, the so-called *great moderation era*, represented by long periods of expansionary monetary policies in the US, led to a steady fall in interest rates, which further accelerated and spread outside the US starting at the beginning of the new century. At the same time, the world financial markets assisted to a growing demand for safe assets.

In an economy displaying growing demand for safe assets, equilibrium in the safe assets markets is generally restored with a reduction in interest rates; in a situation of already very low interest rates, however, this eventually leads interest rates to hit the zero lower bound and at that point monetary policy becomes ineffective. "And when the economy falls into a safety trap, equilibrium can only be restored by reducing demand for safe assets (via a recession) or by increasing their supply" the two authors state.

1.1.2 The Credit Boom

The shortage of risk free assets provided a powerful incentive for the US and EU securitisation markets, which responded through intense innovations especially in the mortgage market; it has often been the case in the past that financial crises emerged specifically as a consequence of liberalization or introduction of innovations,

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[1] Italian economist, high official in the European Commission and President of Consob (the Italian managing body of the Stock Exchange) from April 16 until September 13, 2018.

[2] Marchesi, M., Nava, M., *The EU response to the financial crisis and the economic recession: the Juncker Plan, the Capital Markets Union and the Banking Union.*

as they create a powerful incentive for financial institutions to increase their lending. The last financial crisis was no exception in this sense.

As a matter of fact, financial engineering allowed the creation of structured credit products designed to appeal investors with different risk preferences - such as Collateralized Debt Obligations - and advances in information technology made it easier to securitize subprime mortgages.

Securitization consists of merging various financial assets into a large pool and then dividing them into smaller pieces according to risk: through this process, the market receives more liquidity by enabling smaller investors to purchase shares in a larger assets pool; this process was originally meant to create safer assets and disperse credit risk – while in practice this was not really the case.

This is probably why US securitization astonishingly changed in scope in the last decades, rising from less than 35% in 2000 to more than 70% of nonconforming mortgages being securitized by 2007[3].

1.1.3 Information asymmetries and Agency problems

The credit boom, characterized by increasing lending from institutions, was accompanied by an aggravation of information asymmetries and agency problems.

First of all, being the securities in question new to the market place, the lack of proper regulations gradually determined misallocations in the financial markets, with securities being sold to investors irrespective of the actual risk they could bear and loans being granted against no collateral or collaterals of low value; this condition was made even worse by the general lack of expertise to appropriately manage risk in the new lines of business.

Moreover, brokers and commercial and investment banks were mainly concerned with the volume they originated and therefore quickly distributed loans to investors without previously assessing their capacity to pay back the debt. The moral hazard problem was made even worse by the fact that the originate-and-distribute model implied a delinking between borrowers and lenders, making the risk assignment increasingly unclear.

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[3] Claessens S., Dell'Ariccia G., Igan D., Laeven L., (2013), *The Evidence and Impact of Financial Globalisation,* chapter 48, pages 737-752 – *A Cross-Country Perspective on the Causes of the Global Financial Crisis.*

Furthermore, information asymmetries were aggravated by the conflict of interest faced by credit-rating agencies, which had to advise clients on how to structure the same complex financial instruments they were rating: inevitably, this determined inflated ratings, whereby products were far riskier than investors expected.

When non-performing loans emerged, in a situation of overly risk lending where financial institutions were unable to monitor credit risk, losses began to mount and financial institutions reacted to the sharp fall in their net worth by massively deleveraging in order not to run out of capital.

1.1.4 Non-performing loans in the subprime mortgage market

A vicious circle eventually developed between the growth of the subprime mortgage market and the increasing housing prices: on the one hand easier lending, especially encouraged by the US “democratization of credit” policy, allowed the increase in demand for houses, driving their prices up; on the other hand, the asset-price boom in housing helped to stimulate the growth of the subprime mortgage market even further.

The asset price boom generated a bubble of inflated asset prices above their fundamental value and even high-risk borrowers were granted mortgages as their homes artificially appreciated in value.

However, when the bubble eventually burst, prices aligned with their true value: subprime borrowers found that the value of their house was lower than the amount of the mortgage, the value of collaterals in general decreased and also the net worth of companies fell.

As people had almost nothing left to lose, the moral hazard problem was enhanced and banks became less willing to provide loans; the final result was a further deterioration of banks’ balance sheets due to the rising default on mortgages and a tightening of lending standards from financial institutions.

1.1.5 The credit crash and the epidemic insolvency of financial institutions

The sum of all described factors, therefore, translated into the insolvency of some major financial institutions which, together with the deep asymmetries in information, caused a general feeling of uncertainty that inevitably led to the most serious issue of the contagion of such insolvency to the whole banking system.

As depositors, not knowing the quality of their bank's loan portfolios, started withdrawing their deposits, and mortgages and other financial assets kept decreasing in value, a run on the shadow banking system was triggered; the funds from shadow banks flowing through the financial system, however, were primarily represented by mortgage-backed securities and the rising anxiety about financial institutions' balance sheets caused lenders to require larger amounts of collaterals, known as haircuts.

With the rise in haircuts, financial institutions already in desperate need of liquidity found it more difficult to borrow and were obliged to engage in the rapid sale of their assets through fire sales to raise new capital, therefore making assets' prices dramatically fall and causing the deterioration of the balance sheets of those institutions that were not insolvent yet, resulting in multiple bank failures.

The well-functioning of financial markets is essential to ensure the efficient allocation of funds and financial resources within the economy. As the lending crash causes credit to freeze, the lack of funds flowing to productive investments leads to the failure of firms; the economy enters a recession, with a drastic and general reduction in wealth.

1.2 The financial crisis in the United States and in the European Union

1.2.1 The different means of intermediation in the two economies

Even though the 2007-2009 crisis hit economies all over the world, it developed in slightly different ways in the US and European contexts.

The first factor that is worth underlying, and probably one of the major causes of the quicker US recovery, is the fundamental difference in the prevailing means of intermediation between the two economies.

On one side, in the US most capital is intermediated by investors, resulting in longer and more complex intermediation chains. As previously stated, this may lead to increased moral hazard due to the difficulties arising in terms of risk assignment. However, longer intermediation chains also allow for larger dispersion of credit risk and therefore creates a more solid system benefiting from a differentiated pool of sources of lending. Furthermore, this type of intermediation inevitably favours the creation of safer short-term debt compared to a system of prevailing bank intermediation.

The European economy, on the other hand, is definitely bank-concentrated, as most lending is intermediated by banks: the result is a short intermediation chain composed of households holding deposits and mortgage banks using those deposits to grant loans to other households. Such a situation creates a concentration of credit risk and a predominance of riskier, long-term debt.

Moreover, the value in the bond and stock markets collapsed precisely at the moment when European banks were shifting from their previous policy, mostly focused on lending, to the massive purchase of securities.

1.2.2 The solutions to the Financial Crisis adopted by the Fed[4]

In the US, the answer to the crisis came in a unified form from all the States, which reacted as a single body with harmonized measures aiming at supporting the liquidity of financial institutions. The tools used by the Federal Reserve can be divided into three categories.

The first one concerns the central bank's role as lender of last resort and therefore its provision of liquidity to depository and financial institutions in the short-term. This primarily involved the Term Auction Facility (TAF), the Primary Dealer Credit Facility (PDCF) and the Term Securities Lending Facility (TSLF).

Under the TAF, the Federal Reserve auctioned 28-day loans, and, beginning in August 2008, 84-day loans, to depository institutions in generally sound financial conditions, so as to provide them funds to a broader range of counterparties and against a broader range of collaterals than it could through open market operations.

The PDCF, instead, provided the first opportunity for investment banks to borrow directly from the Fed; before the PDCF, in fact, large investment banks could only finance themselves short-term, but the only solution in the context of the financial crisis would be to sell their long-term securities, therefore putting even a stronger downward pressure on the securities markets.

[4] Federal Reserve Official Website, *The Federal Reserve's response to the financial crisis and actions to foster maximum employment and price stability.*

The TSLF was a weekly loan facility of Treasury securities for one-month term loans against general collaterals, awarded to primary dealers based on a competitive single-price auction in order to promote liquidity in the Treasury and other collateral markets.

The second category involved the provision of liquidity directly to borrowers and investors in key credit markets and it concerned the Commercial Paper Funding Facility (CPFF), the Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), the Money Market Investor Funding Facility (MMIFF), and the Term Asset-Backed Securities Loan Facility (TALF).

Finally, with the third category of tools the Federal Reserve started purchasing long-term securities to support a stronger economic recovery and to help ensure a rate of inflation consistent with the dual mandate; for instance, from September 2012, the FOMC purchased agency-guaranteed mortgage-backed securities at a pace of $40 billion per month and then, starting in January 2013, it purchased longer-term Treasury securities at a pace of $45 billion per month. Starting in January 2014, the FOMC reduced the pace of asset purchases in measured steps and concluded the purchases in October 2014.

Another important measure was the TARP program – Troubled Asset Relief Program: the US government bought preferred stock in eight banks, on the understanding that they would then give the money back to the government in the form of payment of dividends. This program not only helped to inject liquidity in the money market but also to boost market participants' confidence.

1.2.3 The solutions to the Financial Crisis adopted by the ECB

In normal times, the ECB through its conduct of the monetary policy uses the so-called *conventional* tools, which only target money markets and monetary financial institutions. When the financial crisis emerged, the ECB initially kept relying on such tools in order to protect financial stability and prevent liquidity shortages.

The conventional tools included the decrease of interest rates so that it would be easier for banks to borrow from the Central Bank and the modification of the liquidity tender procedure. This implied the passage from a variable rate with fixed allotment, where a fixed amount of reserves was lent at variable rates depending on the institution in question, to a fixed rate with full allotment, meaning that banks could now borrow the entire sum they would ask for and receive limited liquidity provision against collaterals. The ECB also made collateral requirements more flexible, so that more diversified collaterals could now be given as a guarantee in main refinancing operations, and prolonged the maturity of liquidity provision measures.

Nevertheless, these conventional tools only seemed to have positive effects until the *sovereign debt crisis* started. In fact, for several countries, the hard contraction of their economic activity implied reduced tax revenues and additional government spending to finance the bailout of some financial institutions. The fear that such governments would default on their debt due to the dramatic dimension of their budget deficit caused interest rates to climb incredibly, moving away from the low levels these countries had converged to thanks to the adoption of the common currency, to the extent that they were obliged to undertake austerity measures to cut on their government spending and to go through severe recessions, with increasing unemployment rates.

With credit rationing, the liquidity injected by the ECB remained stuck at the level of monetary financial institutions, creating a *Liquidity Trap*: as a consequence, the ECB had to directly provide liquidity to financial markets and non-monetary financial institutions, by putting in place some *unconventional* tools.

Through the Securities Market Program, the ECB purchased corporate and government bonds while sterilizing the monetary interventions, so as to provide liquidity and restore the proper functioning of the monetary policy transmission mechanism, without modifying the central bank liquidity.

The required reserve rate was reduced from 2% to 1% and Targeted Long Term Refinancing Operations were used to face the credit crunch by lending additional liquidity to banks provided that they extended loans to the non-financial private sector in the euro area.

Finally, the Quantitative Easing Asset Purchase Program was introduced, consisting of the purchase of Asset-Backed Securities, covered bonds and government securities in the secondary market: this increased money supply with the purpose of promoting lending.

1.2.4 The difference in the reactions to the banking crisis between the US and EU

One of the main reasons why the United States faced a quicker recovery from the recession compared to the countries belonging to the Euro area is probably because of the different conditions of their banking systems. In effect, the US reacted to the banking crisis in a unified way and acting as a single body, therefore adopting the same strategy to solve banking failures across the different States.

In the Euro area, instead, a crucial issue contributing to a slower recovery was represented by a lack of coordination and data sharing coming in two forms.

First of all, the system of the single currency was based on the Treaty of Lisbon, which established that the ECB should only act as a manager of the monetary policy in the name of price stability. Therefore, while the Fed has both duties of conducting monetary policy and supervising and regulating financial institutions, the Treaty did not foresee any supervisory power on the side of the ECB, but it was instead considered inherently incompatible with its role in the monetary policy conduction, as it would probably compromise its independence.

The lack of a single and powerful supervisory body within a system of countries sharing the same currency and monetary policy was for sure a crucial factor in determining serious financial instability.

Secondly, much discretion was left to single Member States on how to deal with banks' insolvency and failures, with the consequence that each country adopted different solutions and there was not a unique and harmonized reaction from the whole system.

CHAPTER 2: THE EUROPEAN REACTION TO THE CRISIS BESIDES MONETARY POLICY INTERVENTION

2.1 Demand and supply side policies

2.1.1 Impact of a risk-free assets shortage on corporate financial behaviour

One of the first causes of the financial crisis was represented by the shortage of risk-free assets determined by the coincidence of ever-decreasing interest rates and the growing demand for safe assets.

Risk-free assets are an important determinant of firms’ corporate finance decisions on how to invest their resources, the share of debt and equity they use as financing and the share of cash to return to investors in the form of dividends or to reinvest in other investments. When there is a shortage of risk-free assets, firms will seek to find short-term cash-generating investments rather than focusing on long-term business or operating investments yielding a higher added value.

Moreover, after the risk-free assets shortage in 2007 investors strictly penalised companies for holding back from paying out dividends, discounting the value of firms when reinvesting cash.

The overall consequence of both the search for short-term cash-generating investments from the side of companies and the pressure put by stockholders to receive back their dividends was a sharp reduction in companies’ long-term investments. The dramatic decline in annual investments by about €430 billion was one of the crucial factors determining Europe’s slow and delayed recovery; furthermore, some analysis carried out by the European Commission recently showed that great part of the weakness in investment dynamics was specifically attributable to private debt deleveraging.

2.1.2 The Juncker Plan[5]

The extended effect of private sector deleveraging on investment dynamics underlined the urgency of developing some policies aiming precisely at fostering capital formation, which is why the Juncker Commission announced an Investment Plan based on a European Fund for Strategic Investments (EFSI).

The Investment Plan can be thought as being based on three pillars.

First, the removal of obstacles to investment through the cooperation between the European Commission and its strategic partner, the European Investment Bank group, in the creation of the EFSI, which would provide an EU guarantee to mobilise private investment.

Second, the European Investment Advisory Hub and the European Investment Project Portal would provide technical assistance and greater visibility to investment opportunities, thereby helping proposed investment projects to become reality.

Third, promote more efficient use of financial resources by removing regulatory barriers both nationally and at the EU level, so as to improve the overall business environment.

The main idea behind the Juncker Plan was that in the post-crisis environment of general uncertainty and low investor confidence, investors tended to avoid the risks associated with infrastructure investments: hence, in order to boost investors confidence, public funds would be used to absorb some of the risks associated with infrastructure projects, therefore creating new demand for private investment.

2.1.3 Impact of a risk-free assets shortage on financial assets allocation

The scarcity of safe assets in the years preceding the financial crisis also facilitated the emergence of deeper global imbalances.

Due to the shortage of risk-free assets, the main providers of safe assets in the international monetary system, namely the US and the so-called *core countries* in the EU, were demanded to supply an extra amount of those assets to other countries. In Europe, this determined peripheral states to receive massive capital inflows, as they borrowed from core European countries.

[5] European Commission official website, *What is the Investment Plan for Europe?*

When the sovereign crisis emerged, these flows were interrupted and the public sector had to absorb most losses by increasing taxes and cutting on government spending, with the consequence of decreasing investors' confidence and reducing investment.

Besides, with massive cross-border bank flows going through the international interbank market, institutions may not be incentivised to adequately monitor who they are lending money to, increasing the risk of misallocation and the emergence of non-performing loans.

Finally, as explained by the Capital Asset Pricing Model, risk-free assets are extremely relevant in the process of portfolio diversification, as investors can use them to balance the overall risk exposure of their portfolios to achieve a proper level of risk given their returns. Therefore, in the absence of riskless assets, investors can hold a level of risk that is suboptimal compared to the one they could achieve with risk-free assets: investment portfolios are less diversified and risk premiums are higher.

Taking all of this into account, the overall impact of the safe-assets shortage on financial markets was an intensification of financial frictions implying a reduction in the availability of credit and an expansion of misallocation of financial resources.

2.1.4 The Capital Markets Union[6]

The worrying issues stemming from the context of growing financial assets misallocation underlined the relevance of adequately monitoring global macroeconomic imbalances and eventually introducing remedies where necessary.

In this sense, the Capital Markets Union was thought as a set of initiatives aimed at reducing the effect of financial frictions and improving the allocation of financial resources, building a deeper and more liquid EU financial market.

More specifically, the creation of a single market for capital represents a plan to mobilise capital in Europe and it is an integrating part of the European Commission investment plan.

The main objectives of the CMU are to provide businesses with a greater choice of funding at lower costs, offer new opportunities for savers and investors and make

[6] European Commission official website, *What is the Capital Markets Union?*

the financial system more resilient. In fact, the creation of a single capital market would allow to develop a more diversified financial system complementing bank financing with improved capital markets and unlock the currently frozen capital around Europe and put it to work for the economy; this would give investors the opportunity to raise funds without border barriers, therefore with the availability of a more diversified range of resources at lower costs.

Notwithstanding, some challenging issues still need to be faced, whereby the CMU remains an unrealised project. In fact, investment in Europe has a long lasting and heavy reliance on banks – differently from the US – and there are significant differences in financing conditions between EU countries themselves, with contrasting rules and market practices for similar products, making regulation even more complicated. On the other hand, the set of measures adopted in the context of banking regulation – the Banking Union - is already at a more advanced stage of development, as it will be inferred from the next sections.

2.2 Bank regulatory policy responses: the creation of the Banking Union

2.2.1 The legacy underlying the Monetary Union

In the light of the recent financial crisis and of the difficulties faced to effectively launch the recovery of EU countries, the necessity of achieving a deeper integration of the banking system was evident in order to promote a safer and more stable financial sector for the single market.

Therefore, the creation of the Banking Union has its roots in the system of the single currency and can actually be seen as its integration and improvement, whence its legacy necessarily derives from the one regulating the Monetary Union.

The long preparatory work that led to the single currency obviously included several factors that needed to be regulated and were officialised through the Maastricht Treaty. The Treaty included all provisions needed to implement the European Monetary Union, therefore regulating the introduction of a European Central Bank and of *convergence criteria* that each Member State would have to meet so as to participate in the euro area.

Additionally, in 1997 a "Stability and Growth Pact" was agreed as a legal framework to ensure sustainable public economic finances in the interest of the stability of the Economic and Monetary Union, including stronger monitoring and coordination of national fiscal and economic policies and the enforcement of deficit and debt limits.

2.2.2 The creation of the Banking Union through the integration of the EMU

The progression and consolidation of the Monetary Union after the crisis came in two forms.

In the first place, the discipline of the Stability and Growth Pact was deeply reviewed through the adoption of the "Six Pack" and "Two Pack" regulations, enhancing the monitoring and requirements concerning levels of government debt.
In particular, the two regulations modified the Excessive Deficit Procedure for countries that did not respect deficit and public debt level limits and established the so-called *European Semester,* an annual cycle of economic policy coordination through a detailed analysis of EU governments' economic reform plans and country-specific recommendations for the next months; moreover, they implied a stricter enforcement of fiscal rules and new arrangements for monitoring risky economic imbalances.

On top of that, the "Single Rulebook" was drafted, implying a set of initiatives aimed at developing a unified regulatory framework for the EU financial sector that would complete the Single Market in financial services, establishing stronger prudential requirements for credit institutions and rules for managing failing banks and improving protection for depositors.

The specialty of the Single Rulebook is that it provides a deep harmonisation in terms of regulatory requirements, as through the Capital Requirements Regulation and the Capital Requirements Directive it ensures that the same definition of regulatory aggregates and the same methodologies for the calculation of capital ratios and liquidity standards are used everywhere throughout the EU.

Such harmonisation also takes place through the Deposit Guarantee Directive on how national deposit guarantee schemes must function in all 28 Member States.
All of this aimed at the development of a more transparent and comparable institutions' financial situation, as uniform regulatory requirements and deposit

guarantee schemes not only allow more effective supervision, but it also generates higher confidence in investors.

A more transparent and efficient European banking sector is at the very basis of the creation of the Banking Union, which is expected to realise these objectives through three pillars: the Single Supervisory Mechanism, the Single Resolution Mechanism, and the European Deposit Guarantee Scheme.

2.2.3 The first pillar: the Single Supervisory Mechanism[7]

A determining factor of the major financial instability generated during the crisis was surely given by the lack of uniform supervision of European financial institutions, despite the common monetary policy shared by Member States.
This is why the first pillar of the Banking Union is represented by the Single Supervisory Mechanism (SSM), which is responsible for the prudential supervision of all credit institutions across the Member States and ensures that the European policy is implemented coherently and effectively everywhere such that credit institutions are subject to supervision of the highest quality.

The SSM is composed by the European Central Bank and all National Competent Authorities (NCAs): it therefore seeks to combine, from one side, the ECB's macroeconomic and financial stability expertise, and on the other, NCA's knowledge in supervision of credit institutions within their jurisdiction so that they can take into account their national specificities.

In carrying out its prudential tasks, the ECB applies all relevant European Union laws and national legislations: if a necessity for further harmonisation emerges, the ECB issues its own standards and methodologies, while considering the Member States' national options and discretions under EU legislation.
Accordingly, the functioning of the first pillar of the Banking Union requires really strict cooperation between the European Central Bank and National Competent Authorities.

In particular, the ECB is responsible for the direct supervision of all *significant* institutions, that is to say, those credit institutions whose failure could potentially harm the financial stability of the single market, given their size. Regular reviews are

[7] European Central Bank (2014), *Guide to Banking Supervision.*

conducted by the SSM in order to assess whether institutions meet the criteria for significance. The control over significant institutions is carried out by a Joint Supervisory Team for each institution, composed by staff from both the ECB and NCAs and whose main tasks concern the conduct of day-to-day supervision.

Meanwhile, the supervision of less significant institutions is delegated to NCAs, coordinated by the so-called Colleges of Supervisors. An institution is considered *less significant* if the total value of its assets does not exceed 30 billion euro or if the ratio of its total assets over the GDP of the participating home Member State does not exceed 20%.

Hence, besides its primary objective of ensuring proper prudential supervision, the SSM also crucially embodies the incentive to a common supervisory culture and a sense of commonality of purpose, representing a cornerstone of the further integration of the single market.

2.2.4 The second pillar: the Single Resolution Mechanism[8]

The second pillar of the Banking Union consists of the Single Resolution Mechanism (SRM), designated for the effective resolution of failing banks, where *resolution* is intended as the orderly restructuring of a bank which is failing or likely to fail by a resolution authority, in order to ensure that a bank failure does not harm the broader economy or cause financial instability.

More precisely, the establishment of the SRM aims at creating a uniform set of rules and procedures for the resolution of credit institutions across Member States. As a matter of fact, the incredibly slow recovery of the EU was certainly aggravated by the fact that banking crises were managed differently in every Member State, without any coordination or agreed strategy.

The SRM builds upon the legacy of Regulation No 806/2014: its purpose is to guarantee that if a bank fails despite stronger supervision by the SSM, its resolution will be efficiently managed with minimal costs for taxpayers and the real economy through a Single Resolution Board (SRB) and a Single Resolution Fund (SRF).

The SRB is a fully independent EU agency acting as the central resolution authority within the Banking Union and it is composed of a chair, a vice-chair, four

[8] European Commission official website, *Single Resolution Mechanism.*

permanent members and the authorities from all participating countries: once again, an EU institution relies on really close cooperation with and among national authorities. In fact, the SRM is only directly responsible for the resolution of banks that are directly supervised by the ECB, while other institutions remain under the direct responsibility of national authorities and the Board intervenes only in case of necessity of the SRF.

When a bank displays worrying signals of a potential failure, the SRB drafts a resolution scheme to be submitted to the European Commission for formal approval.

In exceptional circumstances, the SRF may be used as a last resort: the SRF shall be gradually built during the first eight years through the contribution of all Member States. The intergovernmental agreement it builds upon allows for the transfer of banks' contributions to national compartments of the fund and foresees the progressive mutualisation of such contributions to the Fund, implying also a mutualisation of risks across Member States.[9]

2.2.5 The third pillar: the European Deposit Insurance Scheme[10]

The third pillar of the Banking Union is not in place yet and consists of the November 2015 Commission's proposal to set up a European Deposit Insurance Scheme (EDIS) for bank deposits in the euro area.

The proposal already ensures that all deposits below €100 000 are protected, relying on the system of national deposit guarantee schemes.

The actual creation of the EDIS would provide a safer financial environment and generate deeper depositor confidence, as by weakening the link between institutions and their national sovereigns it would avoid that depositors' level of reliance on a bank depends on its location. Moreover, it would help a further integration of the single market through a more uniform degree of insurance cover.

Specifically, the EDIS would be progressively set up, getting to a final stage of full financing of bank deposits in the case of a bank's insolvency.

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9 Single Resolution Board official website, *What is the Single Resolution Fund?*

10 European Commission official website, *European deposit insurance scheme.*

CHAPTER 3: THE ITALIAN BANKING CRISIS

3.1 Developments of the banking crisis in Italy

3.1.1 Main phases of a banking crisis

As analysed throughout the first chapter, financial crises display some specific stages, which are also reflected in banking crises.

More specifically, the credit cycle is composed of four main stages: credit bubble, credit crunch, stabilisation, and re-leveraging.

A credit bubble emerges as a result of a rapid increase in real GDP and inflation, leading to an expansion of borrower and bank leverage. Meanwhile, default rates remain broadly stable and as the loan-to-deposit ratio climbs, banks' capital is stretched and funding is constrained. Also, M&A activity is profoundly intensified.

Eventually, as the bubble bursts, real GDP growth declines sharply and inflation falls; default rates rise and non-performing loans amount, causing a contraction of credit and M&A activity.

The stabilisation phase displays low real GDP and inflation, with the system leverage and bank capital still declining and M&A activity getting stable.

Finally, in the re-leveraging phase GDP growth and inflation start increasing again, as well as credit, asset prices, and bank profitability.

3.1.2 Liquidity and solvency banking crises[11]

Banks are susceptible to a wide range of risks, which not only derive from the contingencies of the external environment but especially from the structure of their balance sheets. Hence, in order to understand the dangers banks are exposed to, it is useful to analyse the general composition of banks' balance sheets.

On the side of assets, we find liquidity, composed of cash items and reserves deposited at the Central Bank, securities - such as treasury bills, notes, and bonds -, loans, including both interbank and consumer loans, derivatives, and real assets. The

[11] The World Bank website, *Global Financial Development Report - Banking crisis.*

asset side of the balance sheet indicates different uses of funding, as they pay interests, dividends, and returns, entering the income statement as revenues.

Returns vary inversely with liquidity and directly with riskiness and we can divide assets according to their maturity, liquidity, and relative riskiness – where riskiness is awarded higher interest earnings. Hence, from the safest and most liquid to the riskier and less liquid, we have first cash and bank reserves, then securities, and finally loans.

The side of liabilities, instead, represents different sources of funding, which enter in the income statement as costs. The liabilities are composed of borrowings, both from the Central Bank and other banks, deposits, - distinguished according to maturity in current account deposits, together with sight deposits and demand deposits, saving deposits, and time deposits -, bank bonds, non-interest bearing liabilities, and bank capital.

Therefore, the risks banks face can be divided in three main categories: credit risk is mainly associated with the eventuality that a loan ceases to perform, liquidity risk arises when withdrawals exceed available funds and interest rate risk is the risk that rising interest rates reduce the value of bonds held by banks, forcing the bank to pay relatively more on its deposits than what it receives on its loans.

These risks may lead to different types of banking crises, namely insolvency or liquidity banking crisis.

In particular, insolvency crises are related to a drop in the value of assets, which may be due, for instance, to a collapse in real estate prices. As assets' values decrease substantially, banks can end up with liabilities exceeding their assets, meaning that they are insolvent.

On the other hand, a bank crisis can also be triggered if banks face too many liabilities and do not have sufficient liquidity to satisfy them, becoming illiquid and causing a liquidity crisis. This may happen, for example, with *depositors runs* when many depositors want to withdraw their deposits at the same time.

It is important to underline that insolvency and illiquidity are different things and, even though they tend to come together, it may not necessarily be so: a bank can be solvent but illiquid, in the sense that it can have enough capital but not enough liquidity to satisfy cash demand.

3.1.3 Italian banking crisis' features compared with other European countries [12]

The prime peculiarity of the Italian banking crisis is that it came relatively late compared to the rest of the World: at the peak of the crisis, the financial stability of the Italian banking sector seemed generally safe.

Before 2007, Italian banks were still based on a business model mostly focused on traditional commercial banking activities and their domestic market; hence, they only had limited exposure to international markets and they were only indirectly affected by the spread of the financial instability coming from the US.

Italy was one of those countries of peripheral Europe affected by the delayed effects of the global financial crisis, whereby the Eurozone government debt crisis in 2010, encouraged by the incompleteness of the European project, hit the countries' individual weaknesses.

As a result, due to its poor economic performance in the years preceding the crisis and the dimension of its public debt, doubts started to arise about Italy's ability to repay its debt and domestic confidence dropped: investors sold their government bonds, making interest rates climb, and banks reduced their supply of credit in the intent to reduce their exposure. The dominant role of banks in financing the Italian economy and the relatively underdeveloped capital market contributed to amplifying the credit problems during the crisis, leading to a deep recession while all other countries were recovering.

The recovery of other countries created the false hope that recovery would be close also for the Italian economy and banks raised capital on this promise; as it became evident that Italy was still far from recovering, banks found themselves insolvent and investors' confidence definitively collapsed.

For these reasons, Italy had to face the much slower process of a recession-driven solvency crisis, while the majority of other countries experienced liquidity crises, which are much quicker and tend to emerge with less delay.

[12] Codogno, L. and Monti, M. (2018), *Italy under the spotlight of another financial crisis*, LSE Business Review.

3.1.4 The general resolution procedures established by the European Banking Union

The deep transformation of the banking supervision introduced by the creation of the banking union implied a passage from a distant relationship between supervisors and entities supervised to a situation of really close cooperation among them, to the extent that on many occasions the regulator even sits in the board of directors.

What regulators mostly observe and focus on now are risk-weighted assets and the level of capital, intervening when capital ratios and liquidity buffers of a banking group decrease by an excessive amount. In that case, there are different measures to deal with banks capital deficits, depending on the individual conditions of the entity and on the seriousness of the impact its failure may have on the whole financial system's stability.

The first factor regulators need to assess is whether the capital needed can be raised from private sources in the market. If this is the case, the regulator does not intervene and leaves the question to a State aid-free solution, as the situation is outside the scope of EU aid regulation.

If instead, the capital cannot be raised in full from private sources, the regulator needs to determine if the bank is solvent.

If the bank is solvent, nor it is likely to fail and hence appears viable in the long-run, but it is still in the public interest that the entity is given additional capital, then the *precautionary recapitalization* applies, such that the interested State is allowed to finance the bank: a specific and very stringent regulation is triggered so as to manage the impact of the recapitalization on competition. This was what occurred with the Carige group.

In the case where, on the other hand, the bank is not solvent and failing, or it is solvent but still likely to fail, authorities have to establish whether it is in the public interest that the entity is put under resolution.

If not, the situation is managed by National Authorities and the bank is put under *liquidation*: equity is zeroed and the bank is sold to another entity, as it was established for the majority of Italian banking groups. As the bank becomes insolvent, meaning that it cannot pay its obligations, company operations end and the remaining assets are used to pay creditors and shareholders, based on the priority of their claim.

Finally, if the entity is not solvent and its failure may cause serious consequences on the economy and the safeness of the financial system, the bank is put under *resolution* based on the EU framework. Resolution is a more rapid process compared to liquidation and implies the orderly restructuring of the bank through reliance on European means, namely the Single Resolution Fund.

3.1.5 Examples of how bank failures were managed under the Banking Union regime

Due to the relative delay of the Italian banking crisis, its first signs materialised when the Banking Union was already in place, even if still incomplete. Therefore, Italy dealt with failing banks based on the procedures established at the European level: this section provides two examples on the main solutions adopted to rescue problematic entities in Italy, based on the Banking Union principles. These were substantially of two types: recapitalization of Monte dei Paschi di Siena and liquidation of most other entities.

As previously stated, according to the BRRD Directive[13] when a bank is solvent and is not likely to fail, but still needs additional capital in order to ensure its safe functioning, national authorities may proceed with its precautionary recapitalization.

This was the case of Monte dei Paschi di Siena, whose recapitalization was managed through a delicate collaboration between the Italian government and the European Commission, which eventually led to a plan that would ensure the long-term viability of the bank, while still limiting the impact of the intervention on competition.

The plan established that State aids would concern €5,4 billion, while €4,3 billion would be provided by private parties, namely shareholders and subordinated bondholders: the public contribution implied that about seventy percent of MPS shares were put under the State control, who is expected to sell them by 2021. [14]

For the majority of Italian banks, however, the situation was quite more complex, as in most cases they turned out to be insolvent: the only options left were liquidation or resolution if in the public interest.

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13 *Bank Recovery and Resolution Directive*.

14 Carli, A. (2017), *Salvataggio MPS: aiuti pubblici per 5,4 miliardi, dai privati 4,3 miliardi*, Il Sole 24 Ore.

Liquidation concerned numerous entities, and a particular case is worth mentioning, as it created quite a loud media echo: the simultaneous failing of four major banks, namely Etruria, Marche, Chieti and Ferrara banks.

The reason why these banks were not rescued through State intervention lies in part in the fact that Italian public debt was already excessively burdened, and was partially due specifically to the new EU regulations, that prohibit Member States to provide additional capital to banks in difficulty without the authorization of the Commission.

Consequently, this is how the failure of these entities was confronted: €3.6 billion were sustained by the rest of the Italian banking system through their contributions to the National Resolution Fund, while the remaining €430 million were borne by subordinated investors. More precisely, *bridge banks* absorbed all rights, assets and positive liabilities, while non-performing loans and subordinated debts flowed into a unique *bad bank,* which had the responsibility of reallocating them on the market after their devaluation. [15]

3.2 Case Study: Veneto Banca

3.2.1 Reasons for analysing this case

Veneto Banca is a commercial bank of significant size, presenting branches located especially in the North and the Centre of Italy. It also operated in the South of Italy through its affiliate Banca Apulia and in some other European countries, namely Ireland, Romania, Croatia, Moldova, and Switzerland. At the end of 2016, it owned about 1% of the Italian market share both in terms of deposits and credit.

The main reason for analysing specifically the case of Veneto Banca is that it provides an interesting summary of the functioning of the European mechanisms of single supervision and resolution, as it represents a practical application of various issues earlier described in the previous paragraphs.

As a matter of fact, examining how the principles established at the level of the Banking Union applied to this example is useful to get an idea of how the ECB and

[15] Grassia, L. (2015), *Quattro banche fallite: ecco tutti i perché*, La Stampa, Economia.

European Commission may act under certain circumstances and what guides their decisions.

Moreover, this instance also brings to light the major weaknesses of the current, incomplete, project of a single system of supervision and resolution and therefore represents a starting point for improving the functioning of these institutions of fundamental relevance.

3.2.2 What led Veneto Banca to failure [16]

The crisis of Veneto Banca was not only caused by the acute recession that hit Italy as a consequence of the global financial crisis and the European sovereign debt crisis but was also due to the unfair conduct of its managers and directors.

The first signals of deterioration emerged following some inspections conducted by the Bank of Italy in 2013, which revealed the overstatement of regulatory capital: the bank had not subtracted from its regulatory capital the outstanding stock repurchased from stockholders by the issuing company – contrarily to the European normative.

When VB was eventually requested to adjust its regulatory capital consistently with the normative of the single mechanism, the bank experienced a substantial negative impact on its assets, with the consequent aggravation of a serious reputation crisis, leading to a fall in investors' confidence.

Subsequent inspections disclosed other relevant irregularities, concerning notable losses stemming from excessive risk exposure, consistent liquidity outflows and an inadequate business model involving incongruity with respect to the requirements imposed by the Single Supervisory Mechanism.

Moreover, investigations following the failure of VB also revealed management's fraudulent attitudes, consisting of selling shares to investors without disclosing their actual degree of riskiness and without verifying the adequateness of investors' financial position to sustain such risk.

[16] Pezzuto, A. (2017), *La liquidazione delle Banche Venete*, Diritto Bancario.

3.2.3 Why liquidation?

Following the first inspections, the Bank of Italy solicited VB so as to put in place a drastic replacement of corporate bodies and the radical innovation of its governance structure, in order to develop a coherent set of corrective measures aimed at reinforcing their capital position.

Furthermore, the bank was requested to attain, as soon as possible, a merging with another banking entity of adequate standing and to launch a preparatory program to transform the bank into a joint stock company, as requested by the government to all the so-called *banche popolari.*

Nevertheless, VB was unable to find sufficient private sources for the transformation in a joint stock company, and for this reason, it was subscribed by the *Fondo Atlante.* The latter had been constituted from all banks and the Deposits and Loans Fund, on solicitation of the Government, in order to acquire Banca Popolare di Vicenza and avoid the systemic risk that its unsuccessful recapitalization threatened to cause – the recapitalization was guaranteed by Unicredit but rather determined the failure of both entities. Consistently, also VB was bought by the Fondo Atlante, whose proposal of merging between Veneto Banca and Banca Popolare di Vicenza, described in the *Progetto Tiepolo,*[17] was not authorised by EU authorities.

Due to its inability to collect enough private sources to allow for its regeneration of capital, VB proceeded with the request for precautionary recapitalization to the MEF[18]. After intense confrontations between the MEF and the ECB and the European Commission, European authorities ultimately decided not to authorize the State aid directed to VB, in the lack of the fundamental requisites to allow for a State precautionary recapitalization. Nor it was the case, in the opinion of the European authorities, to put the bank under the control of a commissioner, as the major losses observed were not such to compromise minimum capital requirements.

In the end, VB was not considered in the conditions for being put under resolution, as its operations were only concentrated in some specific areas of the national territory and not sufficiently extended to be acknowledged as systemic and

[17] The project describing the eventual merging between Veneto Banca and Banca Popolare di Vicenza, rejected by the ECB.

[18] Italian Ministry of Economy and Finance.

hence in the public interest. VB was ultimately considered *failing or likely to fail*[19], and therefore insolvent, by the ECB, leading to the approval of the Decree[20] that put it under liquidation.

3.2.4 The adopted measures and the process of liquidation

Decree n.99 on July 25, 2017, established the liquidation of Veneto Banca, as decided by the MEF based on the proposal of the Bank of Italy. The process of liquidation, however, was accompanied by additional measures with respect to those foreseen by the EU regulation, as the Decree also allowed limited public interventions so as to prevent aggravated repercussions on the economy. The measures adopted were fundamentally three.

First of all, based on the indications of the European Commission, an open and competitive procedure was launched in order to select the acquiring firm. A data room was developed displaying all analytical data of VB; five banking groups and one insurance company requested to access it and ultimately the bank was ceded to Intesa Sanpaolo.

The assignment to Intesa Sanpaolo included great part of the company's assets and liabilities and predicted to preserve the continuity of all existing economic relationships: all ordinary bondholders and depositors were transferred to Intesa Sanpaolo, so that the formers would still receive the payment of interests and reimbursement of capital, while depositors continued to use their bank accounts. Everything kept functioning at the same conditions that were in force before the liquidation.

It is worth underlying that an additional issue needed to be taken into account: by acquiring Veneto Banca, Intesa Sanpaolo could potentially achieve a dominant position, with the effect of undermining competition. However, the Italian antitrust authority[21] actually ensured that the operation of acquisition did not represent the

[19] Art.18, EU Regulation 806/2014.

[20] Decree no.99 06/25/2017.

[21] Autorità Garante della Concorrenza e del Mercato (AGCM).

foundation nor the strengthening of a dominant market position such as to eliminate or substantially reduce competition.[22]

Secondly, all non-performing loans were delivered to the S.G.A, a society specialized in the activity of recovery of NPLs that is entirely controlled by the Italian Ministry of Economy and Finance. All revenues coming from the reclamation of NPLs – net of costs – were used to satisfy the creditors of VB, in order of priority.

The third measure foresaw an injection of liquidity of about €4,8 billion, together with State guarantees for a maximum of €12 billion, so as to cover the bankruptcy mass and the corporate restructuring of VB and Banca Popolare di Vicenza.

3.2.5 The consequences: costs for the State and impact on creditors

It might be surprising that the European Commission, after denying the authorization to proceed with the precautionary recapitalization, actually allowed the State contributions established by the Decree.

The European Commission, however, eventually agreed upon the compliance of the support measures with the European normative on State aids to banks[23], since existing shareholders and subordinated bondholders completely contributed to the costs of recovery, with the effect of reducing the burden of public intervention. According to the Commission, both guarantees and capital contributions were covered by senior credits claimed by the State on the activities included in the bankruptcy estate, in such a way that the net cost for the State would be decisively lower than the nominal amount of the foreseen provisions[24]. Taking everything into account, the costs faced by the State were eventually lower than those it should have faced in the case of precautionary recapitalization.

Notwithstanding, shareholders and some particular bondholders were generally heavily affected. In fact, in adherence to the normative of the Banking Union[25], even though senior bondholders and depositors remain completely safeguarded,

[22] Provision of 07/10/2017 based on art.6 law 287/90.

[23] In particular, the measures were considered coherent with the Communication on the banking sector of 07/30/2013.

[24] Press release 06/25/2017.

[25] Banking Communication 2013.

shareholders and subordinated bondholders are subject to *burden sharing*, contributing to the absorption of losses. Accordingly, shares and subordinated bonds were not transferred to Intesa Sanpaolo, but rather remained under liquidation.

The Decree involved, anyway, a compensation mechanism for non-professional investors who underwrote their subordinated bonds before 12/6/2014[26] and hold their ownership until the beginning of the liquidation procedure. Such investors could apply to the Solidarity Fund in order to obtain a reimbursement of about 80% of the investment, provided that the interested person had movable assets for a value not exceeding €100,000 or taxable income below €35,000.

3.2.6 Revealed weaknesses and strengths of the Banking Union

The experience of Veneto Banca highlighted the benefits coming from the introduction of the Banking Union, but it also revealed some of the deficiencies of a newly established and largely incomplete process.

The first positive factor emerges in the context of the SSM, as it was specifically in the occasion of the passage to the system of unique supervision that the Bank of Italy reinforced its control over the Italian banking system. In fact, it was in the light of the new European normative that the national authority included, among the objectives of an inspection programmed for the beginning of 2015, the analysis of the operations concerning the treasury stock of Veneto Banca.

The inspections detected that the described irregularities had significant dimensions, but also revealed that they were mostly referred to the biennium 2013/2014: hence, the infringements had been discovered almost immediately after being perpetrated.

Another element that is worth underlying concerns the process that led to the liquidation of the company. On the one hand, the decision of not putting the bank under resolution symbolised the fact that the entity did not fall under the definition of *systemic* institution; nevertheless, the failure of Veneto Banca undoubtedly had a profound resonance on the Italian economy, as its presence in the North of Italy was crucial, together with the Banca Popolare di Vicenza, which experienced a similar ending.

[26] Date of publication on the Official Journal of the Bank Recovery and Resolution Directive 2014/59/UE.

Similarly, the European authorities did not authorise the precautionary recapitalization of the bank and, if the liquidation presumably presented much lower costs for the Italian State compared to those connected with a precautionary recapitalization, it is also true that the latter should usually be allowed when the means of getting new capital from the market are not available. In the case of VB, it was evident both from the breakdown of the merging with Banca Popolare di Vicenza and of the transformation in S.p.a that the bank would in no case be able to find new sources of financing.

Moreover, the necessity for the Government to recur to the Fondo Atlante reflected its reluctance to make use of the European normative, whose implications were considered so much unclear to create a really complex structure that kept alive the two entities, with the consequence of provoking elevated costs for contributors – despite the intent of the Government to avoid the application of the bail-in specifically for the same reason.

Finally, the losses suffered from the majority of investors call for an improvement of investment protection, given the fundamental importance of market participants' confidence for the well-functioning of capital markets, and the actual creation of the EDIS would provide a substantial contribution in these terms.

Besides, a relevant issue in the case of VB is that some subordinated bondholders were actually induced in that position by fraudulent attitudes of the company's management, and it is therefore dutiful to raise the question of whether it is fair to expect that they suffer burdensome losses instead of being reimbursed.

CHAPTER 4: CURRENT IMPERFECTIONS OF THE BANKING UNION

4.1 The limitations of the SSM

4.1.1 Joining monetary policy and banking supervision in a single institution

The main issues concerning the single supervision stem from the high political priority of the Banking Union subject, which implied that "compromises had to be made, leading to a system that in certain respects does not conform to the precepts of good supervisory design according to post-financial crisis thinking, and in which some unresolved tensions remain".[27]

The first matter of contention concerns the legacy of empowering the ECB with banking supervisory powers besides those of managing monetary policy: the Maastricht Treaty established the role of the ECB as a monetary policy manager, but excluded banking supervision from its tasks, which was only introduced with the Regulations of 2012.

Most uncertainty about the compatibility of the two tasks comes from the strong form of independence of the ECB in deciding about monetary policy. Such independence is viewed as one of the major strengths of the ECB, which helps it to build credibility in maintaining price stability, but banking supervision needs to be regulated by more severe accountability mechanisms: for instance, bank supervisors are provided a variety of investigative and sanctioning powers which can be used against bank and financial firms, and therefore need to be subjected to accountability controls.

Moreover, the two mandates also tend to be conflicting in terms of objectives, as empirical evidence shows that dual mandates often result in fewer bank failures, but higher inflation – which is contrary to the ECB primary objective of low and stable inflation. This is because the price stability mandate can be influenced by short-term goals, such that the ECB's role as banking supervisor may create pressures to lower interest rates or loosen conditions for bank access to liquidity with the aim to stabilise the banking sector.

[27] Ferran, E., Babis, V. (2013), *The European Single Supervisory Mechanism,* Legal Study Research Paper Series, University of Cambridge.

4.1.2 A complex division of tasks

A proper definition of tasks and responsibilities also represents a crucial matter for the development of an effective system of unique banking supervision.

On one side, there is a complex relationship between the ECB and National Competent Authorities to be managed, where the ECB retains *exclusive competence* of specific supervisory tasks and direct control over significant banks, while NCAs' direct supervisory powers are only limited to less significant credit institutions.

The major issue concerning the relationship between the ECB and NCAs is the actual ability to "operate competently and effectively within 17 national legal systems that remain different in many important respects in spite of harmonization efforts"[28], and hence the capacity to manage the multiplicity of different national authorities conferred with specific responsibilities that are not transferred to the ECB. In this respect, in their recent research[29] Lucchini[30] and Zoppini[31] analyse the complex dynamics emerging within a system of single supervision. These include, among other things, the possibility for each bank to interact with the ECB in its own language and that the birth of new bureaucratic institutions easily brings about their wish to affirm their power and role; also, EU bodies are based on the work of officials with really different cultural and professional educations, with the consequence of an additional complication for effective harmonisation. An immediate consequence of this may be, in the context of less significant banks, reduced and delayed visibility of problems, obstructing timely intervention due to the operational chain involving a transmission mechanism from NCAs to the ECB.

An additional point to be analysed consists of the fact that the ECB is limited in its scope as a macro-prudential supervisor specifically by the division of tasks with NCAs. As a matter of fact, the ECB can indeed take macro-prudential measures for significant banks and has exceptional powers to impose higher prudential requirement and additional capital buffers, but the use of these tools actually rests primarily with the NCAs. Therefore, the ECB mostly engages in micro-prudential supervision on a

[28] Ferran, E., Babis, V. (2013), *The European Single Supervisory Mechanism,* Legal Study Research Paper Series, University of Cambridge.

[29] Lucchini, S., Zoppini, A. (2019), *Vigilare le banche in Europa: chi controlla il controllore?,* Centro di Consulenza dell'Università di Roma Tre

[30] Chief Institutional Affairs and External Communication Officer at Intesa SanPaolo.

[31] Civil Law Professor at Roma Tre University.

regular basis of individual credit and financial institutions, while macro-prudential regulatory and supervisory functions are largely left to the competent authorities of the single Member States. [32]

Another complication of the system of cooperation between the ECB and NCAs is represented by the potential asymmetries that may emerge despite the intent of harmonisation behind the Banking Union. In his intervention at the Italian University of Bolzano[33], the President of the European Research Centre Vladimiro Giacché underlined that the supervision carried by the ECB has different effects depending on the single national banking systems. The President argues that this is a consequence of the definition of systemic institutions, resulting in lighter control of less concentrated systems. For instance, according to an investigation conducted in 2017 by the Bundesbank and the Bafin, direct EU surveillance of German banks only accounts for 59% of overall activities of the German banking sector[34]; on the other hand, based on the annual report carried out by the Bank of Italy in 2018, 74% of all Italian financial intermediaries' activities are directly controlled by the ECB[35].

These asymmetries constitute a problem in that they clearly undermine the project of European harmonisation and potentially damage the efficiency of financial markets by creating market distortions that may provoke an inefficient allocation of financial resources.

On the other side, the interaction between the SSM and the SRM also constitutes a delicate concern, especially due to the lack of specific allocation of decision-making powers between the two bodies. Sure enough, in order to allow for quick and decisive crisis management, it is fundamental to ensure that there is a clear allocation of responsibilities so that the transition from ex-ante supervisory powers to ex-post crisis management measures is as smooth and automatic as possible. Furthermore, the division of SSM and SRM may imply a loss of effectiveness and

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[32] Kern, A. (2015), *European Banking Union: a Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism,* Articles, University of Zurich.

[33] Giacché, V. (2018) *L'Unione bancaria e la riforma del credito cooperativo: impatti e prospettive per gli intermediari italiani,* intervetion in the Libera Università di Bolzano.

[34] *Results of the 2017 low-interest-rate survey, Deutsche Bundesbank – Bafin,*, (29 May 2018), Press Conference on 30 August 2017.

[35] *Relazione annuale,* Banca d'Italia.

credibility for the SSM, as suggested by the Chair and Vice-Chair of the Advisory Scientific Committee of the European Systemic Risk Board[36], due to the fact that the SSM is not empowered with resolution tools.

4.1.3 The limited scope of the ECB

A relevant limitation to the ECB competencies is given by article 127(6) of the Treaty on the Functioning of the European Union, which confers to the ECB detailed tasks only relating to credit institutions and other financial institutions[37]. This implies that insurance undertakings and the shadow banking market are explicitly excluded by the ECB's competencies, the shadow banking being one of the major sources of systemic risk that caused the 2007/2009 crisis and being once again outside the control of direct and effective supervision[38].

Consequently, as a result of Treaty constraints, it was not possible to empower the ECB with a far-reaching scope, and the SSM will not have the opportunity to achieve the same flexibility in terms of the non-bank system found in both the UK and US. In the UK, for example, the Financial Services Act of 2012 put in place a new framework that provides for regulations[39] under which the English Prudential Regulation Authority (PRA) can designate certain firms to "deal in investments as a principal" for direct prudential supervision of the PRA. Similarly, in the US the Financial Stability Oversight Council has the key function of individuating systematically important non-bank financial firms and financial market utilities to be

[36] Sapir, A., Hellwig, M., Pagano, M, (2012), *A contribution to the Discussion on the European Commission's Banking Union Proposals,* Advisory Scientific Committee Reports.

[37] Under Directive 2006/48/EC, art 4(5) a financial institution is an undertaking other than a credit institution whose main activity is to acquire holdings or to carry one or more of a number of specified activities (lending, financial leasing, money transmission services, issuing and administering means of payment, guarantees and commitments, trading for own account or for account of customers in specified instruments, participation in securities issues and the provision of services related to such issues, advice to undertakings on capital structure, industrial strategy and related questions, money broking, portfolio management and advice, safekeeping and administration of securities).

[38] Ferran, E., Babis, V. (2013), *The European Single Supervisory Mechanism,* Legal Study Research Paper Series, University of Cambridge.

[39] Financial Services and Markets Act 2000, section 22A (PRA-regulated activities), order 2013.

put under the direct supervision of the Federal Reserve with enhanced prudential standards.

Accordingly, the impossibility for the SSM to have transparent supervision over the shadow banking market embodies a relevant danger to the stability of the financial system, as it entails a significant source of uncontrolled credit risk.

4.2 The SRM and the complexity of ex post crisis management

4.2.1 The credibility and predictability of the SRM's resolution powers

For the Single Resolution Mechanism's resolution powers to be effective in terms of financial policy, it is undoubtedly indispensable that it acquires credibility and predictability, which, however, are quite questioned due to its institutional complexity and the vast discretion about how the SRB can use its powers.

First of all, a factor that needs to be highlighted is that the SRB only has a purely preparatory and recommendatory mandate - its discretionary authority solely covers its preparatory powers in drafting a resolution plan and recommending the use of resolution tools -, but the ultimate decision of such plans rests in the hands of the Commission and the Council, who establish whether to approve it or not.

Moreover, the SRM's operations are also limited by the Member States' fiscal sovereignty, in the sense that if the Single Resolution Fund has not adequate funds, MS cannot be obliged by the Commission and Council's approval of an SRB recommendation to restructure a bank with temporary public financial support using financial resources of the national resolution authority fund.

These limitations clearly undermine the credibility of the SRM as resolution authority, but the major issue actually consists in its unpredictability. An effective resolution regime should require authorities to adhere to specific rules governing the use of resolution tools during a bank crisis, as "a predictable resolution mechanism is necessary to secure public acceptance and reduce market panic"[40]. This, in fact, allows market participants to know exactly what would be the impact of a bank restructuring on their investment, depending on the type of their investment.

The main problem of the SRM in these terms depends on the uncertain definition of the relative importance of banks: since there are no discernible criteria for determining whether a bank resolution may cause severe adverse consequences on the stability of the financial system, much discretion is left to the SRB and national resolution authorities to decide whether or not to put a failing bank into resolution. It is also true that the opinion of national authorities is necessary due to the single

[40] Kern, A. (2015), *European Banking Union: a Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism,* Articles, University of Zurich.

Member States' regional specificities that must be taken into consideration when analysing failing institutions and that regulators must be allowed some degree of flexibility in reacting to the unique circumstances of a crisis. Nevertheless, the lack of agreement on such a relevant concept may lead national authorities to be subject to particular pressures: for example, influential investors groups facing large potential losses in the eventuality of a bank resolution may put pressures on regulators to use public finances instead of bail-in[41].

On account of this, to allow for a more stable financial system it is necessary that more precise rules concerning resolution measures are adopted so as to render the SRM more predictable and subject to a higher accountability.

4.2.2 The incompleteness of a common backstop fund

As described in section 2.2.4, the structure of the SRM foresees the creation of a common backstop fund that would provide financial sources for the restructuring of banks across Member States. The Single Resolution Fund, under the control of the Single Resolution Board, will be funded by contributions from all the banks in the participating Member States and is expected to reach the target level of 1% of covered deposits in 2024 after an eight-year transition period; during the transition period, the SRF will consist of "national compartments" corresponding to each Member State's resolution authority, which will gradually become mutualised until they will become a unique common backstop fund at the end of the transition period.

The SRF, which is currently incomplete, represents a crucial step towards a unique banking system, as homogeneous regulation and resolution measures cannot be expected to produce effective results unless the risk is mutualised across all the participating countries and a common fund for the rescue of credit institutions is developed. In fact, a full harmonisation is unattainable until the national banking systems are subjected to the same regulations and capital requirements, but their final stability depends upon distinct national resolution authorities with different capabilities of raising funds that can be devoted to banks' rescue. As a matter of fact,

[41] *Bail-in* implies that the rescue of a failing bank is carried out through the involvement of shareholders and unsecured creditors, and hence provides relief to the credit institution by requiring the cancellation of their debts; it is opposed to *bail-out*, whereby the rescue of the financial institution is left to external parties, typically governments.

a common fiscal backstop is also fundamental to increase investors' confidence that banks failures will cause less instability.

4.2.3 Asymmetries resulting from the SRM

In his intervention at the University of Bolzano, mentioned in section 4.1.2, the President of the European Research Centre also made references to the asymmetries created by the SRM, claiming that it builds on the prohibition of bail-out for banking systems with very different recent histories.

Giacché argues that the new prohibition of bail-out came from the unprecedented amount of public aid provided to banks in the context of the crisis emergency and that profoundly altered the competitive environment of the European banking system. Hence, the bail-out prescription in the aftermath of the crisis evidently penalised those countries – for instance, Italy – that experienced a delayed banking crisis and did not proceed with massive contributions to the banking sector in the previous stage of the crisis.

In the specific case of Italy, the President explains that the penalisation introduced by the forbiddance of bail-out not only came in the form of a more difficult rescue of banks but also arose as a result of the specific circumstances of the Italian crisis. Being the Italian banking crisis recession-driven, it already implied a drastic fall in investment, which was further depressed by the introduction of new EU Regulations, that established the direct engagement of shareholders and bondholders in the restructuring of failing banks on the grounds of a still insufficient Single Resolution Fund.

4.3 The EDIS: the last step towards a complete Banking Union

4.3.1 The rationale behind the EDIS

The rationale behind the EDIS and its key features have already been introduced in section 2.2.5. The fundamental reason for the constitution of a single insurance deposit fund is to enhance financial stability by making depositors more confident about the safeness of their deposits: evidently, one of the main aggravating circumstances of banking crisis takes place when depositors, concerned about a bank's solvency, start withdrawing their deposits, provoking liquidity shortages; whence, increasing depositors' confidence in these terms helps to reduce liquidity risk and consequently the likelihood of financial crises.

Additional positive aspects of a deposit insurance scheme can be represented by stronger competitiveness of smaller banks and larger incentives to save that would foster economic growth; moreover, such schemes imply contributions coming from banks themselves, reducing the cost taxpayers and depositors should face in the eventuality of resolution and insolvency[42].

Therefore, the EDIS represents a vital step for the completion of the Banking Union in order to reinforce the single currency, since it is needed to protect financial stability by providing homogeneous and uniform depositors' protection regardless of geographical area, which would enhance depositors' trust and prevent bank runs.

4.3.2 The main concerns about the EDIS

Deposit insurance schemes have the main objective of preserving depositors' confidence; nevertheless, it is precisely this increased confidence that may lead to unintended negative effects. First of all, they may increase moral hazard by creating incentives for bankers to take on a higher degree of risk; moreover, they also tend to reduce market discipline, reducing incentives for depositors to effectively monitor banks, accurately choose the best bank to store their savings and demand higher returns as compensation for higher risk.

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[42] Bernet, B., Walter, S., (2009), *Design, Structure and Implementation of a Modern Deposit Insurance Scheme,* SUERF - The European Money and Finance Forum.

Specifically, empirical evidence[43] shows that market discipline tends to decrease especially with deeper involvement of the government in the sources of funding. However, measures exist and can be adopted to maintain market discipline, for instance by introducing risk-based premiums, coverage limits and co-insurance in the scheme design.

A further element that should be underlined is that the EDIS does not foresee the protection of every deposit, but only retail deposits of small and less sophisticated investors: the EDIS, in fact, is only direct to *eligible* deposits and guarantees a maximum level of coverage of €100,000 per depositor per bank. This is precisely aimed at achieving a balance between depositors protection and financial stability, while still limiting moral hazard.

Finally, the major source of contention in the context of political debate consists in the fear that the constitution of the EDIS would lead to unwarranted cross-subsidisation, whereby banking sectors of some participating countries would have to pay for bank failures in other Member States.

4.3.3 An assessment of the Commission's proposal

In April 2018 the European Central Bank[44], in the light of concerns and doubts raised with regard to the establishment of a single deposit insurance scheme, released a paper providing a first assessment of the European Commission's proposal for the creation of the EDIS. The paper investigates the validity of such concerns through studies on the potential risk exposure of the EDIS and the impact that a new financial crisis may have on the Member States' banking systems in the presence of a single deposit insurance scheme.

The first conclusion of the authors is that a fully-funded deposit insurance fund[45] would be sufficient to cover losses even superior to those suffered during the 2007-2009 crisis.

[43] Hovakimian, A., Kane, E. and Laeven, L. (2003), *How country and safety-net characteristics affect bank risk-shifting,* Journal of Financial Services Research, Vol. 23, No 3.

[44] Carmassi, J., Dobkowitz, S., Evrard, J., Parisi, L., Silva, A., Wedow, M., (2018), *Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?,* Occasional Paper Series, no.208/April 2018, European Central Bank.

[45] With ex-ante contributions of 0.8% of covered deposits.

Secondly, the paper highlights that the Deposit Insurance Fund's exposure would only develop in the case of extremely severe crises, with the 3% or 10% riskiest banks failing simultaneously and experiencing losses for about 20% of total assets, and even in that case, the DIF would not be completely exhausted.

Moreover, the EDIS would be developed based on risk-weighted contributions of the single banks, so as to ensure not only that institutions pay accordingly with the risk they generate – which would create a disincentive to accumulate excessive risk – but also that the features of banks and banking systems can be accurately controlled. This could also yield additional benefits, allowing for the prediction of various sources of risks, as risk-based contributions would represent an indicator of banks' loss-absorbing capacities and provide for information about the likelihood of an entity to go into resolution or insolvency. An interconnectedness indicator could also be introduced to deduce the effect of a bank's failure on the whole banking system, which would be particularly useful in the context of a banking system composed by a multitude of interconnected institutions.

Finally, the paper concludes that the preoccupation of unwarranted systematic cross-subsidisation is unfounded, given that in the EDIS there would be no banking system systematically contributing less than what they would benefit from the fund. In fact, even those cases where contributions would be lower than benefits concern exceptional losses with a rare probability of occurrence and that would only take place in the event of a much more serious crisis than the 2007-2009 one. The authors also underline that cross-subsidisation in actually desirable in terms of risk-sharing achieved through resource-pooling, which would allow standing major shocks compared to national deposit guarantee schemes.

CONCLUSIONS

The slowness of European countries' recovery from the last financial crisis, due to the lack of commonality of purpose that led each country to react differently despite sharing a common currency, demonstrated that the creation of a Banking Union is indispensible in order to guarantee the safeness and stability of financial markets. For this reason, the Banking Union was thought as being composed of three pillars that would guarantee homogeneous and effective supervision over all credit institutions, a common set of rules for rescuing failing banks and a single fund to ensure deposits protection.

The first two pillars of the Banking Union are now in place and had a powerful impact on the solution of the Italian banking crisis. According to the measures established in the context of the Single Resolution Mechanism, most Italian banks were liquidated, while in other cases – for example with Monte dei Paschi di Siena – the EU Commission allowed the precautionary recapitalization at the expenses of the State.

From the Italian experience and from the opinions of experts of the field, however, we can deduce that the work for the creation of an effective Banking Union is still in progress and improvements need to be made.

With regard to the SSM, the major concerns are about the ability to entitle the ECB with supervisory powers besides its role as monetary policy manager, without compromising its independence – since its role as supervisor would subject it to enhanced accountability – nor the objective of low and stable inflation, and the limits that delegation to NCAs implies in terms of reduced reactiveness and impossibility for the ECB to recur to macro-prudential measures.

Other issues seem to stem from asymmetries in the supervision of the various Member States' banking systems, the potential difficulties to properly distinguish between supervisory and resolution powers and effectively assign responsibilities to the SSM and SRM so as to render their interventions as rapid as possible, and the incapability for the ECB to check on major sources of credit risk such as the shadow banking.

Concerning the SRM, the major incompleteness is clearly represented by the Single Resolution Fund, which, however, is expected to be completed by 2023.

Another point in question currently remains unsolved, namely, the limited credibility and predictability of resolution measures, given the purely preparatory and recommendatory role of the Single Resolution Board and the fiscal sovereignty of participating countries.

Yet, a beneficial contribution may come from a more precise definition of the relative importance of banks and therefore the decisions that the EU Commission and ECB are likely to take in the case of failure; as a matter of fact, increased predictability of the SRM is needed to prevent market panic and eventual pressures on the SRB.

Finally, also in this case some asymmetries have been found, provoking competitive imbalances in the banking environment; these were especially due to the prohibition for those countries experiencing delayed banking crises to proceed with massive public contributions to failing banks, as other countries did before the establishment of the bail-out provisions.

The larger gap in the Banking Union is currently represented by the lack of the third pillar, the European Deposit Insurance Scheme. The main arguments that have been raised against the creation of the EDIS concern the potential increase in moral hazard, and the subsequent alteration of market discipline, that could arise after its introduction and the fear that it could force some Member States to pay for bank failures in other participating countries.

What emerges from a first assessment of the Commission's proposal, however, is that not only the EDIS is necessary to boost depositors' confidence regardless of the geographic location of banks, but would also be extremely desirable to attain higher resilience of the financial system through risk-sharing in the context of a deep interconnectedness of different credit institutions.

The Banking Union surely embodies an ambitious project, presenting particularly discouraging difficulties and gaps; for this reason, in order to achieve its completion it is useful to keep in mind the original European plan, that is to achieve an integrated and single market characterized by the free movement of goods and services, where all diversities are fruitful sources of exchange. Therefore, the Banking Union represents building block of a further harmonisation of the whole European Union, and the single market it aims to create, through the strengthening of a single financial market, where the free movement of financial resources is fully permitted so that they can be allocated to their most efficient users without obstructions.

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