

Banking union for Europe - risks and challenges

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An EZ banking union is on the way, but nobody yet knows what it will look like. Which banks are to be regulated, by whom and how? Regulation goes hand-in-hand with bank rescue (in cases of illiquidity) and bank resolution (in cases of insolvency). But who pays for the rescue? Who organises the resolution and under whose law? This column introduces a new Vox eBook in which the world's leading experts examine the issues and make concrete recommendations.

The Eurozone crisis has gone through its fair share of buzz words – “fiscal compact”, “growth compact”, “Big Bazooka”, etc. The latest kid on the block is the *banking union*. While it has been discussed since the Eurozone’s foundation, banking union is now at the top of the Eurozone agenda. But what kind of banking union? For whom? Financed how? And managed by whom? This column introduces a new Vox eBook, *Banking Union for Europe - Risks and Challenges* (available to download [here](#)), with 15 papers on the topic by leading economists from both sides of the Atlantic.

The authors do not necessarily agree on every single issue and point to several tradeoffs. However, there are several consistent messages coming out of this book:

- No piecemeal approach.

Centralising supervision alone at the supra-national level, while leaving bank resolution and recapitalisation at the national level, is not only unhelpful but might make things worse!

- A banking union is part of a larger reform package that has to address sovereign fragility and the entanglement of banks with sovereigns.
- Immediate crisis resolution vs. long-term reforms.

There is an urgent need to address banking and sovereign fragility to resolve the Eurozone crisis. Transitional solutions that deal with legacy problems, both at the bank as at the sovereign level, are urgently needed and can buy sufficient time to implement the many long-term institutional reforms that cannot be introduced immediately.

Addressing the current crisis

The push for a banking union stems from the realisation that the financial safety net for the Eurozone is incomplete. While the original Eurozone structure did not foresee it, the ECB is effectively the lender of last resort, but – as argued by *Charles Wyplosz* - is ill equipped to act as such. First, it has limited information about banks and no authority to intervene. Second, national authorities with the responsibility to intervene, restructure, and recapitalise banks procrastinate as long as possible, putting additional pressure on the ECB to intervene, but only when it is too late. The Spanish case is very illustrative in this context, as discussed by *Luis Garicano*. In order to fully discharge its duties as lender of last resort, the ECB would therefore need not only supervisory but also resolution authority for all Eurozone banks.

Slowly, slowly – I am in a hurry!

Claudia Buch and *Benjamin Weigert* argue that a banking union should be part of a long-run institutional framework but that the transition is blocked by legacy problems. Therefore, there should be no hasty move toward a banking union, but rather intermediate solutions. Any direct recapitalisation of banks by EFSF and ESM

should still turn into liabilities for national governments to match financial and operational responsibility for resolving banks. At the same time, and based on a recent proposal by the German Council of Economic Experts, Buch and Weigert advocate the establishment of a European Redemption Pact that includes joint and several liability for countries' sovereign debt above the threshold of 60%, while also introducing a tightened fiscal compact and a sovereign insolvency regime. This reflects a common theme throughout several of the contributions: banking and sovereign distress have to be tackled at the same time, as they are interlinked in a vicious cycle. This can also help get the ECB out of the fiscal policy realm.

Several authors point out that one should distinguish between solutions to the current crisis and institutional solutions to make the euro a long-term sustainable currency union by constructing a banking union. Using a Eurozone-wide deposit insurance and supervision mechanism to solve legacy problems is like introducing insurance after the insurance case has occurred and also overshadows important changes in the European architecture with distributional conflicts related to crisis resolution. *Thorsten Beck* therefore suggests establishing a crisis resolution mechanism (European Resolution Authority), using the EFSF and ESM as backstop funding sources, while at the same time establishing the necessary structures for a banking union.

The disentangling of banks and sovereign is not limited to the resolution of the current crisis. *Viral Acharya* makes clear that "a fuller solution to the problem of entanglement of sovereign and banking sectors requires not just a banking union in Europe but direct addressing of the sovereign excess in the borrowing markets". This requires adjustments in capital charges for sovereign bonds, and government bonds eligible for liquidity holdings must be in the highest quality bucket and possibly diversified across sovereigns. A point also made by *Wolf Wagner*, who calls for diversified sovereign bond

holdings of banks or, alternatively, the introduction of synthetic Eurobonds, which are claims on portfolios of Eurozone sovereign bonds. Alternatively, the ECB would have to apply haircuts in taking sovereign debt as collateral in line with the sovereign's credit risk.

Addressing imbalances within the Eurozone

A properly working banking union can also help address the macroeconomic imbalances within the Eurozone. *Daniel Gros* starts from the observation that the desire to protect the home turf in northern Europe has bottled up large amounts of savings there, thus contributing to the severity of the Eurozone crisis. Providing the ECB with supervisory authority could have an important macroeconomic impact because the ECB would not penalise cross-border lending in the way national supervisors do today. Such a move would thus allow the Single European Market in Banking to function again, including intra-bank capital markets, i.e. flows between parent bank and subsidiaries, a critical condition not only to making the credit channel of monetary policy work again, but also to restarting growth especially in peripheral countries, and thus dampening the multiplier effect of fiscal policy.

The current debate on banking union can also be directly linked to the recent debate on TARGET2 imbalances, as argued by *Frank Westermann*. The large imbalances in the Eurozone payment system reflect not necessarily deposit flight, but the financing of weak banks in peripheral countries by national central banks, refinanced in turn through the TARGET2 system. This propping up of weak banks by accepting non-marketable securities without the relevant haircuts illustrates again the delay in properly addressing bank and sovereign fragility in peripheral countries, and also shows the urgency to do so. A Eurozone-wide deposit insurance will therefore not be able to stop these imbalances by itself, but has to be accompanied by tackling the

bank fragility directly as well as other structural problems in peripheral countries.

Banking union for whom?

One critical question is whether the banking union should be “just” for the Eurozone or for the whole European Union? *Thorsten Beck* argues that the need for a banking union is stronger within a currency union, as it is here where the close link between monetary and financial stability plays out strongest and where the link between government and banking fragility is exacerbated as national governments lack policy tools that countries with an independent monetary policy have available. *Jeromin Zettelmeyer, Erik Berglöf and Ralph de Haas*, on the other hand, argue that non-Eurozone countries should be allowed to opt into the banking union but, if they do so, must be given a say in the governance and access to euro liquidity through swap lines with the ECB. Apart from full membership, intermediate options could be considered which would extend some but not all benefits and obligations of membership to all financially integrated European countries – including countries outside the EU.

While initial proposals posited a banking union only for large, cross-border banks, several authors stress the need to include all banks, including smaller ones. As the example of Spain shows, it may be “the small institutions … [that] play the role of the canary in the mine in anticipating the systemic problems” (*Luis Garicano*). And if the ECB is to fulfill its role of lender of last resort to all banks, it also needs the authority to supervise and resolve all banks (*Charles Wyplosz*).

The institutional details

Should the responsibilities for running the banking union be concentrated in the ECB? Before deciding to do so, better consult the experiences with central banks managing possible conflicts of interest,

argues *Vasso Ioannidou*. There are clear arguments to separate bank resolution and deposit insurance in an institution outside the ECB, to avoid conflicts between monetary and micro-stability goals and introduce an additional monitoring instance (*Dirk Schoenmaker*). One argument for a supra-national supervisor is to reduce political capture of regulators that could be observed across Europe over the past years and became obvious during the current crisis. This lesson can also be learnt from Spain, as *Luis Garicano* points out: “the supervisor must be able and willing to stand up to politicians”. In addition, there is a supervisory tendency to be too lenient towards national champions, while bailing them out is too costly, explains *Charles Goodhart*.

Franklin Allen, Elena Carletti, and Andrew Gimberargue, however, that the ECB might not necessarily be a tougher supervisor than national authorities. It might actually be more lenient, as it is concerned about contagion across the Eurozone and because it has more resources available. Tying its hands by rules might therefore be necessary. Several authors, including *Dirk Schoenmaker*, criticise the sequential introduction of supervision and bank resolution, which might lead to less, rather than more, stability, as conflicts between the ECB and the national resolution authorities are bound to arise. Schoenmaker argues for the joint establishment of a strong European supervisor (the ECB) and a credible European Deposit Insurance and Resolution Authority (EDIRA). Similarly, *Charles Wyplosz* argues that “a partial banking union is no better than no banking union at all, and possibly worse.” Without resolution powers, it will find itself forced to inject more and more liquidity and keep the zombies alive. But what about taxpayer back-stop funding; how will such losses distributed across the Eurozone countries? Establishing ex-ante rules for burden sharing across countries that “share” a failing cross-border bank is critical, as pointed out by *Charles Goodhart*.

The crisis has not only exposed political capture of supervisors, but also the risk of supervisory inertia due to career concerns or a “not-on-my-watch” attitude, a syndrome present certainly not only in Spain, but also in other countries in the Eurozone and beyond. For every failed Spanish caja, there is a failed German Landesbank. Expanding the supervisory toolbox is not sufficient, supervisory incentives have to be addressed as well, a lesson that goes well beyond our continent!

While a banking union can solve many problems, it might create new sources of systemic risk, argues *Wolf Wagner*. By combining resources, banking fragility in one country can actually more easily drag down the other countries. He therefore argues for a two-tier approach with both national and European insurance in place. The national insurance system will be the first line of defense against domestic crises, while the European fund would serve as back-stop funder. A second challenge lies in the harmonisation of supervision and regulation that is likely to come about with a banking union. If all institutions are subject to the same supervisory and regulatory environment, they will tend to undertake similar activities and react in similar ways – also known as herding, which enhances the risk of joint failures.

Looking west across the Atlantic

This time is not different! Studying history can be insightful, both for economists as for policymakers. Accordingly, several observers have looked for comparisons in economic history for clues on how to solve the Eurozone crisis. *Joshua Aizenman* argues that the US history suggests large gains from buffering currency unions with a union-wide deposit insurance, and partial debt mutualisation. It is important to note, however, that it took the US a long time to get to where it is now, quite some institutional experimentation and several national banking crises. And as currently discussed in Europe, the US had to address

both banking fragility and state overindebtedness. Fiscal and banking union go hand in hand.

It's the politics, stupid!

In addition to a banking, sovereign, macroeconomic and currency crisis, the Eurozone faces a governance crisis. Diverse interests have hampered an efficient and prompt resolution of the crisis. And as financial support for several peripheral Eurozone countries has involved political conflicts both between and within Eurozone countries, so the discussion on the banking union has an important political economy aspect, *Geoffrey Underhill* points out. More importantly, there is an increasing lack of political legitimacy and sustainability of the Eurozone and for the move towards closer fiscal and banking integration. “Citizens in both creditor and debtor countries increasingly perceive rightly or wrongly that the common currency and perhaps European integration tout court have intensified economic risks”. A banking union can therefore only succeed with the necessary electoral support to not get further caught in a legitimacy vortex.

This political economy analysis of the Eurozone is consistent with what several authors refer to as the Eurozone’s Tragedy of Commons problem. It is in the interest of every member government with fragile banks to “share the burden” with the other members, be it through the ECB’s liquidity support or the TARGET2 system. Rather than coming up with crisis resolution on the political level, the ECB and the Eurosystem are being used to apply short-term palliatives that deepen distributional problems and make the crisis resolution ultimately more difficult. And at the same time, national supervisory authorities restrict the single banking market further and further, acting out of national interests but ultimately undermining the currency union.

Conclusions

The Eurozone crisis is as much a banking as it is a sovereign debt crisis. Foremost, however, it is a crisis of governance structures and political constraints. The crisis has been exacerbated by half-baked approaches and unsustainable policies. Political inaction has put greater responsibility and stress on the ECB, expanding its realm far beyond monetary stability and its democratically assigned responsibilities, and forcing it to go for second- or third-best solutions. If the Eurozone countries are not to be caught in the downward spiral of a failed currency union, it is time to act now. We economists have certainly made our contribution, showing different alternative paths and policy options. It is time for Eurozone governments to think outside the box and act!

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