DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

How Should a European Banking Union Work?

NOTE

Abstract

This paper discusses arguments for banking union in Europe and outlines how such a union could be implemented. While there are some arguments for a common bank supervisor across the EU, such a proposal is unlikely to ever work. The absence of a monetary policy and exchange rate tool for euro area members makes banking crisis more threatening for these countries and strengthens the argument for a common bank supervisor backed by common deposit insurance and resolution funds. The ECB is the best placed institution to play the role of common supervisor due to its position as the lender of last resort to banks. The paper notes that current discussions on banking union leave the euro area a long way away from a coherent and workable banking union.

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1. INTRODUCTION

After a long period in which banking crises were a fairly rare occurrence in modern economies, the banking sector has been central to the macroeconomic problems confronting global policy makers since the middle of 2007. Within the euro area, the costs of rescuing the banking sector contributed to large run-ups in sovereign debt burdens and the risks of sovereign default now pose a serious threat to the solvency of banks. The euro area leader's summit statement of June 29 this year provided an official acknowledgment that it was "imperative to break the vicious circle between banks and sovereigns."

The summit's communique continued that "When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly." However, despite lots of discussions since June (including detailed proposals from the European Commisision) there is still very little clarity as to how far European governments are willing to move towards a banking union that genuinely meets their commitment to break the vicious circle.

There are a series of unresolved questions about the implications of June's summit. The first set of questions relate to how the single supervisory mechanism is supposed to operate. Should it be limited to supervising only the largest banks or be tasked with overseeing all banks? And which organisation should be charged with this task: The ECB or a new supervisory body?

Probably more important, however, is the lack of clarity about an essential element that needs to accompany a common supervisory mechanism: The sharing of bank-related risks. This risk sharing is necessary to honour the summit's commitment to break the vicious circle between banks and sovereigns. It is also necessary for a common supervisory approach to work: If national governments are responsible for recapitalising banks, they are unlikely to accept having outside supervisors insist on recapitalisation requirements.

Unfortunately, despite the apparent acceptance of the linkage between supervision and risk sharing in the June statement, the recent joint statement from the German, Dutch and Finnish finance ministers suggests that some member states are now seeking to place severe limits on the extent of risk sharing. This development threatens to undermine progress towards breaking the vicious circle acknowledged by the leaders in June.

The rest of this paper is organised as follows. Section 2 discusses the arguments for harmonising banking regulations, deposit insurance and resolution regimes and why there is a strong argument for a common bank supervisor in the euro area if not the EU. Section 3 discusses the ideal structure for the common supervisory approach. I argue that this structure should involve the ECB as supervisor for all banks as well as a common European deposit insurance and resolution fund as recommended by Gros and Schoenmaker (2012). Section 4 then assesses where we currently stand in relation to the banking union discussions.

2. WHY BANKING UNION FOR THE EURO AREA, NOT EU?

The phrase "banking union" has been widely used in European policy circles in recent months but it is not always clear what this term means or who it would apply to. Before discussing broader concepts of banking union, I first want to focus on the narrowest possible definition of such a union: The idea that the same set of banking rules and regulations should apply across the same area. I then discuss the arguments for a common supervisor and conclude that this approach should be applied to the euro area but is unlikely to work for the EU as a whole.

2.1 The Need for Harmonisation Across the EU

The first way in which Europe's banking sector differs from those in more integrated economic unions is the absence of a common rule book for banking regulations. Within Europe's single market, with its free movement of capital, disparities in banking regulations can cause important distortions and can potentially magnify risks associated with the banking sector.

Consider, for example, the role played by bank capital regulations. Currently, methods for calculating bank capital differ widely across different EU member states. This type of disparity could allow banks from certain countries to take greater risks and perhaps out-compete banks from other areas when looking for business as they are allowed to expand more aggressively. This kind of disparity can also lead to pressure from banking representatives to "dumb down" regulation to the weakest level allowable while still complying with EU regulations. The range of different methods used to calculate capital ratios also contributes to confusion during crises as investors find it difficult to compare observed capital ratios for banks across the EU when deciding whether to make debt or equity investments. A common rule book will benefit transparency and the safety of the financial system.

In the same way, regulations relating to bank liabilities also need to be harmonised across Europe. If one country in the EU decides to offer its depositors better insurance conditions than others, funds may move towards that country's banks and again there may be pressure on other countries to imitate these measures, perhaps placing too much financial risk on taxpayers. The absence of a harmonised approach to bank liabilities was a complicating factor in the EU during the financial tensions of late 2008. For example, in September 2008, the Irish government passed a near-blanket guarantee of the liabilities of its domestic banks. For a short period, this guarantee led to an inflow of funds into these banks and raised pressure on other EU member states to issue liability guarantees. Only later did it become clearer that the Irish guarantee was an expensive mistake.

Harmonisation should also be extended to policies on bank resolution. If shareholders and bondholders believe they are less likely to lose money on a failed bank in one country because the government is more likely to bail them out, then banks in that country will have a lower cost of funds and may be more able to expand rapidly; such banks may also take greater risks because of the moral hazard problems induced by the implicit promise of a bailout from the government.

2.2 Arguments for a Common Supervisor

Accepting the case for harmonisation of banking rules across the EU, there are a number of reasons to argue that this should be supplemented by a common EU bank supervisor.

- **Supervisory Culture**: Even with a "single rulebook" in place, differences in supervisory practices could lead to important disparities in how these rules are applied. For example, one country could choose to enforce rules via an aggressive interventionist approach in which supervisors conduct regular visits and ask probing questions about bank operations, while another country could choose to have a poorly-funded regulator that relies on a "light touch" or "principals-based" approach to enforcement. A single supervisory body across the EU that would have a common approach to supervision would increase the likelihood of the rules and regulations are being enforced in the same way throughout the EU.
- **Financial Stability**: Europe's banking system today is a patchwork of institutions with a wide range of inter-linkages. Cross-border banks are an obvious source of inter-linkages but the linkages relating to funding are perhaps more profound: Banks throughout the euro area receive large amounts of funding from depositors or investors from other countries or from the euro area member states as a group in the form of Eurosystem funding. As Schoenmaker (2011) argues, these linkages mean that the implications of bank failures may not be taken fully on board by individual countries, so that policy interventions fail to consider fully the implications for cross-border financial stability.

On their own, however, these reasons have not yet been sufficient to convince European governments to agree to have a common bank supervisor. There are a number of reasons for this.

First is the difficulty of separating banking supervision from the fiscal costs associated with dealing with failed banks. A system in which a centralised European supervisor can insist that a bank be shut down or recapitalised at the expense of taxpayers in that bank's home member state is one that is likely to be fraught with tensions. With national governments "on the hook" for the fiscal costs associated with financial failures, it is hard to see how they can be asked to give up national control of supervision. This makes the question of who supervises banks a highly sensitive question: To work, it is likely that shared supervision will have to be combined with shared risk.

Second is the heterogeneity of the banking sector across EU member states. In particular, countries with large and complex financial sectors, such as the UK, are unlikely to want to pass over regulatory control of such a key sector of their economy without assurances that it would remain unharmed. Conversely, the rest of the EU may have reservations about entering into a risk-sharing arrangement involving sharing losses generated by large institutions operating in the City of London.

For these reasons, a full banking union at an EU level is not something that is likely to occur at any point in near or medium-term future. However, the debt crisis in the euro area has raised a new and separate argument for banking union.

Many countries in the EU now have high levels of public debt. This has raised questions about whether they can cope with banking failures. These doubts can produce important negative feedback effects. Doubts about the capacity of the sovereign to cope with a banking crisis can raise yields, negatively affecting fiscal sustainability and damaging the

balance sheets of banks that hold sovereign debt. Doubts about the ability of governments to ensure the safety of deposits or equally-ranked creditors can lead to deposit flight, which contributes to a credit crunch, thus weakening the real economy, which in turn raises further doubts about fiscal sustainability.

Crucially, unlike countries outside the euro area such as the UK, euro members do not have access to their own national central bank that can step in to purchase bonds to avoid default. This is still the case even after the announcement of the ECB's OMT programme, as that programme is partial, highly conditional and comes after a precedent has been set in Greece that euro area member states can be put through an orderly sovereign default. Designed in this fashion, banking weakness is likely to lead to a threat of default across a number of euro area member states.

Any proposal to share the costs of banking recaps across member states is bound to be controversial. While one can think of theoretical arguments in which such "risk sharing" acts as a kind of insurance policy that benefits all member states, the reality is that we have a pretty good idea which countries have the weakest banking systems and are thus most likely to benefit from the introduction of the risk sharing element of a banking union. Citizens of member states that would be responsible for funding recapitalisations in other states are understandably unhappy about this prospect. Still, without risk sharing of this type, the vicious circle identified in the June statement will continue.

The relationship between risk sharing and common supervision is a two-way street. Not only is a external supervision without risk sharing unlikely to be acceptable to member states, it is also the case that risk sharing is unlikely to work without a shared and trusted supervisory mechanism. Indeed, it is the June summit's commitment to take some initial steps towards risk sharing between euro area countries that is providing the impetus for the common supervisory mechanism, a fact acknowledged by the European Commission which has stated[1]:

> *an integrated supervision is necessary to make sure that all euro-countries can have full confidence in the quality and impartiality of banking supervision, opening the way for the European Stability Mechanism (ESM) to directly recapitalize banks that fail to raise capital on the markets.*

Of course, an agreement in principle to sometimes share risk is one thing. Figuring out how to make this agreement work in practise is a different thing.

3. HOW SHOULD A EURO AREA BANKING UNION WORK?

As of now, we have few details about how a common bank supervisor would work. Here I discuss three aspects of these decisions: Who should supervise, how many banks should they supervise and which additional institutions are required.

3.1 Who Supervises?

The June summit statement proposed that "an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area". The exact level of ECB "involvement" was unspecified but the European Commission has subsequently proposed a regulation that would confer the key supervisory tasks for all euro area credit institutions

[1] See European Commission (2012a)

on the ECB.[2] Despite these proposals, some European politicians have argued that the ECB should not be given enhanced supervisory powers.[3]

I support the Commission's proposal to give the ECB responsibility for supervising banks in the euro area. However, I disagree with the Commission's rationale for this decision. A detailed FAQ document (European Commission, 2012a) lists a number of reasons why the ECB should be given this role, including its expertise in financial stability analysis. However, the Commission has also emphasised the need to separate monetary policy and banking supervision tasks. The proposed regulation discusses this issue as follows:

> *Monetary policy tasks will be strictly separated from supervisory tasks to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision. To implement the necessary separation between both tasks and ensure appropriate attention to supervisory tasks, the ECB will ensure that all preparatory and executing activities within the ECB will be carried out by bodies and administrative divisions separated from those responsible for monetary policy.*

I think this emphasis on the importance of separating supervisory and monetary policy tasks is misplaced. The question of whether central banks should be involved in bank supervision is an old chestnut that academics have debated for many years and practice in the years before the global financial crisis swung somewhat towards separate bank regulators.[4]

In my opinion, the global financial crisis has swung matters decisively back in favour of central banks playing a key role in supervising banks. During a crisis, the central bank's lender of last resort role is crucially important. The communication difficulties between the UK Treasury, the FSA and the Bank of England during the Northern Rock crisis in 2007 illustrated some of the problems that can occur when there is incomplete co-ordination between the lender of last resort and the bank supervisor. The 1997 removal of banking supervision from the Bank of England is now being reversed.

The crisis in the euro area has led to a breakdown in European interbank markets as well as the longer-term bank funding markets. This has left much of the banking system heavily dependent on the ECB for its funding. There is no point in pretending that this role of lender of last resort is completely independent of monetary policy as it has led to very substantial money creation, with the Eurosystem's balance sheet now exceeding €3 trillion in size. Key monetary policy operations, such as the LTRO, are working directly through their effects on the banking system and are providing support to large numbers of weak banks.

In practice, the ECB is already playing a central role in dealing with failing banks because the ECB Governing Council must make decisions about whether to provide liquidity to these banks against eligible collateral or, as has become fairly common, in the form of Emergency Liquidity Assistance. In addition to formalising the ECB's role in resolving failing banks, the new approach to supervision should see a removal of the current distinction between the risk associated with ELA relative to regular Eurosystem loans. If the ECB Governing Council decides that the Eurosystem must act as a lender of last resort to a bank, then the risk associated with non-standard loans should be shared among all states, rather than falling only on the bank's local member state.

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[2] See European Commission (2012b).

[3] See for instance, http://www.reuters.com/article/2012/09/22/us-germany-banking-supervision-idUSBRE88L04S20120922 and http://uk.reuters.com/article/2012/09/20/uk-eurozone-barnier-germany-idUKBRE88J0S820120920

[4] See Goodhart and Schoenmaker (1995) and Peak, Rosengren and Tootell (1999) for two pre-EMU examples of papers that debated this question.

Overall, I believe that an official role for the ECB in supervising banks will help provide a far more efficient set of procedures for diagnosing problems with banks and then diagnosing the correct mix of solvency and liquidity measures required to resolve these problems.

3.2 How Many Banks?

The June summit statement about establishing "an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area" does not specify anything about excluding some banks from this supervision. The Commission's proposed regulation clearly states that the ECB should supervise all euro are credit institutions.

Still, there have been strong objections from Germany to the idea that the ECB should supervise all banks. In particular, the German Finance minister, Wolfgang Schäuble, has proposed that the ECB should only supervise larger "systemically relevant" banks.[5]

The argument for applying a common supervisory mechanism to only larger banks appears to be based on the idea that the problem being solved by the common supervisor is the systemic risks to financial stability posed by these banks. I think this argument is incorrect. Large banks are not the only threat to financial stability. The European Commission have defended their proposal for extending common supervision to all banks on the grounds that "small banks can also cause problems." I think the correct argument is more subtle. It is that collections of small banks with similar characteristics can often act in the same way so that the sector as a whole can occasionally presents a threat. This has been a familiar story running from small bank failures during the Great Depression, the Savings and Loans debacle of the 1980s or the problems with Spanish cajas and German Landesbanks. Leaving banks below a certain threshold out of the common supervisory framework would be a serious mistake.

German objections to the ECB supervising all 6000 banks in the euro area have also focused on the practical implementation problems associated with the ECB taking over the supervision of so many banks all at once. I believe these practical implementation difficulties are overstated and that true reasons for German objections are more likely related to the unwillingness to have highly politicized small German banks come under European supervision.

An analogy with the common monetary policy is relevant. One could argue that taking over running monetary policy operations supplying liquidity to 6,000 different banks and involving the work of tens of thousands of central bank staff would lead to severe implementation problems and require a huge centralised staff. In practice, most of the day-to-day work of the Eurosystem is still done in the national central banks and the ECB itself operates as a form of centralised secretariat rather than a huge bureaucracy. In the same way, even if the ECB becomes the official supervisor of all euro area banks, the majority of day-to-day supervisory tasks would remain with local supervisors, with the head office staff at the ECB designing common policies and taking the key decisions in relation to specific problem banks.

3.3 Needed: A Euro Area FDIC

As discussed above, it is clear that to operate effectively, a common supervisory mechanism needs to be combined with a common and shared approach to the risks associated with failed banks. The European Commission have proposed a harmonised

[5] See news story here http://www.reuters.com/article/2012/09/03/us-eurozone-banks-schaeuble-idUSBRE88204U20120903

approach to deposit insurance and a common bank resolution framework.[6] However, for a banking union to work effectively, I believe it is best to combine these two elements together to produce a Euro Area version of the US FDIC. Gros and Schoenmaker (2012) discuss such a proposal in detail, labelling their proposed body the European Deposit Insurance and Resolution Authority (EDIRA).

While the June summit statement could be interpreted as indicating that the euro area's leaders are taking some first steps towards accepting the need for sharing the costs associated with failing banks, the question of shared deposit insurance is even more controversial. This is because the sheer scale of the total amount of insured deposits (euro area residents have bank deposits of over €17 trillion) suggests that a common insurance scheme would involve states taking on enormous risks.

In practice, deposit insurance and bank resolution are just two sides of the same coin. The safety of deposits is protected by ensuring that banks remain solvent. Thus, the costs associated with deposit insurance schemes such as the FDIC's are simply the capital shortfalls that occur at failed banks. Well-organised bank resolution procedures that minimise the costs to the taxpayer of failing banks are the best way to make sure that deposit insurance schemes cost as little as possible.

Indeed, given the high debt levels across the euro area as a whole, it is important that banking union proposals don't end up inflicting unacceptably high debt levels on every member state that participates in the euro. This is why the most efficient way for a banking union proposal to work is for the ECB as a central supervisor to work hand in hand with an EDIRA to resolve failing banks in a way that minimises public costs.

One final point observation in relation to resolution schemes is that the flip side of well-designed bank resolution procedures that minimise the cost to the taxpayer (via the implementation of bail-in procedures for unsecured creditors for example) is that non-deposit "bank runs" featuring banks losing access to unguaranteed funding will undoubtedly be an occasional feature of such regimes. (Even the best-run supervisory system cannot guarantee the absence of bank failures). This makes the central involvement in supervision of the lender of last resort, the ECB, all the more essential once such proposals are introduced.

4. WHERE WE STAND NOW

Having put forward a vision for how a euro area banking union could work, it is chastening to note how far away we are achieving such an outcome. While the June 29th statement was widely hailed as a first step on the road to banking union, the reality is that it represented a very small step towards risk sharing. All that was promised was that "ESM could, following a regular decision, have the possibility to recapitalise banks directly." The statement that ESM *could* recapitalise banks is a long way away from ESM *will* recapitalise banks nor did the statement clarify the conditions under which "could" becomes "will".

The joint statement on September 25th of the finance ministers of Germany, Netherlands and Finland has affirmed that the euro area's major creditor states are deciding to interpret this June summit statement in the most minimalist way possible.

[6] See http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/918 for the deposit insurance proposals. The common bank resolution framework proposals can be found at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/570

This statement articulates some “principles” for how these countries believe ESM should operate in relation to bank recapitalisations.

- “When an effective single supervisory mechanism is established” is being interpreted by Germany, Netherland and Finland as “once the single supervisory mechanism is established and its effectiveness has been determined.” In other words, these three countries are signalling that original statement’s reference to “effective” allows them to delay any decisions on recapitalisation until they are fully satisfied with the new arrangements.
- These countries now state that “the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities.” In other words “if it happened under your watch, it’s your problem”. Given that, by definition, all of the banking problems that are afflicting Europe today occurred prior to the new supervision, this appears aimed at minimising the number of banks that could receive investment from ESM in the coming years.
- Finally, the three countries have asserted “that direct bank recapitalisation by the ESM should take place based on an approach that adheres to the basic order of first using private capital, then national public capital and only as a last resort the ESM.” This approach suggests that ESM can only invest in banks as a last resort when national public capital cannot be used. In other words, countries need to be effectively bankrupt and locked out of financial markets before ESM can be used. This new “principle” appears to enshrine the vicious circle as official policy rather than get rid of it.

European Commission staff and finance ministers from other countries have been insistent that the statement by Germany, Netherlands and Finland does not undo the June 29th statement and that the statement stands as official policy. However, this is beside the point. Without concrete actions to enforce it, the affirmation that it is imperative to break the vicious circle between banks and sovereigns will stand alongside many other EU aspirations: Nice words that make people feel better but don’t do much else. In the meantime, the vicious circle that has already trapped Spain and Ireland may widen its radius and continue to undermine the integrity of the euro as a common currency.

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