Europe's banking union – glass half full or glass half empty?

Thorsten Beck[1]

Earlier this year, European authorities agreed on the second pillar of the banking union, a single resolution mechanism, to come into effect in 2016. After the ECB taking over responsibility for bank supervision (directly for the largest, indirectly for all banks) in the Eurozone, centralizing resolution as complement for centralized supervision has been an important next step. The result is a coordination mechanism on top of national resolution mechanisms that also involves the European Commission. A third pillar, a joint deposit insurance funding scheme, has been quietly dropped.

In late October, the ECB published the results of the Comprehensive Assessment, a year-long effort to assess capital positions across the largest banks in the Eurozone and apply stress tests to these capital positions to establish their resilience. This test was seen as entry point for the ECB assuming its responsibility as Single Supervisory Mechanism on November 4.

Both events are important steps for the Eurozone and the European Union towards the recovery of a sound and stable banking system and the Single European Market in banking. But it is important to put these into the broader perspective of crisis resolution and the future of banking in Europe. Economists have put forward many suggestions to address the crisis in previous year, including the establishment of a banking union. In this paper I will ask (and hope to answer) several questions in this context: (i) Where does Europe stand in terms of regulatory integration? (ii) Will these recent achievements help us overcome the crisis? (iii) Will it help us get back to a Single European Banking Market? (iv) And what else is there to do? A peak preview with the four tentative responses: (i) at the very beginning, (ii) no, (iii) it might eventually, (iv) a lot.

The remainder of this paper is structured as follows. First, I will discuss the need for a banking union, based both on theoretical arguments and on experiences from the recent crisis. I will then propose different elements for an "ideal" banking union, before comparing this to the structure currently in place or being planned.

Why do we need a banking union?

One can make many theoretical arguments on the need for a full-fledged banking union in Europe, but maybe it is better to use the recent crisis experience to illustrate where a banking union might have helped better address the recent crisis.[2] This discussion is based on the assumption that having a Single Market in Banking brings high benefits for the European Union, especially for the Eurozone, in terms of higher competition and better risk diversification.[3] Alternatively, one can see the disintegration of the Single Market in Banking after the onset of the Eurozone crisis in 2009 as hurting optimal resource allocation and economic recovery, often supported by regulatory ring-fencing actions.

---

[1] Cass Business School, City University London, and CEPR.
[2] For a discussion of different arguments in favour of a banking union, see the different articles in Beck (2012).
[3] See Allen et al. (2012) for a general discussion on benefits and risks of cross-border banking.

First, the crisis has shown that bank supervisors focus on national stability interests and do not take into account externalities that arise from bank failures for banks and economies outside their regulatory perimeter. This is consistent with theory and empirical evidence during the Global Financial Crisis (Beck, Todorov and Wagner, 2013). Given the importance of banks and the close political connections between the banking sectors and governments, there is also a tendency to protect national champions. In the crisis, this will lead to a more lenient approach of regulators vis-à-vis their own banks.

The recent Comprehensive Assessment has provided evidence for this tendency towards regulatory forbearance by national supervisors. For example, more than 20 per cent of the reviewed debtors were reclassified as non-performing in Greece, Malta and Estonia. Slovenia even saw a 32 per cent reclassification, with one bank hitting 43 per cent. The large variation in loan reclassification across countries and the rather high number in some countries suggests that this is not simply due to different national loan classification regimes but rather a high degree of regulatory forbearance.

Second, resolution mechanisms that focus on maintaining as much of the failing bank's franchise value rather than liquidating the entire institution are limited in small financial systems, where the options to merge a failing bank with a healthy bank are limited. In smaller financial systems banks are most likely to co-vary in their performance. And even if possible, such a merger might have negative repercussions for competition in a small market. If resolution is limited to the national level, this therefore leaves recapitalization and nationalization or liquidation, where the former option was chosen in most European countries with failing banks.

Third, the limitations of resolving a failing bank are even worse in countries with weak fiscal position, exacerbated where banks concentrate a large share of their government bond holdings in claims on their own sovereign. This phenomenon is often referred to as the deadly embrace of sovereigns and banks and has been documented especially for banks in several periphery countries of the Eurozone. The Irish and Spanish governments' fiscal positions came both under the pressure, partly due to resources used for bank bail outs. Greek banks needed a bail-out when Greek government bonds were restructured in 2011. A more recent example is failure of the Portuguese Banco Espirito Santo: the Portuguese government had to rely on Troika (EC, ECB and IMF) funding to resolve the bank, in light of its own precarious fiscal position.

Fourth, deposit insurance has developed into an integral part of the financial safety net across all EU member states. However, the experience of Cyprus has shown that a deposit insurance scheme is only as good as the sovereign backing it. During the negotiations on European support for Cyprus the idea was floated to make all depositors participate in the losses of Cypriot banks, even insured depositors, though it was masked in the form of a tax. Ultimately, this idea was dropped due to political pressure.

Fifth, the protracted resolution process of Cyprus showed, that in addition to a banking, sovereign, macroeconomic and currency crisis, the Eurozone faces a broader governance

crisis. Decisions are taken jointly by national authorities who each represent the interest of their respective country (and taxpayers), without taking into account the externalities of national decisions arising on the Eurozone level. It is in the interest of every member government with fragile banks to "share the burden" with the other members, for example through the ECB's liquidity support. This is in absence of a proper financial safety net on the Eurozone level that can internalize these problems.

Sixth, the limited institutional and fiscal capacity to resolve failing banks have incentivized many national supervisors into actively pushing their banks into ring-fencing, which ultimately undermined the Single European Market in Banking.

This tragedy of commons character of the Eurozone does not only apply to the area of banking, but is much broader as it also relates to policy coordination in other areas, including fiscal policy but also geographically tainted arguments over monetary policy. While recognizing the general problem of policy coordination, in the following I will focus exclusively on banking.

A transatlantic comparison

Gros (2012) offers a very useful comparison to underline the benefits of not just a banking but a broader economic union for states subject to a large economic shock, such as a housing bust. Specifically, he compares two political units of similar size – Ireland and Nevada. Both economies are of similar size and both experienced a housing and credit boom and bust cycle in the 2000s. The critical difference between the two is that Ireland is a country while Nevada forms part of a fiscal, banking and political union. Ireland suffered from a major financial crisis, while Nevada did not suffer from a local financial crisis (though obviously from the U.S. financial crisis). While banks in both Nevada and Ireland failed, this did not turn into a systemic banking crisis in Nevada as it did in Ireland. The Federal Deposit Insurance Corporation (FDIC) intervened and transferred the operations to other, stronger banks, often outside Nevada. While the total costs of these resolutions amounted to 30% of Nevada's GDP, the state government's fiscal position was not affected to that extent, as the losses were borne on the federal level, unlike in Ireland where losses were transferred to the government. In addition, in Nevada a lot of losses accumulated on the balance sheets of banks headquartered outside the state, unlike in Ireland where most mortgage lending was provided by local banks. While this clearly shows the advantages of a banking union, this is obviously embedded in both a fiscal and a political union in the U.S., both of which do not exist as of yet in the Eurozone.

On a broader level, the different structures in the Eurozone and the U.S. also explain the approaches to crisis resolution on the two sides of the Atlantic. In the U.S. an early recognition of losses through stress tests and forced recapitalization was at the core of crisis resolution, while in Europe most government shied away from both transparency and hard choices after the initial round of bail-outs in 2008. The response was rather a "bunker" approach where nations focused purely on their own banks' fragility and the attempt to "share the burden" through liquidity support from the ECB. The state aid examinations by DG

Competition of the European Commission – intended to ensure that competition was not being distorted by bailouts and that these were undertaken only as emergency measures with the overarching aim of financial stability – were the only indirect coordination mechanism across the European Union. This also imposed a higher burden on the ECB and the network of national central banks to provide liquidity support, even where the health of banks was clearly in doubt, as in the case of the Cypriot banks.

Banking union – the ideal

Based on the analysis so far and the crisis experience, how would the ideal banking union look like? A complete financial safety net on the national level consists of an effective regulatory and supervisory framework, and an effective resolution framework that minimizes both moral hazard risk of bailing out and the negative effects of bank closure for the rest of the banking system and the real economy. If a deposit insurance scheme is in place, then it should be linked to the resolution framework and have sufficient funding arrangements in place, either ex-ante or ex-post, and with a public backstop funding.

A financial safety net on the supranational level, such as planned in the form of a banking union for the Eurozone should therefore contain similar components. This has been referred to as the three pillars of a banking union, with a single supervisor, a single resolution framework and a joint deposit insurance fund. Importantly, the deposit insurance fund would have to have access to public backstop funding. This last issue points already to the political sensitivities involved, especially in the absence of a full fiscal union in the Eurozone.

The equivalent to a national financial safety net also implies that a banking union that complements the currency union should not only focus on cross-border banks, but on all banks. It does not imply that supervision is centralized in one institution; rather it means that the ultimate responsibility lies at the supra-national level – the buck stops at the European level. Most importantly, the establishment of a supra-national supervisory authority alone is not sufficient. Rather, and in line with the arguments above, bank resolution, i.e. both the power and the resources to be able to intervene in failing banks is critical for the success of such a banking union, as also argued by Schoenmaker (2012) and others. The critical issue is that powers and resources to intervene failing banks have to go hand-in-hand. Independence of the institution from both political sphere and from the regulated entities is critical.

What has been accomplished?

There are two ways to look at this, corresponding to the glass-half-full and glass-half empty attitudes. On the one hand, the fact that some basic elements of a European financial safety net have been put in place is a success. It can be considered a great success given the political and legal reluctance against any form of centralizing the financial safety on the European level in the wake of the 2008 crisis. It can also be considered a great success given the general political sensitivities of bank regulation, discussed already above. On the other hand, this compromise is far from the financial safety net that an integrated European banking market would need and a half-baked banking union might actually backfire. In the following, I will discuss the different components put in place and compare them with the ideal.

The Comprehensive Assessment and the Single Supervisory Mechanism

The Single Supervisory Mechanism at the ECB is an important step forward. Such a single supervisor can internalize cross-border externalities as discussed above and reduce distortions in the supervisory process by matching the perimeter of banks with the regulatory perimeter. And given the risk of political capture of regulators that we could observe across Europe (both in the core and periphery), this is also progress. Given how politically sensitive banking has been across Europe, this is indeed a big step for the Eurozone. The Comprehensive Assessment as entry point into the SSM has fulfilled its function of providing a level playing field across banks in the Eurozone and opening the closet somewhat to catch a glimpse at some of the skeletons.

The Comprehensive Assessment and the implementation of the Single Supervisory Mechanism might already have had some positive effects on the return of market discipline. Several banks that are close to the minimum capital requirements have been going to the market in 2014 to raise additional equity, supposedly before being forced to do so by the ECB after the conclusion of asset quality review and stress tests. More specifically, 12 of the 25 banks that the Comprehensive Assessment showed had a capital shortfall as of 31 December 2013 did not have one at the time of publication of the Comprehensive Assessment due to capital raisings during the year. This could very well be interpreted as the return of market discipline. In addition, recent bank failures have seen junior creditors being bailed in rather than bailed out (SNS Reaal and Cyprus), even though the bail-in rule supposedly only kicks in after 2016. It remains to be seen how far this renewal of market discipline carries when more systemic shocks hit and countries are affected that are more closely linked to the rest of the European financial system.

However doubts about the exercise persist, including why a sovereign default was not part of the adverse scenarios and why deflation was not modelled as stress scenario. In addition, the leverage ratio, the unweighted capital-asset ratio, was not taken into account. While, on average, banks have a leverage ratio above the required 3 per cent, there are 14 banks below it, even before applying the AQR, and once the AQR is taken into account 17 fail to pass muster. Including the repercussions of the stress increases this number even further. More importantly, and as shown by Acharya and Steffen (2014), using the leverage ratio (and thus unweighted capital-asset ratio) as metric rather than weighted capital-asset ratio provides a very different ranking of weak banks, with several French and German banks (all of which passed the Comprehensive Assessment) being in need of capital, in line with market-based assessment of bank fragility. Given that the leverage ratio will become part of the regulatory rulebook under Basel 3, additional capital will therefore have to be raised. Importantly, these stress tests are just the beginning of the supervisory process by the ECB, with markets still to be convinced that there are no further skeletons hidden in the 130 banks that were screened or any of the other – smaller – banks.

Other institutional questions remain: What are the relative roles of the European Banking Authority and the European Central Bank? What will happen to the banks with a net capital

shortfall, given that the Single Resolution Mechanism (SRM) discussed below will not enter into effect until 2016?

Going forward, many challenges remain for the ECB as bank supervisor. It has to work with different national banking acts, which might not only throw sand in the wheels of its own procedures but also hamper the development of a level playing field in regulation and supervision. Further, there could be arbitrage possibilities when it comes to monitoring banks that are directly supervised by the ECB and those that are not. The major concerns however, lie less with the SSM – the first pillar of the banking union – and more with the other two pillars: resolution and deposit insurance. These both remain unresolved.

The Single Resolution Mechanism – a political compromise

Resolution frameworks across Europe are being strengthened, on the national level, but also – with the bail-in clause introduced under the Bank Recovery and Resolution Directive – on the European level. The SRM – with all the caveats stated below – is an important first step. In its current form, however, it is still mainly a country-based framework, with supranational support only kicking in at a second stage. In addition, it is a rather complicated coordination mechanism, which also involves the European Commission. The fact that the UK is outside the SRM will critically hamper its effectiveness, given the importance of London as international financial centre. In addition, the target size of the resolution fund of €55bn would not cover any major bank failure, which leaves the problem of too-big-to-fail unresolved in Europe. Further, there is no public back-stop funding mechanism in place, which reduces the effectiveness of the resolution framework.

The third pillar, a common deposit insurance fund, has been quietly dropped, for the same reason that no public backstop has been established for the SRM. Political resistance too loss-sharing across countries was simply too great.

Even in a world with high confidence in the competence, independence and integrity of the supervisory institution and process, the shortcomings of these other two pillars will affect the SSM. How credible can a supervisor be in threatening to close a bank if there is no water-tight resolution process in place? Over the past years, we have seen in several occasions when intervention and the resolution of weak and failing banks was delayed because the necessary tools and resources were lacking – the Cypriot banks being the most prominent example.

In summary, several, several important elements of a fully functioning banking union have been missed, including, a European bank resolution mechanism that deserves the name and a proper funding mechanism. Critically, a public back-stop is missing.

The sovereign-bank deadly embrace continues

Beyond institutional reforms to construct a European financial safety net, there are other important impediments, including zero risk weights for government papers, which further increases incentives to hold government papers and facilitate the “Sarkozy carry trade”, named after the former French president who suggested that banks use cheap ECB funding to

buy government bonds of their home country sovereign to thus ease fiscal pressures. Obviously, this leads to an exacerbation of the sovereign-bank embrace discussed above. An additional regulatory constraint is the lack of any concentration limit for governments bond unlike for private sector lending. Recent statements by ECB officials, however, suggest that this might be addressed soon.

Most importantly, the banking union just agreed on is a forward looking structure, designed for the next crisis, but not supposed to address the current crisis. Beck and Trebesch (2013) and others have suggested shorter-term solutions involving a Eurozone-level bad bank to address the legacy problems. By now it has become clear, however, that Eurozone authorities have opted for the flow solution, hoping that banks will recover capital cushions through profits rather than going for an aggressive recapitalization exercise as in the U.S. Based on past crisis experiences, a rather optimistic approach.

Are we there yet?

Earlier this year, there was an increasing sentiment that the Eurozone is about to exit the crisis. With both Ireland and Portugal having exited or being close to exiting the Troika programs, Greece showing signs of economic recovery and the crisis in Cyprus being less deep than feared, there are understandable hopes the worst might be behind us. On the other hand, there are serious doubts whether many of the overindebted sovereigns in the Eurozone will be able to accumulate sufficient primary surpluses to get out of the crisis by themselves (Eichengreen and Panizza, 2014). In spite of (currently!) quiet and seemingly complacent markets, the sovereign fragility in the Eurozone is not gone! Policy reforms, be they a crisis resolution approach as a European Redemption Pact (see, e.g., Buch and Weigert, 2012) or a longer-term attempt at institutionalizing a sovereign bankruptcy regime have been put on ice. And the Eurozone is far away from even the resemblance of a fiscal union.

The discussion on the banking union is related to a broader question on the role of the banking system in European finance. As pointed out by many observers, European financial systems are heavily bank-based, with a limited role for non-bank financial providers and capital markets (Langfeld and Pagano, 2014). This exacerbates the link between governments and banks, as there is a limited number of non-bank buyers of government papers. It makes financial systems more concentrated and results not only in larger banks, but also a stronger reliance of economies on large banks.

All of this suggests that the reform efforts so far are important advances, but that we are really at the early stages of the overall reform process, at the end of which will hopefully stand a Single European Market in banking matched by a European financial safety net. The road towards that objective, however, still seems rather long.

In the short-term, there are substantial risks for the Eurozone. There is a substantial political risk that elections, especially in crisis countries, will produce governments that deviate from previous agreements and might worsen substantially the fiscal positions of their countries. While on the upside their might be grand bargains, on the downside there might be attempts by populist government to break loose from the “Berlin- Brussels diktat”. Such political

shocks could bring again turmoil to the Eurozone. While the ECB has so far successfully managed such shocks with its "whatever it takes" approach, its reputation has come increasingly under stress in several core countries, most critically in Germany.

In conclusion

The successful completion of the Comprehensive Assessment is a necessary, though far from sufficient, measure to set the stage for a recovery of lending in the Eurozone. A well-capitalised banking system will have more confidence in lending to the private sector.

All that said, there are other significant barriers to a Eurozone recovery, including the lack of consumer demand and the threat of deflation. A similar exercise to the Comprehensive Assessment undertaken a few years ago and a more rapid (and more complete) introduction of the banking union might have resulted in a different economic situation today, but obviously, there is no counterfactual for that. The national political interests that postponed the undertaking of the Comprehensive Assessment and the establishment of the SSM for so long also constrain a comprehensive economic policy approach to the current crisis. This would have to be a sensible mix of supply-side structural reforms, fiscal easing and more aggressive monetary easing in the form of quantitative easing (QE) – all of which would involve far greater political consensus across the EU than is presently forthcoming.

In a nutshell, the Eurozone has made a big step forward, but a long agenda remains. Short-term risks are still there. Most importantly, there is the risk of complacency and regulatory reform fatigue. The Eurozone is not prepared for the next crisis! There is lots more to do!

References

Acharya, Viral and Sascha Steffen (2014): Benchmarking the AQR: A Tale of Two Leverage Ratios, VoxEU 21 November 2014.

Allen, Franklin, Thorsten Beck, Elena Carletti, Phil Lane, Dirk Schoenmaker and Wolf Wagner (2011) *Cross-Border Banking in Europe: What's Next?* CEPR: London.

Beck, Thorsten (Editor, 2012) *Banking Union for Europe – risks and challenges*. VoxEU e-book.

Beck, Thorsten, Radomir Todorov and Wolf Wagner (2013) Supervising Cross-Border Banks: Theory, Evidence and Policy, *Economic Policy* 73, 5-44.

Beck, Thorsten and Christoph Trebesch (2013) A Eurozone Bank Restructuring Agency, VoxEU 18 November 2013.

Buch, Claudia and Benjamin Weigert (2012) Legacy Problems in Transition to a Banking Union, in Beck, Thorsten (Ed.); *Banking Union for Europe – risks and challenges*. VoxEU e-book.

Eichengreen, Barry and Ugo Panizza (2014) A Surplus of Ambition: Can Europe Rely on Large Primary Surpluses to Solve its Debt Problem? Mimeo.

Langfeld, Samuel and Marco Pagano (2014), Bank bias in Europe: Effects on growth and systemic risk, mimeo

Gros, Daniel (2012) Banking Union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system, CEPS Commentary

Schoenmaker, Dirk (2012), “Banking union: Where we’re going wrong”, in Beck, Thorsten (Ed.); *Banking Union for Europe – risks and challenges*. VoxEU e-book.